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The United States and the PRC: Macroeconomic imbalances and economic diplomacy

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**The United States and the PRC:
Macroeconomic Imbalances and
Economic Diplomacy**

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Abstract

This paper explores the ways in which macroeconomic imbalances have driven policy discussions between the United States (US) and People's Republic of China (PRC) in the last decade. The PRC's current account surplus, its growing foreign exchange reserves, and its shifting policies on exchange rate adjustment have become a central preoccupation of US trade policy. The paper considers the evolving political economy of the US policy stance and of the PRC's 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 US and the PRC 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.

JEL Classification: F42, F51

Contents

1.	Introduction.....	3
2.	What Happened? The Economic Record.....	4
	2.1 Comparative Experiences	5
3.	Motives and Politics	14
	3.1 Forces driving the US debate.....	14
	3.2 In the PRC	18
	3.3 Each sides misunderstands the other	20
4.	Diplomatic Efforts.....	20
	4.1 Opportunity Cost of prioritizing currency	20
	4.2 Suggestive Considerations	22
5.	Repercussions for Economic Governance	29
	5.1 Undermining of the G-20.....	29
	5.2 IMF	30
	5.3 Impact on the WTO.....	31
	5.4 The dollar as a reserve currency.....	31
6.	Conclusion.....	32
	References	33

1. INTRODUCTION

The United States (US) and People's Republic of China (PRC) are now the two largest economies in the world. For the last decade, the US has been an important net source of demand for the world economy, running persistent large current account deficits. The PRC 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 the PRC'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 the PRC, has been largely set aside in favor of the Group of 20 (G20), precisely because that group does include the PRC and is therefore deemed more relevant.

Despite the centrality of the US-PRC 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 conflicting and competing approaches among important interest groups within a country can suggest very different approaches to economic diplomacy than those that might be optimal for a unified 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 the PRC joined the World Trade Organization, after 15 years of accession negotiations.¹ Although the PRC had experienced remarkable rates of gross domestic product (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 the PRC, 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 US, 2001 marked the transition from the Clinton administration, which had overseen the bulk of the World Trade Organization (WTO) accession negotiations, to the Bush and Obama administrations, which largely dealt with the PRC as an established, significant member.

¹ Bhattasali, Li, and Martin (2004).

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 yuan would balance the trading relationship, the perception that it would has played a significant role in the political debate in the US and has helped shape the economic dialogue between the two countries. Of course, one hopes that over time perceptions shift to take economic realities into account. That seems to have happened in the US debate over the PRC policy. Over the period in question, the yuan-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 US and the PRC. Section 4 looks at how these political forces shaped the economic dialogue between the US and the PRC 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 US and the PRC 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 to stand tough and fight.

2. WHAT HAPPENED? THE ECONOMIC RECORD

Given the PRC's remarkable growth over the last decade, it can be difficult to go back 10 years and recall the PRC's more modest role in global economic affairs. In 2001, the PRC's GDP, measured with the exchange rates of the time, lagged behind that of the US, Japan, Germany, the United Kingdom, and France. By 2010, the PRC lagged only the US.² At the start of the last decade, the PRC 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, the PRC 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 the PRC's 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

² IMF, World Economic Outlook database, April 2011.

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

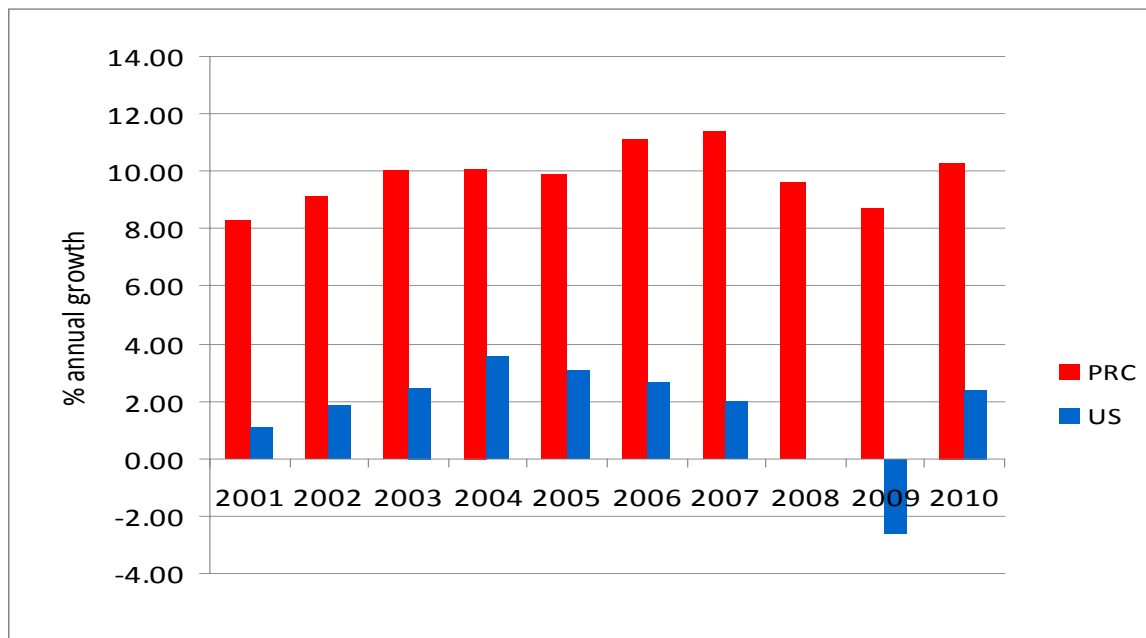
added and attributing everything to the country in which the good was completed.⁴ So long as observers focused on a country's current account balance with the entire world, this made little difference. If a country like the PRC were to provide only 10% value added on its manufactured exports, the imported 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. This, in fact, was what happened between the PRC and the US in the early part of the last decade. That disconnect initially played heavily into US political concern about the PRC policies. Later, when the PRC's multilateral imbalance had grown to match its bilateral imbalance, the PRC's officials would still claim that the US 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.

2.1 Comparative Experiences

2.1.1 GDP growth

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

Figure 1: Annual Growth in GDP, 2001–2010



Source: International Monetary Fund. World Economic Outlook Database (April 2011).

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).

