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China Currency Dispute: Is a Rise in the Yuan Necessary, Inevitable or Desirable?

John A. Tatom

Abstract: China-bashing has become a popular media and political sport. This is largely due to the U.S. trade imbalance and the belief, by some, that China is responsible for it because it manipulates its currency to hold down the dollar prices of its goods, unfairly creating a trade advantage that has contributed to the loss of U.S. businesses and jobs. This paper reviews the problem of the large trade imbalance that the United States has with China and its relationship to Chinese exchange rate policy. It examines the link between a Chinese renminbi appreciation and the trade balance and also whether a generalized dollar decline could solve the global or Chinese U.S. trade imbalance. The consensus view explained here is that a renminbi appreciation is not likely to fix either the trade imbalance with China or overall. Though these perceived benefits of a managed float are small or non-existent, perhaps they should be pursued anyway because of small costs or even benefits for China. Section IV looks at the costs of a managed float in terms of the benefits of the earlier peg. Opponents of a fixed dollar/yuan exchange rate ignore the costs of a managed float for China, especially with limits on currency convertibility. These costs are outlined here in order to provide an economic basis for the earlier fixed rate and China's reluctance to appreciate. Finally it is suggested that the necessary convertibility on capital account, toward which China is moving, could easily result in yuan depreciation under a floating rate regime. This is hardly the end that China critics have in mind and it is not one that would improve U.S. or other trade imbalances with China.

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Keywords: exchange rate policy, China, currency manipulation, current account imbalance.

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The U.S.-China Currency Dispute: Is a Rise in the Yuan Necessary, Inevitable or Desirable?

China-bashing has become a popular media and political sport. This is largely due to the U.S. trade imbalance and the belief, by some, that China is responsible for it because it manipulates its currency to hold down the dollar prices of its goods, unfairly creating a trade advantage that has contributed to the loss of U.S. businesses and jobs. The attacks reached a new plateau in February 2005 with a congressional proposal to impose a 27.5 percent tariff on Chinese goods entering the United States unless China immediately “revalues,” or raises the value of its currency, the renminbi, whose basic unit is the yuan, by 27.5 percent. This figure is the midpoint of a range of estimates that China undervalues the yuan relative to the U.S. dollar by 15 to 40 percent. While this proposal became the centerpiece of federal policy efforts to address the Chinese trade imbalance, the proposed legislation died with the end of the last Congress. In the meantime, China began to push up the value of the yuan in July 2005, but very slowly so that tariff proponents and other protectionists have not been satisfied that China has removed their unfair competitive advantage.¹

This paper reviews the problem of the large trade imbalance that the United States has with China and its relationship to Chinese exchange rate policy (Section I). In Section II, it examines the link between a Chinese renminbi appreciation and the trade balance. In Section III, it looks at whether a generalized dollar decline could solve the global or Chinese-U.S. trade imbalance. The consensus view explained here is that a renminbi appreciation is not likely to fix either the trade imbalance with China or overall. Though these perceived benefits of a managed float are small or non-existent, perhaps they should be pursued anyway because of small costs or even benefits for China. Section IV looks at the costs of a managed float in terms of the benefits of the earlier peg. Opponents of a fixed dollar/yuan exchange rate ignore the costs of a managed float for China, especially with limits on currency convertibility. These costs are outlined here in order to provide an economic basis for the earlier fixed rate and China’s reluctance to appreciate. Finally it is suggested that the necessary convertibility on capital account, toward which China is moving, could easily result in yuan depreciation under a floating

¹ In 2007, the Hunter-Ryan proposal was reintroduced in the U.S. House of Representatives as “The China Currency Act of 2007.” This bill would add currency manipulation to the list of actionable export subsidies under World Trade Organization (WTO) rules. However, in Sanford (2007), the Congressional Research Service argues that it is not clear that this is consistent with WTO rules. Senators Christopher Dodd and Richard Shelby have introduced another approach in the U.S. Senate that would at least define currency manipulation. It would occur whenever a country has both a bilateral and overall current account surplus. No action of any sort is required and no evidence on the real or nominal exchange rate would be required. Another bill that passed the Senate Finance Committee revives the approach of Senators Charles Schumer, Max Baucus, Chuck Grassley and Lindsey Graham. It explicitly specifies anti-dumping duties for a failure of China to appreciate its currency by a specified amount. The International Monetary Fund also toughened its rules of surveillance for currency manipulation in June 2007, at least partially at the urging of the United States to do so.

rate regime. This is hardly the end that China critics have in mind and it is not one that would improve U.S. or other trade imbalances with China.

