U.S. Policy Options in Response to Chinese Currency Practices

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Chairman Levin, Ranking Member Camp, and members of the committee, thank you for the opportunity to testify today on the challenges posed by the currency practices of the People's Republic of China. This issue raises difficult questions about economics, diplomacy, and international institutions. It is also one where U.S. missteps could have serious and lasting consequences.

In my testimony, I will argue that China's currency undervaluation is both real and problematic. While it poses problems for global economic rebalancing, the most acute problems appear in China itself. For that reason, the problem is vexing but not hopeless. It is in China's own interest to move toward an appreciated currency.

Of course, the primary concern of this committee and the Congress is the effect of Chinese practices on the United States. Whether or not Chinese currency practices hurt the United States is a subject of vigorous debate among economists. Even if one is convinced that the undervalued Chinese currency has been harmful, the United States must be very clear on the likely costs and benefits before adopting policies to address the problem. I will contend that neither U.S. actions nor any ensuing Chinese reforms are likely to improve U.S. unemployment significantly. It is not clear that the benefits of trying to force an appreciation of the Chinese currency would outweigh the potential harm to long-term U.S. interests.

The cost to policy errors could be very large. A number of the proposals that have been put forward by prominent commentators could do lasting damage to the international economic system while failing to alter Chinese policies. To reach this conclusion, I will offer some thoughts on the factors driving Chinese decision-making and on the courses of action China might plausibly follow in response to U.S. pressure.

This is not to argue that the United States is impotent. There are a number of potentially fruitful paths the country might follow. These all require patient diplomacy, however, and none guarantees results. This sort of patience is exceedingly difficult in a time of economic distress.

1. Chinese practices and their global repercussions

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.[1] The currency appreciated to 6.83 RMB to the dollar between the summer of 2005 and late 2008, an appreciation of roughly 20 percent. Since then, the RMB has held steady against the dollar.

It is worth noting that in the late 1990s, China held its rate fixed in the face of the Asian financial crisis and pressures to *depreciate*. Nor is there anything 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 recent years, however, the undervaluation of China's currency has become apparent. This undervaluation has occurred as China has assumed a steadily more important role in the global economy. The clearest indicator of a misaligned renminbi is the dramatic accumulation of China's foreign exchange reserves. With a closed capital

[1] Goldstein, Morris, and Nicholas Lardy, "China's Exchange Rate Policy: An Overview of Some Key Issues," Peterson Institute for International Economics, October 19, 2007.

account and an exchange rate that makes Chinese exports appear cheap and imports expensive, there is an excess demand for Chinese currency. To maintain the value of the renminbi, the Chinese government essentially accumulates this excess demand in the form of foreign exchange reserves. Chinese reserves were estimated at $286 billion at the end of 2002. In early 2010, they are estimated at $2.4 trillion. They are forecast to exceed $3 trillion by the end of next year.[2]

Just as there are benign explanations for fixed exchange rates, there are benign explanations for the accumulation of foreign exchange reserves. In the Asian financial troubles of the 1990s, the climax of the crises came when China's neighbors exhausted their foreign exchange reserves and were left to turn to the International Monetary Fund (IMF) for assistance. Many Asian nations learned the lesson that substantial reserves were a form of insurance against such humiliation and China is hardly alone in having accumulated a significant stockpile. But China's reserves far exceed the levels that are needed for such precautions.

The conclusion that China's currency is significantly undervalued has been reached by a wide range of analysts. The Peterson Institute has estimated that the renminbi is 20 to 40 percent undervalued.[3] In its latest update on the Chinese economy, the World Bank recommended that China appreciate its currency to head off inflation.[4] The new European Union trade commissioner, Karel De Gucht, last week stated his view that the renminbi was underpriced.[5] Perhaps most telling from a policy standpoint were the comments of Dominique Strauss-Kahn, the Managing Director of the IMF. He said last week, "The opinion of the IMF… is still that the renmimbi is very much undervalued."[6]

Because of the tight integration between China and other Asian trading nations, it has been difficult for China's neighbors to appreciate their currencies while the renminbi has remained fixed. Thus, the global impact of China's practices extends beyond China's rapidly-growing but limited economic heft. When there are important imbalances in the global economy, exchange rates are a key mechanism by which adjustment would take place. The world is at a point where much of it is trying desperately to stimulate growth while China is concerned with the effects of overheating. In an ideal world, an appreciation of the Chinese currency would relieve pressures on China while increasing the net demand for goods from the rest of the world.

