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In Currency Games, the Prize May Be a Trade War

By **JEFF SOMMER**

THE United States and China have edged away from a trade war, but both sides are keeping their powder dry.

China is quietly preparing for a modest appreciation of its currency, [the renminbi](#), after weeks of criticism from American officials, [The New York Times reported last week](#). Currency markets anticipate a 3 percent climb in the renminbi against [the dollar](#) over the next year.

But an increase that modest is unlikely to satisfy the growing number of members of Congress who are demanding that China hike the value of the renminbi by 25 to 40 percent against the dollar — a sharp shift that they say is needed to reduce America's trade gap and to save domestic jobs. If China doesn't comply, they say, the United States should impose tariffs aimed at making Chinese products more expensive and American products more competitive.

But be careful what you wish for.

The chances of China passively accepting American-imposed tariffs or punitive legislation are "pretty close to zero," said Kenneth G. Lieberthal, a [Brookings Institution](#) scholar and a former adviser on China in the Clinton administration. Unilateral American action would almost certainly invite retaliation.

China is now America's second-biggest trading partner, behind Canada, and it holds more than \$1 trillion in [United States Treasury](#) and government agency debt. If economic hostilities erupted, it isn't clear which side would have the upper hand.

The two countries have become mutually dependent in many ways, and could do considerable damage to each other and to the rest of the global economy, Eswar S. Prasad, a Cornell economist, said in an interview.

"The bargaining strengths of the two countries are finely balanced," he said [in Congressional testimony in February](#). "But the changing perceptions set up a dangerous game of chicken that could spin out of control if unrealistic expectations and the desire to pander to domestic audiences trumps rational collective policymaking in one or both countries."

Aside from imposing tariffs on American goods, China could stop buying Treasuries, for example. Even hinting that it is doing so might drive up yields and drive down prices, and deliver a blow to an already fragile American economy. This would hurt China, too, of course, because the value of its own assets would fall and one of its main markets would be damaged — and the fallout could spread elsewhere.

The point is not that this is likely, but that it could be quite dangerous if it occurred.

Faced with the prospect of direct economic conflict, leaders of the two countries have been backpedaling sharply over the last two weeks.

Treasury Secretary **Timothy F. Geithner** and Wang Qishan, China's vice premier, met in Beijing to discuss bilateral economic issues on Thursday. **President Obama** and **Hu Jintao**, China's president, are expected to continue the dialogue in Washington this week. Further bilateral talks have been scheduled.

The Geithner visit came only days after the Treasury decided to extend an April 15 deadline at which Mr. Geithner was to have certified whether China was a currency “manipulator,” a move that could lead to tariffs.

Last month, 130 members of Congress demanded in a letter that the Treasury affix that label to China. Furthermore, Senator **Charles E. Schumer**, a New York Democrat, and Senator **Lindsey Graham**, a Republican of South Carolina, along with three colleagues, have introduced legislation that might tie the Treasury's hands by requiring it to identify “fundamentally misaligned currencies,” without any need to prove “intent.”

Senator Schumer said that China had disappointed him before, so he intended to move forward with the legislation. “We are dubious that this time would be any different, but will await the details,” he said in a statement. The cheap renminbi was enabling Chinese manufacturers to take jobs from Americans, he said.

Chinese officials say they are concerned about losing jobs, too. China's enormous exports — made possible, in part, by voracious American consumers — have helped generate enough prosperity to ensure a reasonable degree of social stability, several China experts said. A drastic and abrupt revaluation of the renminbi could be quite disruptive — and that would not be palatable to the ruling Chinese Communist Party.

If Chinese officials aren't pushed too hard by the American government, Mr. Prasad said, and if economic conditions are propitious, they might allow their currency to appreciate a bit further than the markets anticipate, perhaps by 5 percent over the next year. Other developing countries that compete with China might then also allow their currencies to strengthen.

All of that would probably not have a big effect on America's trade imbalance, however, implying that the currency dispute could flare up as the November elections approach, especially if unemployment remains high.

Over the longer term, allowing its currency to trade more freely on global markets could help China restructure its economy. While the United States needs to increase national savings and limit consumption, China faces a very different set of issues.

In a new report last week, the World Bank found that despite remarkably steady and rapid growth in China's G.D.P., even during the global financial crisis, the country's economy remained unbalanced, relying too heavily on huge infusions of state-supplied credit into capital-intensive industries.

ALTHOUGH its foreign-exchange reserves are enormous, its banking system is still relatively primitive. Credit does not flow easily to small businesses or to service industries that might generate large numbers of jobs, and China's central bank does not yet rely on interest rates as a lever to guide the economy.

A generation after Deng Xiaoping initiated reforms that have transformed a Soviet-style command economy into a powerful hybrid, the job is still incomplete. Making the renminbi a stronger global currency might advance China's own economic agenda. The question is whether it will be able to do so without the distraction of a trade war.