I. The U.S. trade deficit and China

The U.S. current account deficit, the excess of imports of goods and services or unilateral transfers abroad, has climbed steadily and inexorably to record territory since 1991, except for slight improvements in 1995 and 2001. In 1991, the current account balance was a small surplus of \$2.9 billion, the first surplus since 1981 and the last. Since then the deficit has climbed to a preliminary \$856.7 billion, or 6.5 percent of GDP, in 2006. This is the largest deficit in U.S. history, measured both in billions of dollars and as a percent of GDP. Such a large deficit is also unusual in comparison with the experience in other countries, but when measured as a percent of GDP, it is not uncommon elsewhere, sometimes remaining very large for many years. More often than not, however, such a high level of the deficit, especially if unsupported by rapid growth, ends in a financial crisis.

The risk of a financial crisis arises because current account deficits must be financed. That is, the excess of imports over exports must be paid for. When foreign credit is extended to a country year in and year out in such large amounts relative to GDP, there is eventually concern about the ability of the country to repay its foreign credit or even to service its debt to foreigners through interest or dividends. If creditworthiness comes into question, creditors become less inclined to continue lending and may even begin to reduce it, putting upward pressure on interest rates and downward pressure on the currency in the borrowing country. There are other reasons for concern about deficits that are more transitory and political, but more popular and pressing as well. In particular, many politicians and workers fear that goods and services have been moved abroad and raised unemployment. Businesses that produce exportable goods and services and those that compete with imports view weak exports relative to imports as damaging competition and sometimes lead efforts to protect the domestic economy. Thus, opposition to current account deficits is easily mobilized, despite the positive benefits associated with them.

The connection to China comes from the fact that the U.S. trade imbalance with China is its largest bilateral imbalance. In 2006, the current account deficit with China was \$261.7 billion, or 30.5 percent of the total. To some analysts, this suggests large shifts of business and employment to China and makes China the bull's eye for U.S. protectionists, especially for calls to push China to raise the foreign prices of its goods by dramatically boosting the value of its currency. This movement has been reinforced by support of advocates of letting markets determine the nominal exchange rate through a flexible exchange rate system.

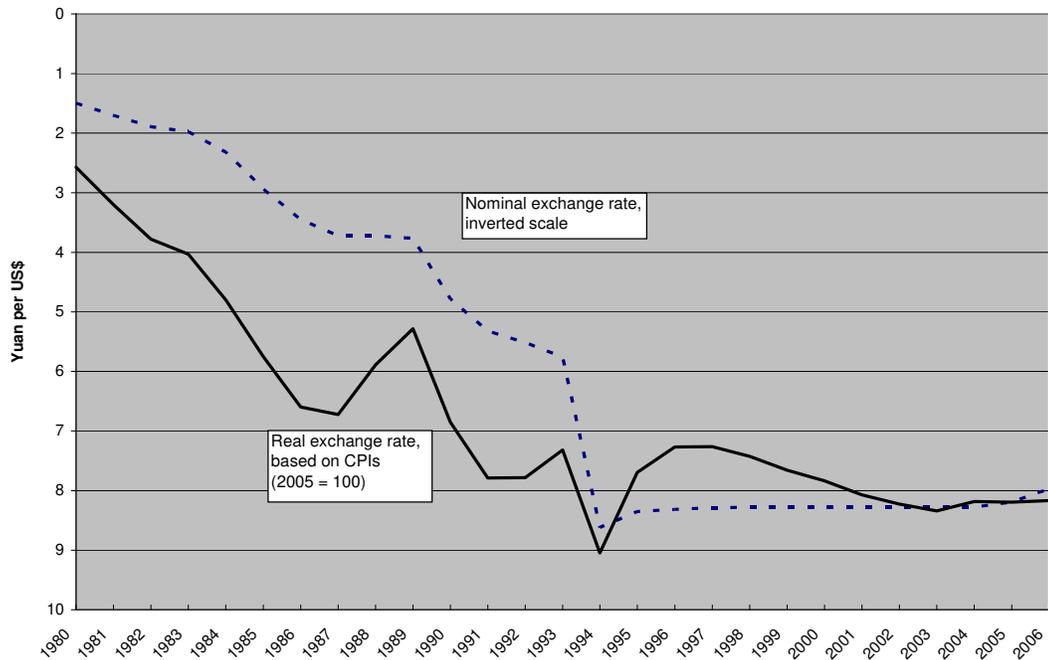
Chinese authorities did begin to push up the value of its currency, the renminbi, whose basic unit is the yuan, against the dollar in June 2005, after being essentially fixed since 1994. But recall that the pressure in Congress was to raise