The very different GDP growth records of the PRC and the US, 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 US, the PRC was commonly seen as an unmitigated success. The PRC, 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, the PRC's income per person is between \$3,000 and \$6,000. The comparable figure for the US 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 US went into a steep recession, while the PRC maintained a rapid rate of growth. This contrast changed the PRC's perceptions of the US and had a notable impact on the tenor of economic discussions in the wake of the crisis. Whereas the PRC's government representatives had previously been willing to acknowledge the US as a global financial leader—and therefore accept advice about financial practices—a new skepticism emerged in 2009.

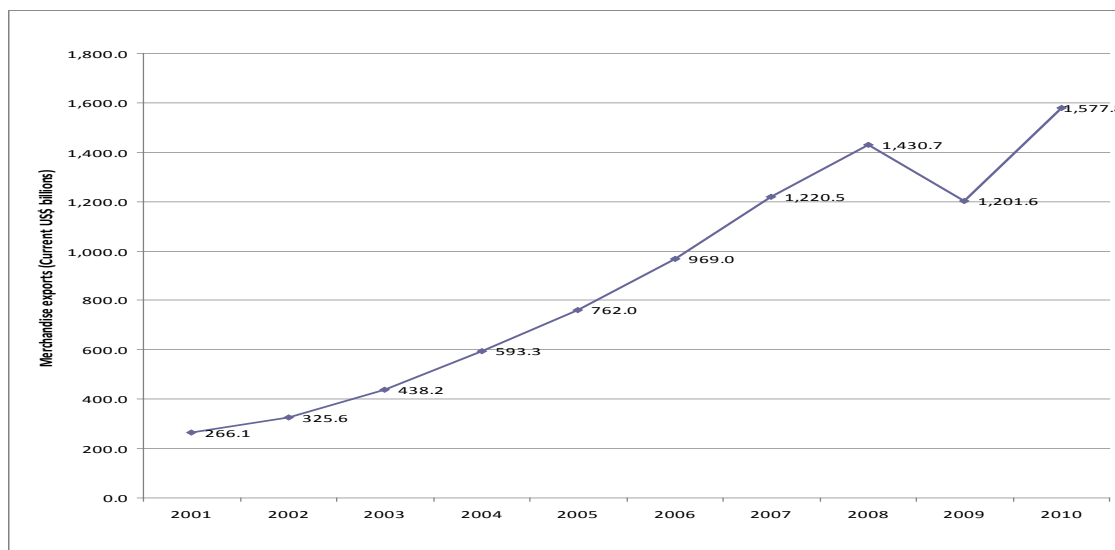
2.1.2 Levels of exports

From 2001 to 2010, the PRC's merchandise exports grew at an average annual rate of 21.8%, far exceeding the growth rate of GDP (Figure 2). There have been debates in the literature about the relative importance of exports in the PRC'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 the PRC's 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

⁵ 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.

⁶ For one discussion of the relative importance of different drivers of PRC growth, see Herrerias and Orts (2010).

Figure 2: PRC's Total Exports, 2001–2010

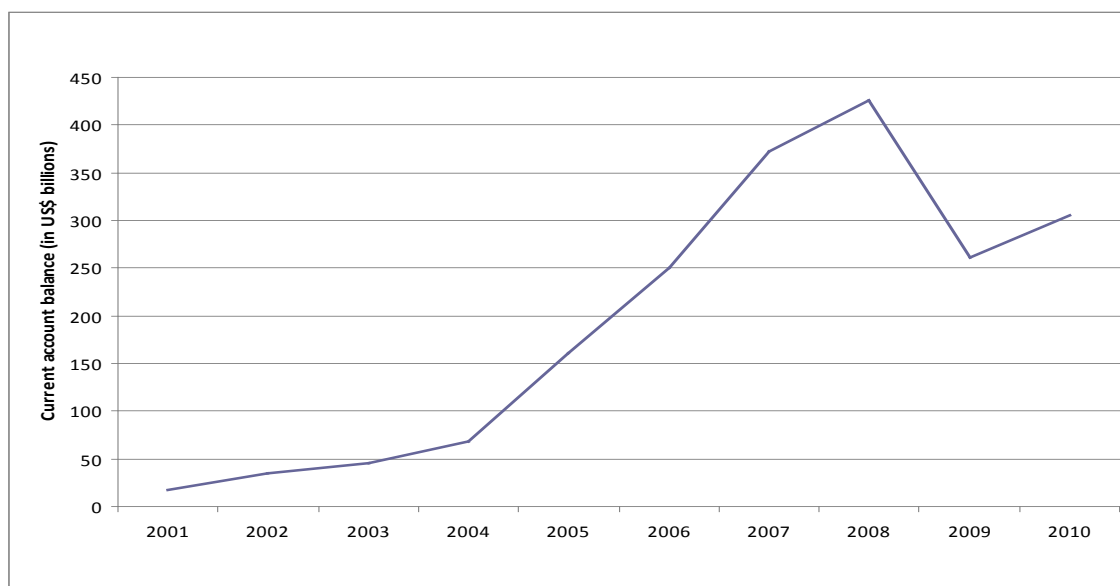


Source: WTO

2.1.3 Current account balances

For the purposes of this paper, the more relevant figures are the macroeconomic imbalances themselves. Figure 3 depicts the PRC'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.

Figure 3: PRC's Current Account Balance, 2001–2010



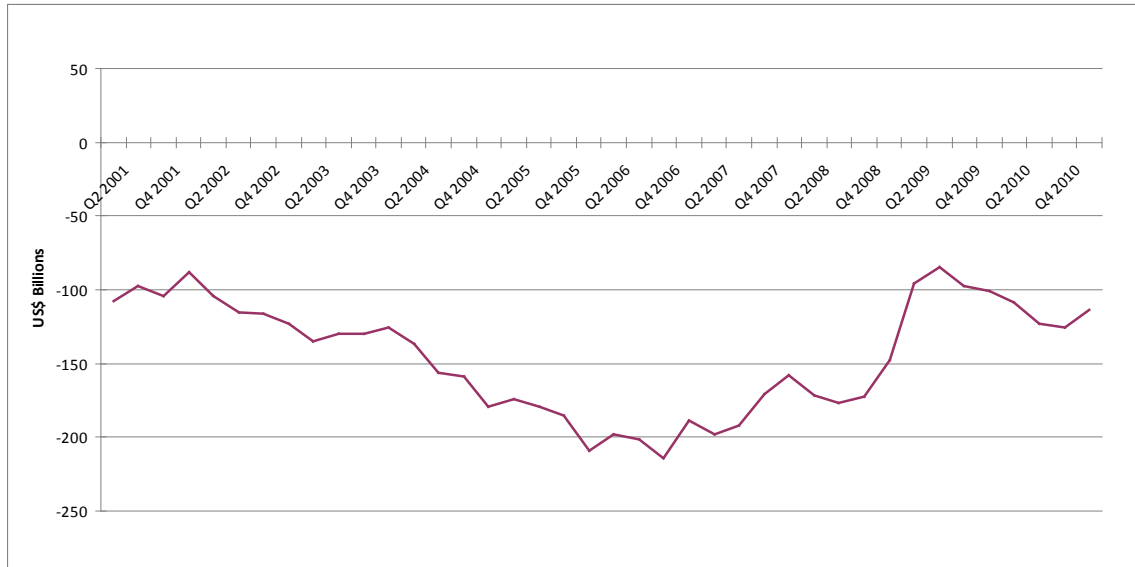
Source: International Monetary Fund. World Economic Outlook Database (April 2011).