2. This poses serious problems for China

In the world of international relations, the most pernicious transgressions are those which help the transgressor and hurt others. In such cases, there is no reason to expect the behavior will change without some intervention. This is not the case with China's currency practices.

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[2] World Bank, China Quarterly Update, March 2010.

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

[4] World Bank, China Quarterly Update, March 2010.

[5] Chaffin, Joshua and Alan Beattie, "EU's De Gucht airs concern on U.S. trade stance," *Financial Times*, March 18, 2010.

[6] *Wall Street Journal*, "IMF Strauss-Kahn: China's Currency Is Undervalued," March 17, 2010.

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 recent 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.[7]

The distinguished Japanese economist Takatoshi Ito has recently 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."[8]

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. 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.[9]

One common misperception is that China at least has the benefit of its \$2.4 trillion hoard, which it ought to be able to use to address its problems. This sum is often misinterpreted as a measure of the success of China's policy. In fact, this collection of I.O.U's from abroad is not a ready account to pay for China's substantial needs. If China were to attempt to spend the foreign exchange on domestic needs, it would first need to convert it into renminbi. That would serve to appreciate the currency. So long as China maintains its currency peg, it cannot use the money at home.

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.

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[7] See, for example, Keidel, Albert, "China's Looming Crisis – Inflation Returns," Carnegie Endowment for International Piece, Policy Brief No. 54, September 2007.

[8] Ito, Takahashi, "China's property bubble is worse than it looks," *Financial Times,* March 17, 2010.

[9] World Bank, World Development Indicators Database, September 2009. The broad range of estimates for Chinese income reflects different methods of accounting for exchange rates. Indirectly, this is another measure of currency misalignment.

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. Chinese central bank governor Zhou Xiaochuan said this month that China's currency peg is a temporary response to the global financial crisis and that China will eventually move away from it. Just not yet.[10]

3. Does an undervalued RMB hurt the United States?

In normal times, there are strong arguments that China's exchange rate policies do not hurt the United States. The flip side of China's currency undervaluation is excess lending to the rest of the world. In general, if a country is borrowing, it benefit when another country offers low-interest loans. It can certainly be argued that the United States misused the funds it borrowed, but that is not the fault of the lender.

If the United States is to borrow from the rest of the world, it must run a capital account surplus (sending bonds and other financial instruments abroad, on net) and a current account deficit (roughly equivalent to the trade deficit). There are good reasons to think that borrowing and macroeconomic factors drive the trade deficit rather than the other way around. [11]

While the current account surplus of China and deficit of the United States are economically significant, the bilateral trade deficit the U.S. runs with China is not. Even if China and the United States each had balanced current accounts, there is no reason to think there would be bilateral balance in a world of many countries. If a country with balanced overall trade imports from one country and exports to another, it will run bilateral surpluses and deficits.

To illustrate how misleading bilateral measures of trade can be, consider China's share of U.S. imports. In 1997, China accounted for 7.2 percent of U.S. imports. By 2009, this share had more than doubled to 19.0 percent. Yet over that same time period, the share of U.S. imports coming from Asia – including China – fell from 38.4 percent to 37.6 percent.[12] This reflects the extent to which China globalized by linking itself to a vibrant Asian production network. Goods that were labeled as Chinese often had very limited Chinese value added; they were simply completed there. If those goods had previously been completed in a country like Malaysia, the switch would alter the share of U.S. goods coming from China while leaving Asia's share untouched.