the prices of Chinese goods by 27.5 percent through a tariff if it did not occur through a rise in the dollar price of the yuan, or a currency appreciation. This is an indication of how much some people think that Chinese goods and services are underpriced when sold in the United States. Yet the rise in the dollar price of the yuan has been only 6.8 percent from July 2005 until February 2007. It rose 3.4 percent in the first year and has risen slightly faster in the past year, up 3.9 percent in the year ending in February 2007. This is hardly a breakneck response to U.S. pressures. Moreover, while the appreciation has quickened recently, so has U.S. inflation so that the dollar prices of Chinese goods are not rising much faster than dollar prices of U.S. goods. Thus, there has been little gain in the pricing competitiveness of U.S. goods. This lack of competitiveness gains highlights the importance of what is called the *real exchange rate*, the observed nominal exchange rate adjusted for prices in the two countries.

It is the real exchange rate that affects the price competitiveness of two countries' goods, not the nominal exchange rate. China's currency could rise in value relative to the U.S. dollar, but if China's yuan prices are rising more slowly than the dollar prices of U.S. goods, China's goods could end up selling at lower prices in the United States than U.S. goods do. The real exchange rate is the nominal yuan price of the dollar times the relative price level in the United States relative to China. Chart 1 shows the nominal exchange rate for the dollar in terms of yuan as well as the real exchange value of the dollar constructed using the U.S. consumer price index (CPI) divided by the CPI in China, where each is set equal to 100 in 2005. The nominal and real exchange rates are the same in 2005. Note that an inverted scale is used to measure the exchange rates so that increases in either line reflect an improvement in the respective value of the yuan. Since the exchange rate is the yuan price of the dollar, an increase in the value of the yuan (in dollars) means a fall in the value of the dollar (in yuan). Increases in the exchange rate, as shown, are increases in the value of the yuan and reductions in the value of the dollar, as desired, but it is the use of the inverted scale that accomplishes this. Like nearly all explanations of exchange rates and their movements, the conventional effort to make the discussion as simple as possible is unusually complicated.

Chart 1 The Chinese currency has begun to slowly rise

The yuan rose 2.1 percent, in real terms, from 2003 to 2006



If the yuan were undervalued and fixed, as critics claim that it has been, it would be expected to appreciate in real terms through faster inflation in China than in the United States. This would occur because an under-valued yuan would accelerate China's export growth and restrict its imports, putting upward pressure on prices, wages and rates of return for its exports and its import-competing industries, until the cost advantage was eliminated. This would be fostered by the general inflow of dollars, which would accumulate at the central bank as reserves and support more inflationary growth of the Chinese money supply. The responses to an undervalued yuan would lead to a rise in Chinese prices relative to U.S. prices, pushing up the real exchange rate for the yuan, given the nominal exchange rate.

This has not occurred to any large degree over the past 13 years. Such a long period of adjustment to a peg makes claims of currency manipulation sound oxymoronic. How could a country be said to manipulate its currency when its nominal value has not changed for more than ten years? And how could an unfair trading advantage persist for over a decade when prices in the United States and/or in China have been free to respond to the demands created by any undervaluation, eliminating it in the process?²

² Two strong proponents of the view that China has manipulated its currency and some of their initial commentary supporting institutional responses are Bergsten (2004) and Goldstein (2005). Absent moves in nominal exchange rates, neither notes in their numerous criticisms that the long decline in China's real exchange rate followed double-digit inflation and a partially offsetting

II. Could yuan appreciation solve the U.S. current account imbalance?

In order to reduce U.S. demand for Chinese goods and promote Chinese demand for U.S. exports, it is the real exchange rate for the yuan that must rise, not the nominal rate. Note that in Chart 1 the real exchange rate began rising in 2003, two years before China relaxed the peg of the yuan to the dollar and began to raise the nominal value of the yuan. The real exchange rate for the yuan can rise independently of the nominal rate. The real exchange rate has not risen any faster since the peg was relaxed than it did over the two years before that action. On an annual average basis, the real exchange value of the yuan rose 1.9 percent in 2004 and only rose 0.2 percent from 2004 to 2006.

