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U.S. ECONOMIC RELATIONS WITH CHINA: STRATEGIES AND OPTIONS ON EXCHANGE RATES AND MARKET ACCESS

HEARING

BEFORE THE

SUBCOMMITTEE ON
SECURITY AND INTERNATIONAL TRADE AND FINANCE

OF THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDRED TENTH CONGRESS

FIRST SESSION

ON

INFORMATION ABOUT STRATEGIES AND OPTIONS ON EXCHANGE RATES AND MARKET ACCESS

WEDNESDAY, MAY 23, 2007

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C O N T E N T S

WEDNESDAY, MAY 23, 2007

WITNESSES

U.S. ECONOMIC RELATIONS WITH CHINA: STRATEGIES AND OPTIONS ON EXCHANGE RATES AND MARKET ACCESS

WEDNESDAY, MAY 23, 2007

U.S. SENATE,
SUBCOMMITTEE ON SECURITY AND INTERNATIONAL TRADE AND FINANCE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The subcommittee met at 2:41 p.m., in room SD–538, Dirksen Senate Office Building, Senator Evan Bayh, (Chairman of the Subcommittee) presiding.

OPENING STATEMENT OF CHAIRMAN EVAN BAYH

Chairman BAYH. I am pleased to call this meeting of the Subcommittee to order. I would like to welcome all of our guests, including our panelists here today. I appreciate your indulgence. The Senate, as you probably are aware, is debating an important immigration measure, and as the Senate is sometimes wont to do, we have votes that are not scheduled. So we just had one at—the clock has stopped. We had one at 2:25, which ran over a little bit, so I appreciate your waiting for us, and I apologize for the delay. It is the nature of the beast, as we might say.

The order of proceedings today, I am going to begin with an opening statement, turn to my colleagues in order of appearance—Jim, I think that means you are on deck, is that right?

Senator BUNNING. Thank you.

Chairman BAYH. You are on deck, to use an expression you are familiar with—and then our other colleagues who will be here. I want to thank Senator Martinez for his participation putting today's hearing together. We have had very good bipartisan collaboration over the years, and certainly in terms of the conduct of the affairs of this Subcommittee.

I would also like to thank the Committee Chairman, Senator Dodd, who has helped to make this hearing possible. It was at his recommendation that the subject matter was expanded to include not only currency valuations but also market access to financial services industries and others. I think that was a very helpful suggestion. It is an important issue and one is that it is timely that we focus on. The Senator could not be with us today, but he does intend to submit a full statement for the record, and I appreciate his sharing his thoughts with us in that regard.

After the opening statements are completed, we will go to witness testimonies. I have had a chance to read some of the prepared statements. If possible—and we are going to have some flexibility—if we can keep it to 5 to 7 minutes, something like that, that would be ideal. We can submit any extra for the record, and then we will go to questions and answers, and we will try and have 5-minute rounds of questions and answers and, if necessary, a second round for questions and answers. So thank you for your patience. I will make a few comments, then, Jim, turn to you, and any colleagues who arrive, and then, gentlemen, we look forward to hearing from you today.

This is a timely hearing. The Strategic Economic Dialogue, the most recent of meeting of that just concluded earlier today. Secretary of the Treasury Paulson called me last week to discuss some of his agenda with me, to talk a little bit about the subject of our hearing today, and I would like to say that I appreciate his efforts. He is a good man. I have known him for a long time. In some ways, he is dealing with some legacy problems, and I would characterize it as a legacy of neglect with regard to some of these issues. His actions and his activities are well intended. We are doing somewhat better than in the past, but the question before us today is whether we are making enough progress and whether that progress is being made in a timely manner. And my answer to both of those questions would be, "Obviously not."

Steps by China so far have been largely cosmetic and symbolic and of marginal substantive import. And the pace of change is glacial, and I use that term in the pre-global warming context. It has been so slow, in fact, that nothing of consequence has been accomplished in any meaningful timeframe. I am reminded of something that John Maynard Keynes once said, which was, "In the long run, we are all dead." And at this pace, we will be before the imbalances that have been allowed to build in the global trading system, particularly the bilateral trading relationship between our Nation and China, are rectified.

It is becoming increasingly obvious that some form of benchmarks for specific actions and specific consequences for failing to meet those benchmarks will be necessary if progress is to be made. For years now, literally years, China has said many of the right things, and we appreciate that. But they have not followed through and done the right things. How long will we accept rhetoric as a substitute for action?