This is a cautionary tale not only about interpreting trade deficit statistics. It also has two important policy implications. First, <u>policies that target only China's trade could prompt a straightforward reordering of trade patterns within Asia that would have little net effect</u>. Second, to the extent that Chinese value added is limited and it imports partially finished products and supplies, an appreciation of China's currency would cut the cost of these imported supplies. That could temper the effect of more expensive final goods.

If we return our attention to worldwide current account deficits, these should not be equated with unemployment and poor economic performance. If we go back to the years

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[10] *Wall Street Journal*, "Zhou Signals Yuan Policy Shift," March 8, 2010.

[11] Levy, Phil, "Do trade deficits call for a sledgehammer?" *Foreign Policy*, April 15, 2009. http://shadow.foreignpolicy.com/posts/2009/04/15/do_trade_deficits_call_for_a_sledgehammer

[12] Author's calculations from U.S. International Trade Commission Tariffs and Trade database.

before the financial crisis, from 2004-2006, the United States, the United Kingdom and Australia all ran current account deficits of 2 to 6 percent of GDP. Their unemployment rates ranged from 4.5 to 5.5. Meanwhile Germany ran current account surpluses from 4.6 to 6 percent of GDP and suffered unemployment rates around 10 percent.[13] Looking at just U.S. data, the U.S. current account deficit shrank from 5.2 percent of GDP in 2007 to 2.9 percent in 2009, while the unemployment rate rose from 4.6 percent to 9.3 percent.[14]

This is all anecdotal, but it illustrates that trade deficits are compatible with low unemployment, while surpluses are compatible with high unemployment.

As the unemployment number well illustrates, there has certainly been hardship felt by the U.S. workforce. There has been a steady decline in manufacturing employment, wage stagnation, and wage inequality. The decline in manufacturing employment dates back to 1979.[15] It appears to have had more to do with an increase in manufacturing sector productivity, which allowed manufacturing production to continue or grow with fewer and fewer workers. Economic studies have shown that the primary drivers of inequality and wage stagnation are differing returns to education and the changes wrought by new technology.[16] Trade affects both wages and prices, of course, and one careful study of the impact of trade with China found that it had significantly reduced U.S. inequality.[17]

It can be difficult to make blanket statements about whether one nation's economic policies help or hurt another nation. Whereas Chinese distortions may hurt one U.S. firm and its workers, they may help another U.S. firm as well as American consumers. Even more frequently, changes in wages and employment that are attributed to trade may in fact be due to technological change, education, domestic competition, and the functioning of labor markets. On balance, there is little reason to think that in normal times, with the United States already borrowing money on world markets, Chinese exchange rate misalignment had a significant negative impact.[18]

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[13] IMF World Economic Outlook Database, October 2009.

[14] Current account statistics calculated from Bureau of Economic Analysis data, http://bea.gov/index.htm, unemployment data are annual averages from the Bureau of Labor Statistics, http://www.bls.gov/cps/prev_yrs.htm.

[15] See Levy, Philip I., "Doing a Job on NAFTA," March 6, 2008. http://www.american.com/archive/2008/march-02-08/doing-a-job-on-nafta. While employment declined, U.S. manufacturing output quantity grew by more than 50 percent from 1987 to 2007, http://www.bea.gov/industry/gpotables/gpo_action.cfm.

[16] See Robert Z. Lawrence, Blue-Collar Blues: Is Trade to Blame for Rising U.S. Income Inequality?, Peterson Institute, January 2008; and Claudia Goldin and Lawrence F. Katz, The Race Between Education and Technology, Harvard, 2008.

[17] See Broda, Christian, "China and Wal-Mart: Champions of equality," Vox, July 3, 2008. http://www.voxeu.org/index.php?q=node/1353.

[18] Nobel Prize-winning economist Gary Becker has written: "On the whole, I believe that most Americans benefit rather than are hurt by China's long standing policy of keeping the renminbi at an artificially low exchange value…The main beneficiaries of this policy are the poor and lower middle class Americans and those elsewhere who buy Chinese made goods at remarkably cheap prices…I believe the benefits to American consumers far outweigh any loses in jobs, particularly as the US economy continues its recovery, and unemployment rates come back to more normal levels…" Becker, Gary, "Should China Allow its Currency to Appreciate?" November 23, 2009, http://www.becker-posner-blog.com/2009/11/should_china_al.html

What about abnormal times?