Thus it is not surprising that there has been no improvement in the bilateral trade balance with China; the price change that would bring improvement about has been weaker since the yuan began to rise than it was before the relaxation of the peg. China has implemented an appreciation of its currency, but it has not “floated” the yuan, or allowed the marketplace to determine its price.

International finance specialists refer to the current exchange rate policy regime as a “managed float,” because the central bank, the People’s Bank of China, has intervened daily to insure that movements in the nominal exchange rate do not deviate from the Bank’s desired path, dictated by the government.

Forcing up the value of the renminbi could presumably improve the U.S. trade balance with China, but there are other forces that could forestall improvement. For example, a rapid nominal appreciation could be offset by Chinese producers offsetting the upward pressure on the dollar prices of their goods by reducing their yuan export prices. In effect, they could take reduced profit margins. Similarly, U.S. importers might lower their margins, absorbing part of the rise in the dollar cost of the goods they purchase from China in order to maintain prices and sales. Of course neither course is sustainable in the long run because reduced margins affect the long-term viability of the enterprises. But it can be a potent offset, neutralizing the effects of a foreign currency appreciation. The same forces could frustrate adjustment for U.S. exports to China. Chinese importers of U.S. goods could refuse to pass along the price cuts that yuan appreciation would allow, taking the lower yuan prices of U.S. goods as increased profit rather than passing along those savings to their customers and selling more U.S. exports in China. U.S. exporters could also attempt to capture some of the price cut that a higher valued yuan would allow by raising dollar prices of their exports without disrupting sales. Again, these are not sustainable actions in the long run, but the short run could, in these cases, be measured in years instead of months. Ignoring these adjustments, a large enough rise in the nominal and real value of the yuan could reduce the bilateral trade balance with China.

currency depreciation that created a 24.5 percent appreciation of the currency in 1994-96 (see Chart 1). About 60 percent of this renminbi overvaluation was eroded away by subsequent U.S. inflation that was faster, on average, than Chinese inflation.

Larger yuan appreciation might improve the balance of trade with China, but it would not fix the overall U.S. imbalance. U.S. buyers would switch away from the more expensive Chinese goods, but they would switch to the next cheapest source of goods that benefit from low wage production, which is not likely to be a U.S. supplier. In fact, this shifting has been occurring without yuan appreciation, as increases in wages or other costs in China have fostered shifting of sourcing of imports to Vietnam, Indonesia or other countries with lower wages relative to productivity. Similarly if U.S. exports to China rise, there will be upward pressure on U.S. prices of those goods so that there will be reduced exports elsewhere. More importantly, the Chinese policy actions that would support a higher valued yuan, essentially deflationary monetary growth, would frustrate the effort to raise the real exchange rate by forcing down yuan prices relative to U.S. prices, leaving U.S. prices of Chinese goods in line with those in the United States, despite the higher yuan.³

III. What about a generalized dollar depreciation?

Even a more generalized fall in the value of the dollar against our trading partners would not be likely to eliminate the U.S. current account deficit or even to reduce it much, at least for very large declines ranging up to, say, 30-40 percent or so. A recent study by Bailey and Lawrence (2007) finds that a 20 percent fall in a broad measure of the value of the dollar would be sufficient, with other steps, to restore balance in trade, although not in the current account balance. The conventional wisdom based on most studies is that a much larger and historically unprecedented decline would be necessary to eliminate the current account deficit. The largest sustained decline in the index Bailey and Lawrence refer to was in 1985-88 when it fell by 35.7 percent. While the current account balance improved, it was not eliminated until some years later. The same measure of the real exchange rate has fallen almost as much as suggested by Bailey and Lawrence and others in recent years; from February 2002 until February 2007, the Federal Reserve's broad measure of the real exchange rate for the U.S. dollar fell 16.1 percent. Nonetheless the current account deficit has worsened from 3.8 percent in the year ending in the first quarter of 2002 to 6.5 percent, according to preliminary data, in 2006. Of course there are many other factors influencing the current account balance and there are lags in the impact of exchange rates on trade, but the recent experience is not encouraging.