Ultimately, it is a matter of credibility, both ours and theirs. When we repeatedly acquiesce to behavior that is harmful to the United States, why should China take us seriously? The answer is that they really do not. When they repeatedly do not fulfill promises to change their behavior, why should we believe them? And the answer is that increasingly we should not.

The current state of affairs is most unfortunate. I wish we did not have this friction in our relationship. No one enjoys tension between two great nations like the United States and China. I want good relationships with China. It is probably the most important bilateral relationship that we will have over the next 50 years. It is a powerful nation with a rich history and culture and bright prospects for the future.

But as much as I want good relations with China, I know that this cannot be achieved by ignoring the interests and the well-being of the United States. We all want China integrated into the global economic and security structure, but for amicable relations to exist, they must be mutually beneficial and sustainable. Growing questions about whether either of these is so exist.

China is concerned about its domestic stability, and this is a real and legitimate concern. With the number of excess workers in agriculture who will be moving into the cities and the number of excess workers in state-owned enterprises, the risk of dislocation is real, and they have a right to focus on that. But in promoting rapid growth and stability at home, China cannot expect to export lower growth and instability to the United States in ways that are artificial. No nation state will voluntarily accept such a course, nor should we.

For example, China policy benefits U.S. consumers but handicaps U.S. producers. That is not a decision for them to make. It is a decision for the United States of America to make.

Another example. They cannot expect unfettered access to U.S. markets while denying open access to their own, particularly in the financial services sector and for turning a blind eye to rampant intellectual property theft, which was a previous subject for a hearing by this Subcommittee.

Currency manipulation, which is an artificial distortion of trade, has had very harmful impacts upon our balance of trade. Some experts, including one member of the panel today, estimate that the Chinese currency is undervalued by as much as 40 percent, and it is getting worse. I think, Dr. Goldstein in previous testimony about 3½ years ago, you indicated at that time the undervaluation was in the area of 15 to 25 percent. Your most recent statement of a couple of months ago was 40 percent, and most experts would agree that the overvaluation is increasing rather than static or decreasing.

The proposed expansion of the trading band is a marginal action at best—and really meaningless, in fact, given the fact that the current band has never been fully implemented. This results in lost sales and jobs to Americans due to reasons other than natural competitive market forces or comparative advantage. It has been estimated that the domestic manufacturing sector alone loses $31 billion of sales per year and that we lose $35 billion in exports to China every year because of their artificial manipulation of the currency.

Other credible research suggests that the manipulation costs the U.S. economy approximately $500 billion per year and that this could translate into 5.3 million jobs. Regardless of the precise nature of these statistics, it is pretty clear that it is having a material impact upon our economy, and this is something that should concern all Americans.

Market access limits exacerbate this imbalance. Not only does China artificially promote exports, it artificially restraints access to its domestic market. This is contrary to its obligations under the WTO. And China continues to discriminate against U.S. firms, particularly in the financial services sector.

The global economy will not function very well if, when other countries, including China, have a competitive advantage, we buy from them, but when we have a competitive or a comparative advantage, they shut us out. But that is the current situation that we confront.

With rights must come responsibilities. I voted for China's accession to the WTO because I believed it was better to have China subject to the rule of law and the discipline of market forces. Too often, unfortunately, they have chosen to flout the law and to manipulate market forces to achieve artificial economic advantages. This is not what anyone had in mind.

The current situation poses great and growing risks to the United States. Economically, the situation is unsustainable. The current account imbalance—I think it is about 6.6 percent as a percentage of our GDP last year—continues to grow and most people believe will ultimately correct. The adjustment can either be gradual or abrupt. The longer we let this situation continue, the greater the chances of a severe correction, with substantially higher interest rates and correspondingly lower growth for the United States economy.

There are also national security implications for this continuing situation. Interdependency is one thing and a positive aspect of globalization. But excessive dependency is another matter, and we are on the cusp of becoming excessively dependent upon China. This raises the possibility, however remote, of coercion.

For example, look at Russia's recent behavior with regard to European nations that are excessively dependent upon Russia for energy exports. We are approaching a point where China could possibly threaten the United States with adverse economic consequences if we do not accede to its wishes. No great nation, particularly the United States, can allow itself to be placed in such a position.

We have also, unfortunately, seen the limited utility of dialog. Endless conversations are not enough if they do not result in meaningful action. China sees the status quo as in its interests and will not change its behavior unless the cost/benefic calculus changes. Put another way, if all we do is complain about the situation, why should they take us seriously or change their behavior?