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 the PRC'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 the PRC's macroeconomic imbalance occurred several years into the decade.

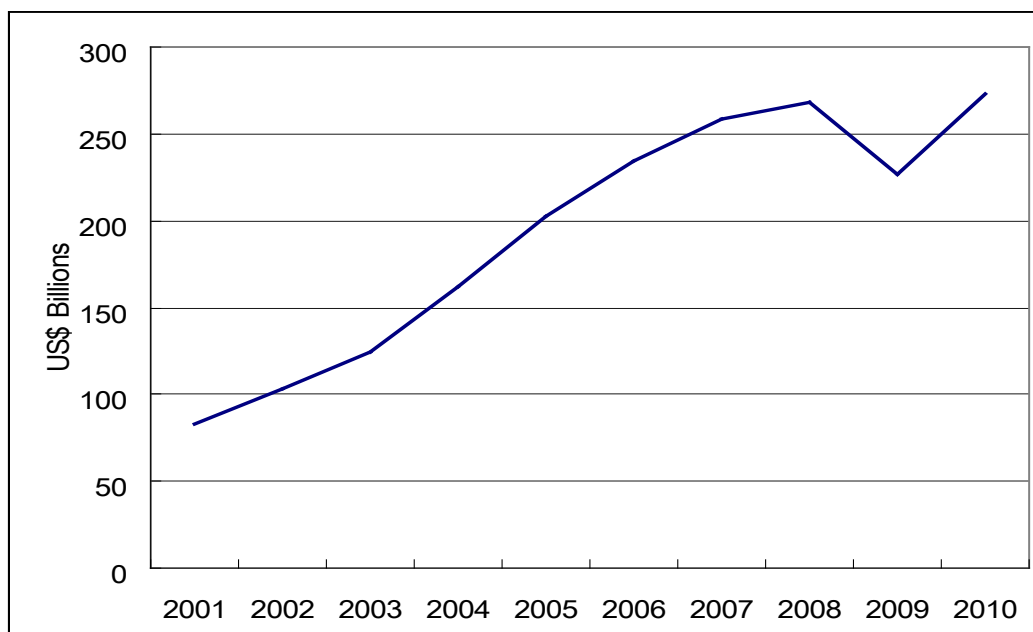
That is important because, of the three depictions of trade imbalances offered here, it is Figure 3 that stands apart. Figure 4 depicts the US current account deficit over the same time period. The deficit appears to grow rapidly from 2002 on, which was a major source of concern domestically.

Figure 4: US Current Account Balance (Deficit), 2001–present



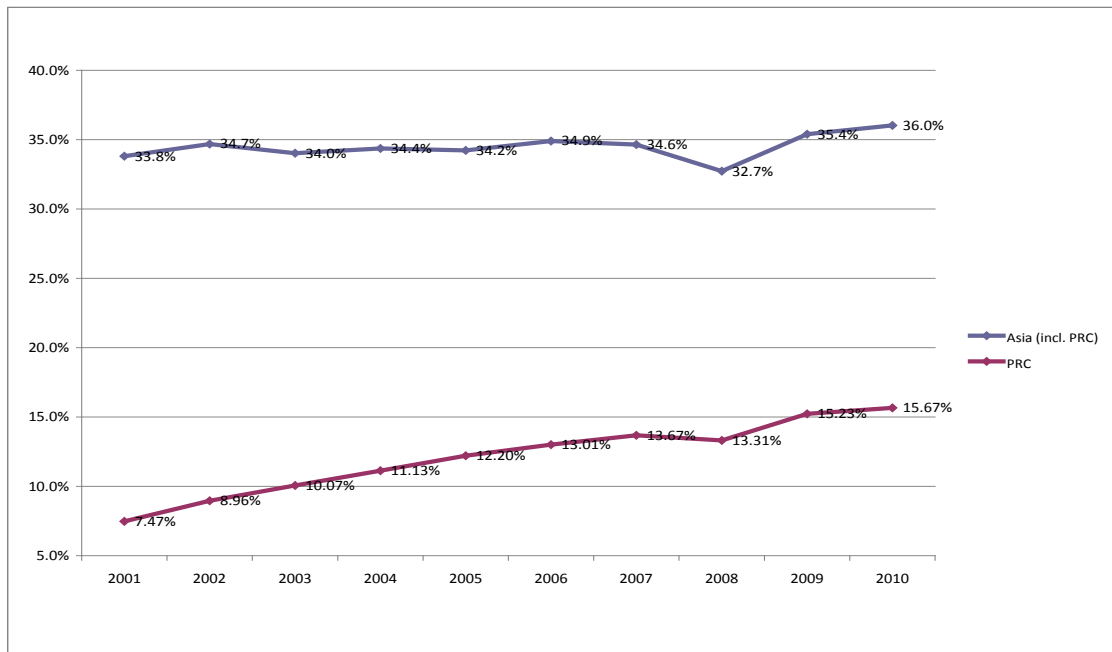
Source: U.S. Bureau of Economic Analysis. International Economic Accounts. *U.S. International Transaction*

The growth of the US current account deficit in Figure 4 seems to mirror the growth of the bilateral surplus in trade between the PRC and the US, as depicted in Figure 5. This correlation, to some observers, implied causality. The result was a stretch of time in which the expansion of the PRC's bilateral trade deficit was sometimes blamed for the rise in the US 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 PRC became a major culprit for those decrying the effects of an open US trade policy. The *prima facie* evidence was the exploding trade deficits.