The more important limitation on the ability of a dollar depreciation to affect the U.S. current account balance is the source of the imbalance. Current account imbalances for a country are reflected in imbalances in the financial account. Thus if a country imports more goods and services than it exports, it has a matching financing flow from the rest of the world to pay for its excess of imports. The central issue is, which causes which? Does a country run a deficit in its current account because it is able to borrow excessively abroad to pay for the excess imports, or does it run a current account imbalance because the rest of the world is trying to acquire more assets in the United States than the United

³ McKinnon (2005) makes this point in a broader review of problems with yuan appreciation.

States seeks to acquire abroad? The conventional U.S. imbalance story emphasizes the former, that the U.S. borrows abroad to finance its excessive imports. But the other possibility is that foreigners want to acquire U.S. assets, flooding the country with foreign currency that is used to buy imports of goods and services that are more attractive than foreign assets. The difference in these two extreme conceptual scenarios is that the dollar falls in the former case, when foreigners must be induced to hold dollar assets, and rises in the second case, when the foreigners are trying to induce U.S. residents to acquire their assets, goods or services in return for U.S. assets. The strength of the dollar over the period of the climbing current account deficit, despite a decline since 2002, suggests that it not excessive U.S. consumption that is driving the current account deficit, but the excessive demand of foreigners for U.S. assets that has powered the current account deficit to historic levels.

The principal solution to current account imbalances will come from market adjustments unless policymakers here or abroad intervene to force an adjustment. Capital inflows to the United States will eventually slow or decline as rates of return abroad become more attractive relative to the United States. The corresponding excess of imports of goods and services will adjust in tandem. Policies that make the United States a less attractive market for investment or make foreign countries more attractive can reinforce that adjustment. Whether this will involve movements in the exchange rate for the dollar will depend on its current over- or undervaluation and on the effects of policy actions on the value of the dollar in the short to medium term.

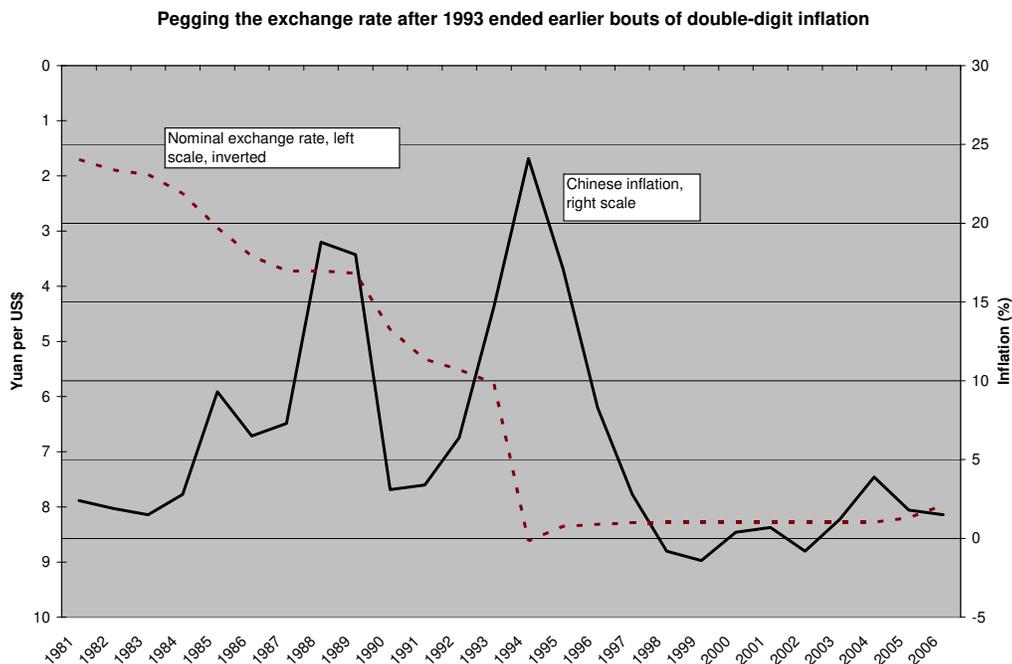
IV. The costs of the managed float

Yuan appreciation in nominal terms is not necessary to achieve U.S. policy interests and it could damage Chinese development, which is not in the geopolitical or economic interest of the United States. If the yuan were undervalued and fixed, it would be expected to appreciate in real terms through faster inflation in China than in the United States. This would occur because an undervalued yuan would accelerate China's export growth and restrict its imports, putting upward pressure on prices, wages and rates of return for its export sector and its import competing industries, until the cost advantage was eliminated. This would be fostered by the general inflow of dollars, which accumulate at the central bank of reserves and support more inflationary growth of the Chinese money supply. China has resisted, to some extent, this inflationary money growth by administrative restrictions on interest rates, credit and through reserve requirement increases. Nevertheless, the response to an undervalued yuan would lead to a rise in Chinese prices relative to U.S. prices, pushing up the real exchange rate, given the nominal exchange rate.