I distinguish between normal and abnormal times because the distinction is central to recent arguments made by leading international economists Paul Krugman and Fred Bergsten. Krugman has been most explicit in his arguments that the United States is in a liquidity trap. Whereas a conventional argument might say that the Federal Reserve will adjust interest rates to achieve full employment, in a liquidity trap situation, interest rates are stuck at zero and the Fed is unable to do this. Krugman writes:

> 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.19

In this scenario, Krugman and Bergsten argue 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.[20] Even if China's policies do not hurt in normal times when we are eager for cheap loans, the argument goes, they are hurting now.

Krugman plays out the scenario that Bergsten described orally:

> 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 …
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> [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.[21]

There are several separate parts to this argument. First, there is the 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

[19] Krugman, Paul, "China and the liquidity trap," The Conscience of a Liberal, *New York Times*, May 15, 2009. http://krugman.blogs.nytimes.com/2009/05/15/china-and-the-liquidity-trap/
[20] Dickson, David M., "China's yuan value hits U.S. economy, two experts say," *Washington Times*, March 15, 2010.
[21] 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/

in demand for U.S. products. Finally, there is the issue of how long the liquidity trap window will last, after which, as Krugman notes, the change would be worth very little.

Is the United States in a liquidity trap? This is not a universally accepted point.[22] After all, while short-term interest rates are near zero, the U.S. ten-year bond is trading at roughly a 3.7 percent interest rate. Paul Krugman has argued that this simply reflects expectations that we will emerge from a liquidity trap in the future. As an example, a 3.7 percent ten-year bond could reflect the expectation that interest rates are zero for two years, then 4.6 percent for the next eight. If that were so, and the rest of Krugman's argument applied, then there would be a two-year window in which we would care about additional Chinese demand, followed by a much longer period in which we would return to welcoming other countries willing to lend us money and hold down our interest rates.[23]

Next, we can consider the effects on China of a 25 to 40 percent sudden currency revaluation. 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 describes 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."[24]

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[22] See, for example, Reynolds, Alan, "Krugman's Liquidity Claptrap," *Forbes*, June 19, 2009. http://www.forbes.com/2009/06/18/paul-krugman-new-york-times-liquidity-romer-opinions-contributors-alan-reynolds.html

[23] On a technical note, it can be argued that the higher rate for longer bonds poses a more fundamental problem to the liquidity trap argument. The premise of that argument is that monetary policy is ineffective. While standard monetary policy works by manipulating short term interest rates, it is also possible to affect the money supply by "quantitative easing" – the purchase of non-traditional bonds. If the Fed can expand the money supply and drive down interest rates by buying other bonds, then monetary policy is still working. The U.S. Federal Reserve has been doing just that during the crisis.

[24] Pettis, Michael, "How will an RMB revaluation affect China, the US, and the world?", China Financial Markets, March 17, 2010. http://mpettis.com/2010/03/how-will-an-rmb-revaluation-affect-china-the-us-and-the-world/

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 describe.

As a final set of caveats to the argument that China's failure to act is hurting the United States in these abnormal times, we note that any increase in net Chinese global demand that might result from a policy shift would not necessarily translate into a quick boost in U.S. production. In many cases, the United States is not producing the goods it imports from China. If the price of those goods were to rise, it could shift demand to other countries that had more similar production, such as those in the developing world.

4. What would we like China to do?

Before considering specific policies the United States might pursue to effect change in China, it is worth considering which Chinese policy would be best for U.S. interests.

One possibility is 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. If China experiences higher inflation than the United States, the effective rate of appreciation could be somewhat faster. This policy would be unlikely to have a dramatic impact on the United States in the short term. To the extent history is a guide, China's earlier appreciation was accompanied by continued current account surpluses and foreign exchange reserve accumulation.

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.