Figure 5: PRC's Annual Trade Surplus with the US, 2001–2010

Source: U.S. Census Bureau. Foreign Trade Division. Trade in Goods with China. 1 June 2011 <http://www.census.gov/>.

There are, of course, economic inconsistencies in this story, and the PRC's 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 the PRC'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 the PRC. Because of standard international accounting practices, the entirety of these goods were attributed to the PRC, 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 US imports from Asia, including the PRC, held roughly constant at around 35%. The PRC's share of US imports grew strongly over the same period, suggesting that goods finished in the PRC were replacing goods produced in the rest of Asia, rather than augmenting Asia's share.

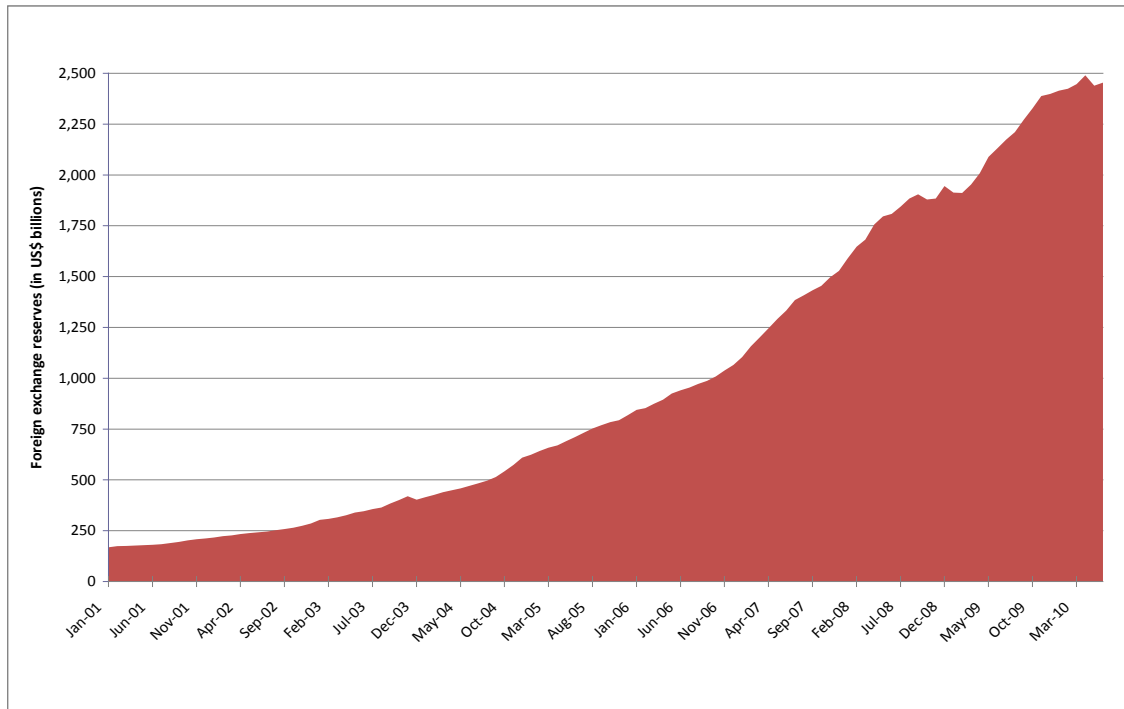
Figure 6: Share of US Imports

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

There were repercussions of US reliance on economically weak arguments in public discourse. It meant that the PRC's 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 the PRC's global current account balance grew dramatically. Yet the inclination to downplay concerns as reflections of economic ignorance persisted.

A final, cumulative measure of the PRC'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.

The PRC 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 the PRC's coffers at an alarming rate and have most recently exceeded \$3 trillion. The rapid accumulation has continued even as the PRC's current account surpluses have moderated, likely indicating an inflow of "hot money"—bets that investments in the PRC will earn not only the regular return on investment but anticipating a currency appreciation as well.

Figure 7: PRC's Foreign Exchange Reserves, 2001–Present

Source: PRC. State Administration of Foreign Exchange. *Data and Statistics: Forex Reserves*. Web. 1 June 2011. <http://www.safe.gov.cn>.

By most any measure, the reserves now appear excessive. In an April 2011 speech, Zhoë Xiaochuan, governor of the People's Bank of PRC, 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

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 the PRC's currency undervaluation has meant that the PRC has been extending large volumes of loans to the rest of the world. Given that the PRC 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 the PRC 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 perspective of the PRC, is that PRC faces the prospect of significant capital losses on its foreign exchange holdings. Either an increase in global interest rates or an appreciation of yuan would cut into the yuan value of the PRC'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

⁷ Li (2011).

moving market prices. When such losses have occurred in the past, as with unfortunate overseas investments, they have been accompanied by public complaint within the PRC.

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

Thus, from a perspective of the PRC, 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 the PRC to extricate itself from this situation.

In the context of US-PRC diplomacy and political economy, the growing hoard of the PRC's foreign exchange reserves has an important, additional role. In the US, it can foster the impression that the PRC is endlessly wealthy. The reserve pile is often misinterpreted as a measure of the success of the PRC's policy and leads to concerns that this is a slush fund to buy up key parts of the US economy or the world. The former interpretation undermines public sympathy for the raft of developmental problems facing the PRC's leaders. The latter interpretation leads to suspicions about the PRC's motives and a potentially adversarial stance.

2.1.4 Exchange rate

Whatever the merits of US concerns about the aforementioned macroeconomic imbalances, they resulted in an intense focus on the yuan-dollar exchange rate, which is depicted in Figure 8. The PRC has held its currency roughly fixed against the US 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%. As the global financial crisis unfolded in 2008 and 2009, the appreciation of the YUAN ceased. The slow and steady appreciation—roughly a 6% annual rate—resumed in the summer of 2010, leaving the yuan at 6.48 to the dollar in early June 2011.

⁸ Wines (2009)

⁹ Goldstein and Lardy (2007).

Figure 8: Yuan-Dollar Exchange Rate (End-Month), 2001–2011

Source: Federal Reserve. Federal Reserve Statistical Release (May 13, 2011).

It is worth noting that the PRC'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 US on the undervaluation of the the PRC's currency.