The cost of an appreciation of the yuan is best understood by looking at the benefit of a peg. China had a history of bouts of very rapid inflation during the early years of reform and rapid growth (Chart 2). Until 1994, occasional mismanagement of monetary policy led to periods of rapid inflation and currency

depreciation. Inflation and currency depreciation threatened foreign investors and the domestic public alike, reducing investment and growth. In order to restore price stability by providing an anchor for prices and expectations, China pegged the yuan's value to the dollar in 1994. This had the intended effect of restoring monetary stability and essentially eliminating inflation for more than a decade. This, in turn, created a very favorable investment climate. Relaxing the discipline of a sustainable fixed exchange rate regime risks freeing the central bank to unintentionally bring back excessive money creation and inflation. This would not only endanger strong investment and growth, it would also create the tensions that earlier led to popular unrest, including the Tiananmen Square crisis in 1989.

Chart 2
Exchange rate stability reduced inflation



Eventually China's recent efforts to strengthen its financial markets will begin to pay off, allowing for liberalization of its international financial arrangements and a freely functioning foreign exchange market. Until then, the discipline of a currency peg and its demonstration effects for foreign and domestic investors alike would be valuable and a key safeguard for policy. The risk of a policy error is heightened by abandoning the peg too early. Relaxing the peg too much, or forcing a managed appreciation too rapidly, will lead to unsustainable capital inflows as speculators bet on the appreciation of the currency, creating unsustainable growth of money, real output and employment and inflation. This would be a replay of the appreciation pressures that led to the eventual breakdown of other Asian pegs and crisis in 1997. China has kept itself isolated from many of the extreme possibilities seen during that earlier era in Asia, but it would not be immune if investors believed that continuing appreciation is possible.

The irony of the managed appreciation of the yuan is not just the risk to China's rapid and stable growth, but it also arises from the fact that a competitive and accessible capital market would mean allowing larger and free outflows from China. Capital outflows are currently highly restricted and small. Despite China's rapid growth and scarce capital, private investors in China have limited access to high-yield financial assets. Bank deposits are the principal asset available and they have very low, regulated yields. Individuals push an unusually large flow of saving through these low-yield accounts, largely because they do not have competitive local markets or access to foreign capital markets where they can find higher and yet safer rates of return. As China relaxes access to external assets, such as foreign bank accounts, mutual funds, or foreign stocks or bonds, it will force higher banking standards on domestic firms and find that citizens are able to diversify their assets and increase both the returns and safety of their asset holdings. A large capital outflow would put strong downward pressure on the yuan, however. Thus, opening of the capital market to substantially boost the welfare of domestic households and the competitiveness of the domestic financial services industry has now become hostage to U.S. political pressures to manipulate the currency in the opposite direction.⁴

V. What is the “right” yuan-dollar exchange rate?

Proponents of the view that the yuan is undervalued point to the large and persistent bilateral trade deficit that the United States has with China. There is no reason why any one country's trade with another has to balance, however. Economic theory and accounting only dictate that, in the long run, a country's overall current account balance with all countries will tend to balance. And even then, the “long run” for this purpose is often counted in decades. A bilateral trade balance is not evidence of an imbalance, at least in the sense that there are economic forces that would eventually eliminate it, or in the sense that it will ever have to go away or that its persistence implies excess costs or risks to either country.