Such considerations have helped prompt calls for a rapid, 'one-off' appreciation. But such a rapid appreciation threatens economic turmoil, as described earlier. There is no easy solution to this dilemma. China should have appreciated its currency some time back when the necessary adjustment was more manageable. This highlights the pressure for China to act on currency sooner rather than later. The delay to date has made China's choice more difficult. Any further delay exacerbates the problem.

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.

The current and past U.S. administrations have wisely advocated for a market-determined exchange rate, but that term suggests a longer-term goal and is different from a call for a freely floating rate.

These are not the only options, of course. One could imagine policies that were less ambitious, more ambitious, or that lay somewhere in between. In fact, this poses a difficult problem for U.S. policy: there is not a bright line between acceptable and unacceptable Chinese behavior. Krugman, Bergsten and others have rightly argued that the extent of Chinese reserve accumulation is extraordinary and beyond the pale. But as soon as the United States puts itself in the position of issuing ultimata, it will need to be able to distinguish between sufficient and insufficient Chinese responses. Would a 1 percent annual rate of RMB appreciation be acceptable? What about a 5 percent rate? Is the acceptability of China's behavior determined by the level of the exchange rate, the pace at which it appreciates, or the extent of Chinese intervention? There are no clear economic answers to these questions.

While China's accumulation of reserves may represent an unprecedented extreme, a multilateral rules-based system requires transparent criteria on behavior. Without such a principled basis for action, a U.S. response will appear arbitrary and may encourage countries to pursue their advantage however they can. In the absence of clear economic answers, the only credible approach would be to work with like-minded major countries to clarify international rules.

In sum, the United States government should be wary of demanding action if it is not clear what action it wants. The most likely possibilities are fraught with problems and none seems likely to deliver major benefits for the United States. Without firm technical grounds for distinguishing between acceptable and unacceptable behavior, the most defensible basis for U.S. demands of China would come from agreement among leading nations.

5. What determines Chinese response – sources of legitimacy

The preceding discussion considered what policies the United States should hope China adopts. In assessing the desirability of different courses of U.S. action, it is also useful to think about the determinants of Chinese behavior and consider the forces driving any Chinese response. It should be emphasized that this is not an argument for putting Chinese interests above U.S. interests. Rather, it is a basic rule of strategy to base actions upon a counterpart's likely response.

As the basis for this analysis, we can presume that the Chinese Communist Party is interested in its survival. Although the CCP is not accountable in elections, it does behave as if Chinese public opinion matters. It is commonplace among analysts of Chinese politics to emphasize two sources of legitimacy for the current regime: economic performance and nationalism.[25] Some of the obstacles to maintaining economic performance have already been discussed. The Chinese government must steer a difficult course between inflation and unemployment. Its misguided currency policies have made this increasingly difficult.

The constraints of nationalist sentiment within China are no less real. The Chinese government has occasionally stoked and occasionally been scared by outbursts of anti-

[25] See, e.g., Shirk, Susan, Fragile Superpower: How China's Internal Politics Could Derail Its Peaceful Rise, Oxford, 2007.

Japanese nationalist sentiment.[26] Historical grievances have generally been behind such movements. 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.

In reporting this month from Beijing, a New York Times reporter 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.
>
> The ruling 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.[27]

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 in the face of Western pressure.

6. Options for Action

What, then, are the options for U.S. policy? To date, the past two administrations have pursued a strategy of quiet diplomacy with mixed success. As noted earlier, China did appreciate its currency by 20 percent from 2005-2008. Outside of that period, however, the RMB has remained fixed against the dollar. China has described the current peg as a temporary measure, but has not given a clear indication of a timetable for change.

Alternative approaches can be divided into unilateral and multilateral tacks. I base this classification not on the adjudicating authority in the case of a complaint, but on whether the United States is alone in pressing a case or whether it is joined by others.

[26] Chellaney, Brahma, "Japan-China: Nationalism on the Rise," *International Herald Tribune*, August 15, 2006. The recent conflict with Japan followed a Japanese prime minister's visit to a shrine for Japanese war dead.
[27] Wines, Michael, "China Blames U.S. for Strained Relations," *New York Times*, March 7, 2010.