The conclusion that the PRC'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 yuan was 15 to 40% undervalued prompted legislation seeking to apply a 27.5% tariff on the PRC's goods (splitting the difference). The Peterson Institute has very publicly estimated that yuan is 20 to 40% undervalued.¹⁰ In the most recent estimate, from May 2011, Peterson scholars find that the yuan is 22.2% 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% of GDP (p. 4). The multicountry analysis highlights several important points of the currency debate. First, the PRC'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%. The euro, as of April 2011, was estimated to be 4% undervalued relative to the dollar. Second, those who

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

stress the importance of the PRC's exchange rate adjustment justifiably note that while the PRC may account for a limited share of US trade, it is very difficult for the PRC's neighbors to adjust when the PRC does not. Thus, Republic of Korea and Japan are estimated to be almost 10% undervalued against the dollar and would both be expected to face easier adjustments if they came alongside yuan appreciation. Finally, there is a sharp distinction between the PRC's global overvaluation (13.8%) and its overvaluation relative to the dollar (22.2%).

Such analyses have been politically influential in the era in which the PRC's global current account surplus have been rising. They have been especially potent in the midst of the US recession, since it is a relatively straightforward (if flawed) calculation to extrapolate from a current account deficit correction to a projected increase in American jobs (Levy 2010).

The assertions about yuan undervaluation are not limited to American critics. The World Bank last year recommended that the PRC appreciate its currency to head off inflation.¹¹ The European Union trade commissioner, Karel De Gucht, asserted that yuan was underpriced.¹² The International Monetary Fund (IMF) Managing Director added that "The opinion of the IMF... is still that yuan 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 yuan-dollar exchange rate as having two speeds: full stop, and a steady 6% 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% appreciation was in force. And the PRC's macroeconomic imbalances grew all the while.

3. 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.

3.1 Forces driving the US debate

In the US, 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 the PRC and the macroeconomic imbalances that have characterized it lies the American union movement. Organized labor in the US had a negative view of trade with the PRC in 2003 and that view has only strengthened since. To some extent, this reflects a negative

¹¹ World Bank (2010).

¹² Chaffin and Beattie (2010).

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

view of international trade in general. Trade with developing countries is held responsible, by some, for the decline in manufacturing sector employment in the US. The PRC is the prime target of this wrath, in part because of its dominance in the supply of consumer goods.¹⁴

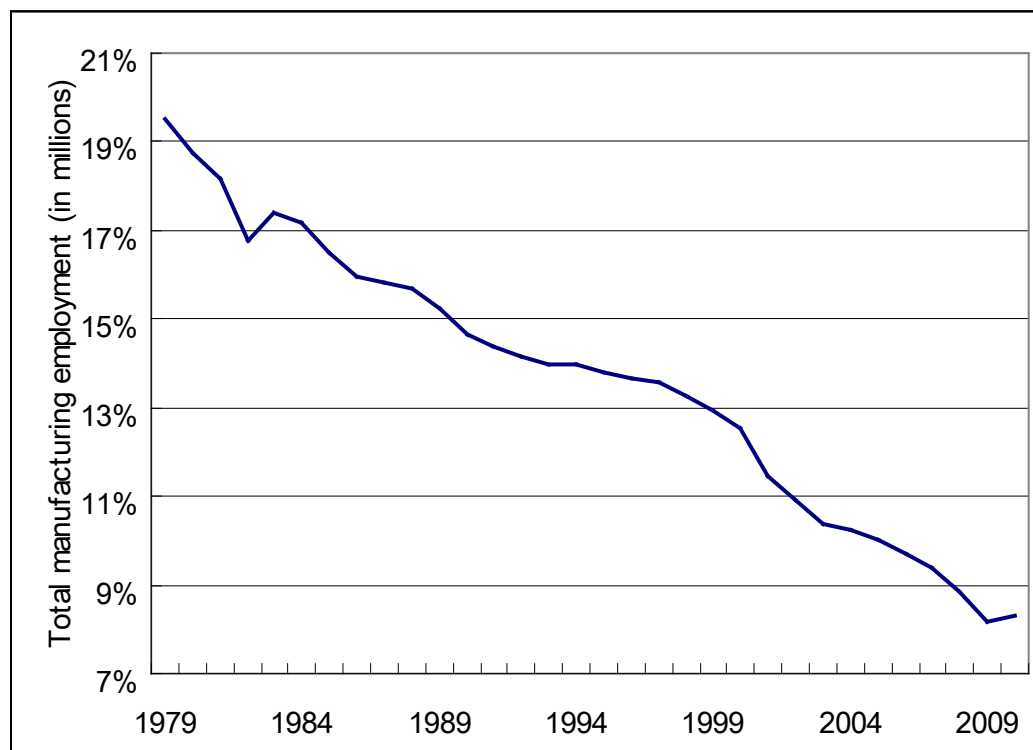
This viewpoint, while strongly held by organized labor, is not unique to that group. Americans who check the origin of their toys or electronics at the local Wal-Mart are likely to see “Made in China.” It is not hard for them to believe that this is where all the well-paid union jobs have gone. They 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 US 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 the PRC’s emergence as a trading power. Yet there is a powerful temptation to attribute the shift to imports of inexpensive manufactures from the PRC. 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 the PRC, they would be manufactured in the US.¹⁵

¹⁴ Interestingly, there is a growing debate among developing countries about currency valuations. Whereas the PRC’s manufacturing product mix can be quite different from that of the US, it poses a more direct challenge to countries like Mexico and Brazil.

¹⁵ This presumption was made explicit in an AFL-CIO filing for a Section 301 case against the PRC, focusing on its hukou labor restrictions in 2005. The model contained only two countries.

Figure 9: Total US Manufacturing Employment as a Percentage of Total Employment, 1979–2010



Source: Bureau of Labor Statistics.

Closely related to the concern that American manufacturing jobs have decamped to the PRC is the perception that foul play was involved. There is a pervasive concern that the PRC has not always played by the rules. The argument is that PRC 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 the PRC's 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 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 US 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 the PRC 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 the PRC’s 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.”¹⁶

In this scenario, Krugman and Bergsten argued that a full revaluation of the PRC’s currency (perhaps by 25 to 40%) could boost demand for the rest of the world’s exports, cut the US trade deficit, and expand US employment.¹⁷ Even if the PRC’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 the PRC 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 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 yuan was significantly undervalued and that this undervaluation had an important negative effect on the US.

This view was not universally shared. There was another school of thought that holds that the PRC’s currency is undervalued, but that the undervaluation’s effect on the US is less clear.¹⁸ 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 the PRC’s exports to the US in the event of a major revaluation.

¹⁶ Krugman (2009).