International financial theory predicts that the real exchange rate of a currency is “stationary,” which means that it fluctuates around its mean, with no tendency to drift off and a systematic tendency to move back to the mean if for some reason it is moved away from it. This occurs because of “purchasing power parity” (PPP), which holds that the same bundle of goods and services will tend to sell for the same price (in a given currency). As a result, the exchange rates must adjust to reflect price differences in the domestic price levels in the two countries, or, given

⁴ China surprised markets when it announced in late August 2007 a large opening of capital markets by allowing private citizens open access to investment in the Hong Kong equity market. This produced a sharp surge of 2.9 percent, similar to the 2.5 percent rise after mid May 2007 announcement of the intention to relax rules for individual investors. Some analysts expect a cumulative outflow with full liberalization that would exceed current reserve holdings, if China's freed investors diversified their portfolios as much as typical OECD or other Asian countries.

a fixed nominal exchange rate, price levels adjust to make PPP hold. PPP rests on the ability to profitably arbitrage price differences when it does not hold.

An example of how PPP works might clarify the point. Suppose, for the sake of the argument, that PPP holds but China appreciates the nominal value of the yuan by 27.5 percent. PPP implies that such an appreciation would cause the price level in China to fall eventually by 27.5 percent relative to prices in the United States. The reason is that the nominal, and initially real, appreciation of the yuan by 27.5 percent would lead Chinese goods to rise by 27.5 percent in dollar terms and U.S. goods to fall by 27.5 percent in yuan terms. Thus the Chinese and Americans would buy more U.S. goods and fewer Chinese goods, putting upward pressure on U.S. prices and downward pressure on Chinese prices. Since the Chinese market is so small relative to the United States, most of the pressure would fall on the Chinese market. The temporary incentive to switch purchases from Chinese to U.S. goods would continue until prices in China fell by 27.5 percent relative to U.S. prices, and then PPP would be restored.

Some price differences across countries could arise from taxes, transport cost or natural endowments of specialized resources. These differences in prices cannot be easily eliminated by arbitrage, so PPP may not as readily hold in these cases. Even when there are such factors, however, the real exchange rate is expected to be stationary in the long run so long as these distorting factors remain unchanged or change in a non-systematic way. But again, the long run can be very long.

The real value of the yuan shown in Chart 1 appears to have a downward drift in the value of the yuan, or upward drift in the value of the dollar until 1991. This should not be surprising, however. The chart begins soon after reform and opening of the Chinese market began. Highly-centralized socialist economies attempt to control prices and hold the prices of essential consumer goods and services at artificially low levels and to control access in order to ration them. They also control exchange rates and access to foreign exchange. In China's case it appears that the real exchange rate may have been set artificially high so that foreign demand was relatively low and domestic demand for foreign goods and foreign exchange (dollars) were rationed. As the economy opened, the real exchange rate fell. It might seem that it could take a long time for the real exchange rate to become stationary. Some simple statistical tests of the absence of stationarity strongly reject this, however. These so-called "augmented Dickey-Fuller tests" show that there is no significant trend and a "unit root," the absence of stationarity, can be strongly rejected at conventional significance levels. Depending on the period used (from 1980 or from 1991), it would appear that the real exchange rate has been slightly overvalued, but by no more than 1 percent in 2006. Of course, it is not possible to have much confidence in such a conclusion based on only 25 years data for an economy in such dramatic transition, but the results are surprising, powerful and suggestive. A more detailed analysis by Cheung, Chinn, and Fujil (2007) provides stronger support for this conclusion, however.

VI. Conclusion

U.S. policy toward China has been to exert strong pressure to get the Chinese to appreciate the yuan as part of its opening up of its foreign exchange and other financial markets to international competition. The focus is on the latter opening, but the expectation is that the currency would appreciate as many other policymakers and industry leaders hope. With a flexible, market-driven exchange rate, market participants determine the right price for a currency in real time, minute-by-minute, so that it is difficult to argue that the exchange rate is ‘wrong.’ Under a fixed exchange rate, such as that maintained for over 10 years by the Chinese, market pressures arising from under- or overpriced currencies do not move the exchange rate, but instead move prices in each country to eliminate any under- or overvaluation. Price rigidities suggest that this process could be much slower than exchange rate changes. In any event, theory and evidence today favor the notion that PPP and real exchange rate stationarity are the long-run determinates of the exchange rate and of international pricing relationships. The evidence suggests that, either way, the yuan may be very close to correctly valued for the long term. Opening the capital markets further could put strong downward pressure on the renminbi, creating further turmoil among trading partners. Any effort to force more nominal exchange rate appreciation could be deflationary for China, damage U.S. exports and the bilateral trade balance, and it would fail to have any effect on the overall U.S. balance. The value of a symbolic appeasement of short-term protectionist interests unfortunately could have greater value than avoiding such risks.

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