When the United States acts alone, it is most likely to trigger a negative political response from the Chinese government.

Unilateral

- Currency manipulation label. The Treasury will need to determine within a few weeks whether China has been manipulating its currency. Whatever the legal considerations behind such a decision, there would be no immediate policy impact. Applying the pejorative label would make it more difficult politically for China to change its policies but would apply no additional economic pressure unless it were coupled with more substantial accompanying measures.
- Countervailable subsidy. Another prominent idea is to treat China's currency undervaluation as a countervailable subsidy. While I am in no position to offer a legal analysis, there are three broad potential problems with such an approach. First, countervailing duty (CVD) cases are generally narrow in scope and slow to conclude. This limits the extent to which they can have a significant economic impact during the current downturn. Second, it appears doubtful that this approach is consistent with WTO requirements. Gary Hufbauer, a Peterson Institute scholar and leading authority on these matters, has argued that countervailable subsidies must feature a government financial contribution and must be specific rather than general. Broad exchange rate policies would seem to be general, rather than specific to an industry, and there is no precedent for considering such policies as a financial contribution.[28] Finally, a succession of CVD decisions would likely annoy China but would not seem to be of sufficient magnitude to outweigh the concerns mentioned earlier.
- WTO case. A third idea would be to press a case against China under WTO Article XV. That article says, in part: "Contracting parties shall not, by exchange action, frustrate the intent of the provisions of this Agreement…".[29] If a WTO dispute settlement panel were to rule in favor of the United States in an Article XV complaint, the United States could be authorized to raise tariff barriers against China if the Chinese refused to change their practices. There are two major problems with this approach. First, WTO dispute settlement cases can take years; thus, this would be unlikely to get results in the near term. Second, there are no precedents for interpreting Article XV nor is there any negotiating language or guidance that would help a dispute settlement panel distinguish between acceptable and unacceptable behavior. Nor is there much expertise within the WTO to render judgment on acceptable macroeconomic practices; Article XV generally suggests the WTO turn to the IMF on such matters. Thus, a panel

[28] "Gerard Optimistic WTO Will Uphold Currency Initiation on China," *Inside U.S.-China Trade*, March 17, 2010. It has been proposed that currency manipulation be considered a *de jure* "export subsidy," which would not require specificity. However, such prohibited export subsidies, under WTO rules, must be "contingent… upon export performance," whereas the Chinese exchange rate is available to everyone trading on the current account.

[29] General Agreement on Tariffs and Trade, Article XV: Exchange Arrangements, Para. 4.

would either decide against the United States, or it would have to engage in creative elaboration of vague principles. Despite the fact that the U.S. government has long inveighed against such overreach by panels, this strategy would *require* it.

- Unilateral tariff. The boldest unilateral action would be the sort of across-the-board tariff recently advocated by Krugman and Bergsten. Compared to the other actions, this would impose the most immediate economic pain on China, but it would also maximize the likelihood of a strong nationalist backlash from China that would preclude Chinese compliance with U.S. demands. By blatantly violating U.S. commitments under the WTO, a unilateral tariff would do lasting damage to the rules-based multilateral economic system. The United States would be setting the precedent that countries should act whenever they object to trading partner's practices, without regard to agreements and rules. This could be disastrous for a U.S. economy that is integrated into the world economy and that aspires to grow by doubling exports in the next five years. Nor should one expect that the breakdown in cooperation and relations would be limited to the narrow confines of trade relations and currency.
  Advocates of this approach have set aside these long-term consequences and argued that a high tariff could achieve U.S. short-term goals whether or not China complies. This is highly dubious. Such a bilateral measure could be readily circumvented by a reordering of world trade flows, effectively reversing the shift in trade patterns that accompanied China's recent rise. For many of the low-cost goods that China produces, its chief competitors are not U.S. firms but other developing nations. Even if the United States were to enter lines of business from which China had been excluded, such adjustment takes time. Thus, there are few likely short-term benefits to offset the staggering long-term costs.