¹⁷ Dickson, D. 2010. China’s yuan value hits U.S. economy, two experts say. *Washington Times*, 15 March 15, 2010.

¹⁸ See, for example, Fair (2010).

Both groups of economic analysts agreed that the undervalued yuan was poor policy from the PRC'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 US 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 US Chamber of Commerce. In the past, such groups have publicly criticized plans for aggressive trade actions against the PRC. They remain critical of some recent proposals, but their enthusiasm has significantly diminished. In light of their concerns about other the PRC's 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 the PRC in heated debates.

To sum up, as the nature and magnitude of the PRC's macroeconomic imbalances evolved over time, so did the nature of arguments within the US over the impact of those imbalances. This evolution was not always readily apparent, in part because the initial arguments blaming the PRC for US 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 the PRC responsible for distorting the US economy in the lead up to economic crisis and then for impeding adjustment in the crisis' aftermath.

3.2 In the PRC

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

A first such theme is the principle of noninterference. The PRC's leaders have repeatedly put this forward as a theme of the PRC's 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 the PRC should be free to pursue whatever economic practices it chooses. This claim can become awkward when it is extended to claims that the PRC's exchange rate is a purely internal matter. The expectation that the PRC 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 the PRC's decades of economic growth.

A second theme is the importance of economic performance. As ideology has receded as a guiding force in the PRC's politics, the legitimacy that comes from mounting prosperity and poverty alleviation has partially taken its place. This imposes serious pressures on the PRC's leaders. A principal explanation for the PRC's reluctance to appreciate its currency is the fear of the economic dislocation that could ensue. The PRC's government has conducted studies that reportedly show substantial job losses that would flow from even modest currency appreciation. The PRC'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 the PRC cuts both ways, however. The PRC's undervalued exchange rate poses serious difficulties for controlling the PRC's money supply and, in turn, inflation. The exchange rate is not the only driver of inflation; the PRC's post-crisis stimulus was important as well. But the exchange rate makes monetary control more difficult and imports more expensive. Appreciation of yuan 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 the PRC. 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 1989.¹⁹

The Japanese economist Takatoshi Ito argued that the PRC 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.”²⁰

The PRC's 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 the PRC exports fell.

A third theme is national pride. A frequent theme in discussions of the PRC's foreign policy is redress for past humiliations at foreign hands. These grievances may be specific, as with the PRC'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 the PRC to trade.

The practical implication of the PRC's nationalism in this context is that there is a sensitivity to slights on the international stage. While restrictions on the freedom of inquiry in the PRC 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.

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,

¹⁹ See, for example, Keidel (2007).

²⁰ Ito (2010).

some analysts say, there is scant incentive to take positions that rivals could criticize as weak.”²¹

In the context of the PRC’s currency appreciation, the PRC’s 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.

3.3 Each sides misunderstands the other

As a final note on the motivations of the US and the PRC, 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 the PRC is simply pursuing mercantilist lucre as a means of furthering its indisputable prosperity and influence; or that the US is simply using the PRC as a scapegoat for domestic political and economic problems in its manufacturing sector—tend to push toward conflict.

4. DIPLOMATIC EFFORTS

This section has two distinct parts. The first indulges in a modicum of formality to illustrate the choices facing the US in its economic diplomacy. The second part characterizes the nature of bilateral economic diplomacy between the US and the PRC 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.

4.1 Opportunity Cost of prioritizing currency

At one level, the economic diplomacy between the US and the PRC in recent years can appear rather simple. The US government consistently called for the PRC to appreciate its currency against the US dollar. This was not the only matter of economic concern raised by US 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 yuan 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.

²¹ Wines (2010).

4.1.1 Simple Opportunity Cost

To begin, consider a setting with two players, the US and the PRC. The US is demandeur, the PRC is demandee. We will assume that there are two dimensions in which the PRC can act. It can adjust *policies*, p , or its *exchange rate*, x .²² We will assume for the moment that the adjustment is from the initial level (p_o or x_o) to the level that would be ideal for the US (\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 the PRC's action, the US must expend diplomatic effort. We will assume that the US objective function can be depicted as:

$$W(p,x) - e \tag{1}$$

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 the PRC's actions. The only action in this initial version is that the US must choose whether to expend its effort requesting p or requesting x ; it cannot do both.²³ Thus, the government maximize its welfare (assumed equivalent to national welfare) by choosing:

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

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

4.1.2 Compliance

Next, we enrich the model slightly by imposing constraints on the PRC's willingness to respond to US diplomatic efforts. We now assume that US efforts, e_p, e_x , elicit corresponding the PRC's 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 US government is offered a limited menu. Now the US government's

²² To be more concrete, for "policies" one could think of investment restrictions, border barriers, intellectual property rights enforcement, or government procurement policies.

²³ 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 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.

optimal strategy from (2) becomes:

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

This is unremarkable, except that it is now possible that the US 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.

4.1.3 Political Economy Objective Function

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

$$\omega(p, x) \equiv \sum_i \alpha_i w_i(p, x) + W(p, x) \quad (4)$$

where i indexes politically important groups within the US, $w_i(p, x)$ 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).²⁴

Under these assumptions, it is now possible that the US 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.

4.2 Suggestive Considerations

To minimize the formality and to bridge some of the gaps between this exercise and the actual narrative of US-PRC 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 US welfare as a fixed function of the PRC's 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 the PRC's policies, but that relationship

²⁴ We omit the diplomatic effort cost, since it is assumed to be a constant.

certainly would not have been stable over time, as the PRC grew and took on a larger share of US imports.²⁵

Second, there is a useful distinction to be made between the actual relationship and the perceived relationship between the PRC's actions and US 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 yuan appreciated by over 20% against the US dollar. At the same time, the PRC's trade surplus with the US continued to 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 the PRC's 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 the PRC's policy variables and the key domestic determinants of welfare.

Third, a more accurate depiction would allow for the US 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 US government was willing to offer to the PRC in return. The PRC has had a number of persistent requests that it has made of the US. It has sought market economy status as a way of minimizing the impact of US antidumping practices. It has also sought greater access to US 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 US diplomatic efforts to effect change in the PRC's policies.

Fourth, the price that the PRC might demand for a policy change shifted over time. Effectively, for issues on which the PRC was determined to follow its own course without bowing to US influence, the price went from infinity to zero. This occurred because the PRC, 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 US 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 US Treasury on which countries manipulate their currencies, or it could pass bills. Those might range from a broad 27.5% tariff on the PRC's 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

²⁵ For one estimate of the relationship between the PRC's exchange rate practices and US jobs, see Fair (2010), who concludes that the PRC's undervaluation provided net benefits to the US.

partially-completed legislation could send as it advanced, in addition to concern about serious political costs should a presidential veto be required.²⁶

4.2.1 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 US-PRC macroeconomic imbalances.