Multilateral approaches

Each unilateral approach is marred by the inescapable bilateral tension that would accompany it and by the difficulty of setting global rules without a broader consensus, particularly in the absence of clear technical answers. Multilateral approaches avoid both these difficulties. In their stead, they present the difficulty of coordinated action, which can be slow and unwieldy.

- Currency agreement under the WTO. The economists Aaditya Mattoo and Arvind Subramanian have argued for new and clearer currency behavior rules under the WTO.[30] The appeals of WTO jurisdiction are the obvious link to trade and the potential for more effective enforcement through trade retaliation. Mattoo and Subramanian acknowledge the limited competence of the WTO secretariat in such matters, but argue that it could work in close collaboration with the IMF. There are serious obstacles to adopting such

[30] Mattoo, Aaditya and Arvind Subramanian, "”Currency Undervaluation and Sovereign Wealth Funds: A New Role for the World Trade Organization," Peterson Institute Working Paper WP 08-2, January 2008.

WTO rule changes in the near future, however. The most obvious vehicle for adopting such changes, the Doha Development Agenda, is stalled. The Obama administration does not even have trade negotiating authority to assure trading partners that it could meet its trade promises. Further, whether the change was proposed as part of the Doha talks or separately, it would need to win consensus support by WTO members, including China.

- Firmer action by the IMF. As noted earlier, the Managing Director of the IMF has stated the Fund's view that the renminbi is undervalued. This is clearly a topic on which the IMF has great expertise and its Articles of Agreement assign it a role in engaging with member countries to right such wrongs. The difficulty is that the IMF's power to compel action on the part of a member is generally limited to attaching conditions to loans. This has effect only when a country is seeking to borrow and has no relevance when a country like China engages in excessive lending. Setting aside enforcement problems, the IMF would be the appropriate institution under which to establish new norms for international financial behavior, if agreement on those norms could be reached.
- Explicit norms set by like-minded countries. If agreement on new norms could not be reached under the auspices of the IMF, an alternative would be to push for an agreement on principles through a grouping such as the G7.[31] That group and its heads-of-state successor the G8 (including Russia) have fallen to the wayside as international economic diplomacy has turned to more inclusive fora, particularly the G20. While the G20 offers enhanced legitimacy by including countries like Brazil, China, and India, it necessarily makes consensus more difficult to achieve. The return to a smaller grouping could facilitate consensus and action.

None of the multilateral approaches offer a quick or easy course of action. They do, however, offer the possibility of a carefully-developed set of rules for international financial behavior that could govern the international economy for years to come. Further, by avoiding the antagonisms of bilateral conflict, a multilateral approach could make it politically easier for China to accede to the new rules.

7. Conclusion

In the midst of a severe economic downturn and high unemployment, it is difficult to focus on the long-term repercussions of U.S. actions, but for the issue at hand it is essential. It has been a long-standing goal of the United States for China to join international institutions, to follow their rules, and to help share responsibility for ensuring that the global economic system works well. In its currency practices, China has not been meeting that responsibility.

The United States, in its response, faces a choice of whether to strengthen multilateral institutions or to risk tearing them apart. The latter option could destroy a system that administrations dating back to Franklin Roosevelt have worked to build, a system on which future U.S. prosperity will depend.

[31] The United States, the United Kingdom, Canada, France, Germany, Italy, and Japan.

Nor is this really a choice between short-term benefits and long-term costs. As I have described, it is hard to discern a feasible action that China might take that would significantly improve U.S. employment and output in the short run. It is even harder to imagine a scenario in which China would adopt such a policy under the threat of U.S. punishment.

A first precept in crafting a response should be to do no harm to U.S. interests. Many of the policies currently under discussion would, in fact, be harmful. Other policies that stand a reasonable chance of doing good are likely to take a frustrating amount of time. We would be wise to show patience and pursue an approach that relies upon multilateral diplomacy.

I commend the committee for its attention to this important issue and I very much appreciate the opportunity to share these views.