4.2.2 What did the US want?

Two central questions about the object of US economic diplomacy were:

- What was the ultimate objective of negotiation? Was it the exchange rate, the level of trade flows, the bilateral trade ledger or the PRC's current account balance? This is essentially asking which the PRC's policies should be seen as the appropriate arguments in objective function modeled above.
- If US negotiators had been granted a free hand to set the PRC's 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 US-PRC 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.”²⁷ Through the end of 2010 currency was clearly the dominant issue on the US economic agenda with the PRC.²⁸

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

Consider first the implicit idea that the PRC might undertake a dramatic appreciation in a short period of times. Ardent recent critics, such as Paul Krugman and Fred Bergsten, have argued that a full revaluation of the PRC's currency (perhaps by 25 to 40%) could boost demand for the rest of the world's exports, cut the US trade deficit, and expand US employment.²⁹

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

²⁶ In October 2010 discussions with the author, the PRC's officials at the Ministry of Commerce and the People's Bank of China expressed serious interest and concern about advancing currency legislation in the US 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-PRC legislation.

²⁷ Response to author's question, public presentation at the Center for Strategic and International Studies, June 2, 2011.

²⁸ As discussed below, in the fall of 2010, the US 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.

²⁹ Dickson, David M., “China's yuan value hits U.S. economy, two experts say,” *Washington Times*, March 15, 2010.

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."³⁰

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 the PRC's appreciation would result in a rapid increase in demand for US 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.

Suppose, for the sake of argument, that the first two premises (liquidity trap and job linkage) are granted. Then there would be a short window in which the US would care about additional the PRC's demand, followed by a much longer period in which the US would return to welcoming other countries willing to lend us money and hold down our interest rates.

But what would happen if the PRC were to adopt a 25% to 40% sudden currency revaluation? In all likelihood, large swathes of the PRC's low-margin producers would fail and the weak the PRC's 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."³¹

³⁰ Krugman, Paul, "Capital Export, Elasticity Pessimism, and the Renminbi (Wonkish)," *The Conscience of a Liberal*, *New York Times*, 16 March 2010. <http://krugman.blogs.nytimes.com/2010/03/16/capital-export-elasticity-pessimism-and-the-renminbi-wonkish/>

³¹ Pettis (2010).

Thus, if the PRC were to try to revalue too quickly, the ensuing turmoil could prevent the PRC from significantly boosting world demand.³² If the PRC 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 US.

A second possibility, one that ultimately prevailed in 2010, was that the PRC could resume the pace of appreciation that it employed from 2005 to 2008. At that time, the PRC was appreciating at an average rate of roughly 6% per year. Augmented by the PRC's inflation, the effective rate of appreciation has been somewhat faster.³³ While practical, this policy is unlikely to have a dramatic impact on the US in the short term. As noted above, it also need not redress concerns about macroeconomic imbalances, since the PRC's earlier appreciation was accompanied by continued current account surpluses and foreign exchange reserve accumulation.³⁴

A third possibility is that the PRC could avoid the question of how quickly to appreciate by leaving it up to market forces. It could open its capital account and let yuan 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 the PRC's currency would appreciate. The PRC 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 yuan 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 US.

From a diplomatic perspective, the lack of consensus about US negotiating objectives had an important implication for the PRC. There was a significant discontinuity in US reaction around the zero rate of currency appreciation. In those periods when the PRC held the yuan-dollar rate essentially fixed, it managed to unite the different US 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 the PRC was so slow to recognize this. In terms of the impact on the PRC's inflation or unemployment, there was little difference between a minimal appreciation and a fixed rate, whereas the minimal rate of

³² Despite the economic risks, at least one prominent Chinese economist has called for flotation of the RMB. Writing in the *Financial Times*, Yu Yongding opined: "The People's Bank of China must stop buying US dollars and allow the renminbi exchange rate to be decided by market forces as soon as possible. The PRC should have done so a long time ago. There should be no more hesitating and dithering. To float the renminbi is not costless. However, its benefits for the Chinese economy will vastly offset those costs, while being favourable to the global economy as well." Yu (2011).

³³ Treasury Secretary Tim Geithner made this point about the real exchange rate, sparking a debate about whether measured the PRC's inflation, with a heavy weight on rapidly rising domestic food prices, was particularly relevant in discussions about tradables.

³⁴ 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% annual appreciation, any investor who could convert dollars into yuan would achieve an additional 6% return beyond any interest rate differential. This creates great pressures for 'hot money' flows into PRC and complicates the task of tamping down the PRC's inflation. Recent the PRC's experience, with diminishing trade surpluses but rapid foreign reserve accumulation, seems to reinforce these concerns.

appreciation would have required US critics to delineate the difference between an acceptable and an unacceptable rate of appreciation. That was (and remains) a difficult line to draw.

4.2.3 What did PRC want?

There is an asymmetry in describing the PRC's objectives, since they were largely defensive. The PRC had goals such as access to US high technology goods and market economy status, but these were only tangentially connected to issues of macroeconomic imbalances. As noted above, the PRC was concerned about US macroeconomic policies that could affect the value of its substantial holdings of US government bonds, but this did not amount to much more than general admonitions to the US to behave in a prudent fashion. For the most part, the PRC 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 the PRC's initial currency appreciation in 2005, there was an exception to this. At that time, the PRC 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 US. This willingness to seek financial advice dissipated in the wake of the financial crisis.

4.2.4 How to persuade?

Whatever the ultimate goals of US policy toward macroeconomic imbalances with the PRC, 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 US Treasury issue a twice-yearly report declaring which countries among US 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 the PRC was cited in 1994 (GAO 2005). The Bush administration was regularly excoriated for its failure to name the PRC. As a candidate for the presidency, then-Sen. Barack Obama pledged that he would find the PRC 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 the PRC. Once in office, however, the Obama administration declined to name the PRC a manipulator, frequently delaying the report beyond its mandated release date.

It is somewhat odd that the labeling (or failure to label) the PRC as a currency manipulator has become so central to US 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 US has steadily been engaged in such negotiations with the PRC for most of the period under discussion, one might ask what difference it would make. Both the US and the PRC's governments treated the decision as significant, however. US principals endured intense criticism from legislators and commentators for the failure to name the PRC, while the PRC's 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% 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 US 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 the PRC 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 US 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 the PRC currency legislation (Beattie and Politi, 2011).

The bilateral venues included a whole series of dialogues between the US and the PRC, 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, US negotiators felt compelled to make currency movement a top demand. This generally resulted in unsatisfying conclusions to the meetings, since the PRC's leaders were not about to rework their macroeconomic policy just to suit visiting US 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 the PRC's indigenous innovation policies. Currency issues were mentioned, but deemphasized. Rather than encountering the traditional impasse, the talks elicited significant commitments from the the PRC's side (Levy 2011).

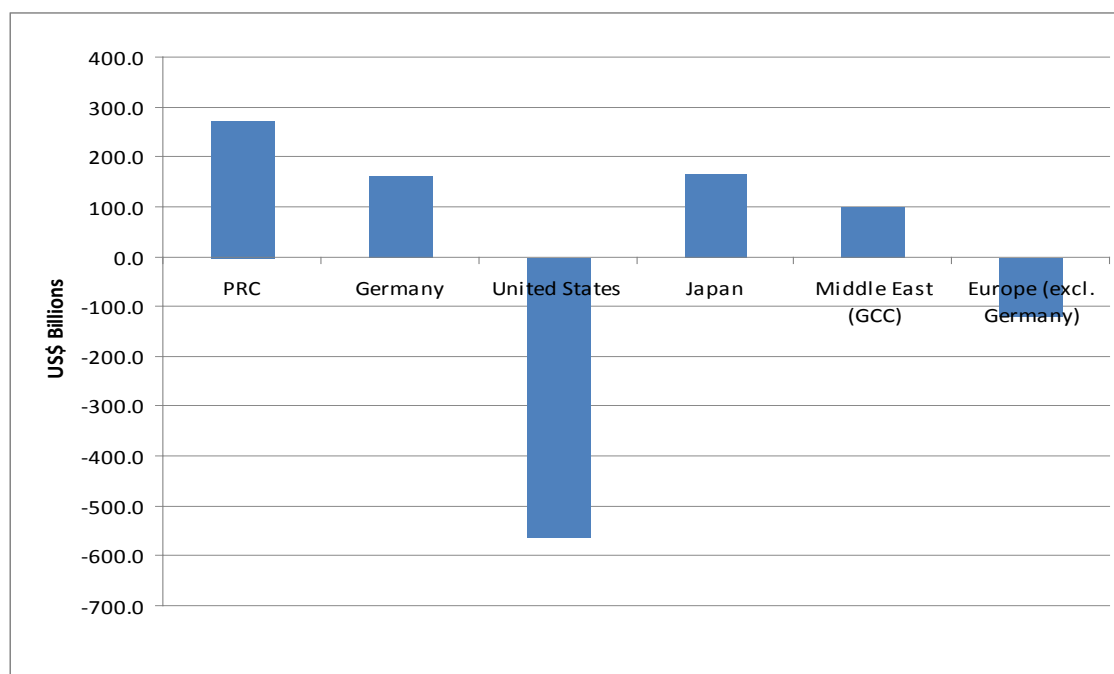
The final venue for addressing macroeconomic imbalance issues was multilateral. It is taken up in the next session.

5. REPERCUSSIONS FOR ECONOMIC GOVERNANCE

With the PRC and the US 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 US and the PRC 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 US and the PRC: the G-20, the status of the dollar as a global reserve currency, the International Monetary Fund, and the WTO.

Figure 10: Global Current Account Balances, 2010



Source: International Monetary Fund. World Economic Outlook Database (April 2011).

5.1 Undermining of the G-20

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, the PRC was easily the most prominent.³⁵

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.”³⁶ In the ensuing Pittsburgh summit later that year, the leaders

³⁵ A great deal of information on the G-20 is available at <http://www.g20.utoronto.ca/>.

³⁶ <http://www.g20.utoronto.ca/2009/2009communique0402.html>, point 21.

pledged “to adopt the policies needed to lay the foundation for strong, sustained and balanced growth in the 21st century.”³⁷ 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 the PRC’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 US effort to make these pledges more concrete hit strong opposition. (Levy 2010b) The US 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 the PRC 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 US 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 the PRC 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 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.

5.2 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, the PRC was prominently given a greater say.

In terms of addressing macroeconomic imbalances, while the managing director did pronounce the yuan undervalued (quoted above), there were no policies to prod the PRC in that direction. Nor, for that matter, were there policies to compel the US 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 US and the PRC. Not only does the IMF lack levers over their behavior, but it is generally loath to take actions to offend its principle funders.

³⁷ <http://www.g20.utoronto.ca/2009/2009communique0925.html>, line 11.

5.3 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. The PRC 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 the PRC's accession, this meant that any country offering new market access had to offer it to the PRC as well. As the PRC grew into an exporting powerhouse, this became a steadily more fearsome prospect. This mattered less to advanced developed countries such as the US 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 the PRC. 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 the PRC in a range of markets.

The WTO is also threatened by moves to compel it to render judgment on the PRC's currency practices. This has been one popular course of action in the US 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.

5.4 The dollar as a reserve currency

The final institution of global economic governance to be challenged by US-PRC macroeconomic imbalances has been the status of the US dollar as a reserve currency, an institution in the figurative sense. With the US 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, US 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 the PRC and other creditor nations, who worried that the US was failing to fulfill its duties as provider of the world's reserve currency. Given the troubles of the eurozone and Japan, critics of US 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 US and the PRC 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.

6. CONCLUSION

Over the last decade, macroeconomic imbalances between the US and the PRC have grown significantly. The policy instruments that could potentially bring about adjustment have been the subject of intense political debate in both the US and the PRC. Throughout the decade, concerns about the PRC's 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 US 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 the PRC from its commitment to an undervalued currency and rapid reserve accumulation, the PRC's own demographic and economic forces could succeed in effecting change. The advent of inflationary pressures within the PRC 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 US and the PRC are likely to exacerbate tensions. In the US, there is little political return to being tolerant of the PRC; in the PRC, there is little political return to appearing subservient to the US. Second, the broader macroeconomic performance of the two countries will matter significantly. It was fear of a sharp downturn in 2008 that caused the PRC to stop its policy of currency appreciation. It was the sharp upturn in US unemployment that led prominent economists to begin discussing winnable trade wars against the PRC.

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

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