Action in some meaningful timeframe is needed—undertaken cooperatively with China if we can, unilaterally if we must.

That is the subject of today's hearing, and, Senator Bunning, I will now turn to you and would very much appreciate your thoughts.

STATEMENT OF SENATOR JIM BUNNING

Senator BUNNING. Thank you, Chairman Bayh.

I want to thank Senator Bayh for inviting me to participate in today's hearing. I am glad the Banking Committee and this Subcommittee are taking the time to discuss what is self-evident to even the most casual observer: China's manipulation of its currency.

Congress has long recognized that a nation can subsidize its export industries and establish trade barriers simply by undervaluing its currency. In fact, that is why Article XV of the General Agreement on Tariffs and Trade and Article IV of the IMF Charter clearly prohibit currency manipulation, and China has signed both of these agreements. Yet some say that because the IMF and the Treasury Department failed to recognize a plain fact, that there is no currency problem.

Chairman Bayh knows how concerned I am that the Administration and the IMF have refused to use the tools available to address China's currency manipulation. In fact, my colleagues on this Committee, including the Chairman, Senator Casey, and Senator Brown, have joined with me and Senator Stabenow to introduce a bill, the Fair Currency Act of 2007, which would identify exchange rate misalignment as a prohibited export subsidy under the U.S. trade law, thereby allowing injured companies the right to seek trade law remedies.

American workers and businesses that compete with China are impatient for change. Congress is impatient. Yet, we have been told for multiple reasons that the United States does not need to act against China now.

Time and time again we have been told that change will take time. It is argued that China needs to make numerous changes—particularly to OK banking and financial systems—before they can allow the value of the yuan to float more freely on the international market.

Or, we are told China is already making changes, cosmetic at best.

Yet, China is doing even more today to manipulate its currency. It has dramatically increased its monthly average exchange rate buying to $45 billion per month. The chart I have shows where the yuan would be, if it were not for China's action. In other words, the yuan is here, and all the way up to where it should be would be a 40-percent appreciated value. And despite China's professed policy of allowing the yuan to float, it is not. China's extraordinary level of intervention is not only a barrier to trade, it is a growing danger to the global economy and one that Congress is obliged to address.

I have a number of questions for our witnesses, and I look forward to their responses.

Thank you.

Chairman BAYH. Thank you very much, Senator Bunning. And it has been a pleasure to work with you on the Fair Currency Act. I am grateful for your interest in these issues, and it is great to have good neighborly relations between our two States.

I will now turn to our panelists. Again, thank you for your patience, and I will go from this end of the table to that end of the table.

Dr. Goldstein, thank you for joining us. Dr. Morris Goldstein is the Dennis Weatherstone Senior Fellow at the Peterson Institute for International Economics. Prior to joining the Institute in 1994, Dr. Goldstein spent 25 years at the International Monetary Fund, the last 8 as Deputy Director of Research. He consults widely with central banks, Ministries of Finance, and private financial institutions. He earned his Ph.D. in economics from New York University. Dr. Goldstein is kind enough to stand in today for his colleague, Dr. Fred Bergsten, who unfortunately is under the weather today. Please give him our best.

By the way, you were not at NYU when John Brademas was President by any chance, were you?

Mr. GOLDSTEIN. I was.

Chairman BAYH. Very good. Some good Indiana influence on that fine institution.

Our next panelist, Mr. David Hartquist, "Skip"—I think you go by "Skip"—is counsel to the China Currency Coalition and Chairman of the International Trade and Customs Practice at the law firm of Kelley, Drye & Warren. Mr. Hartquist's experience has involved industries such as specialty steel, copper and brass, tissue paper, oil and gas, electronics, chemicals, tableware, and apparel—all of this in connection with international trade litigation and negotiations. He has advised the U.S. Government on trade negotiations with China, the European Community, Japan, Korea, Taiwan, and other nations, as well as the Doha Round of the WTO negotiations. Before joining his present law firm in 1976, Mr. Hartquist worked for President Ford as General Counsel of the White House Counsel's Office on international economic policy. He earned his law degree from what we like to refer to as the "Indiana University of the East," otherwise known as Harvard in some quarters.

[Laughter.]

That is the advantage of being Chairman, Jim. You can take some liberties.

Our next panelist, the Honorable Robert S. Nichols. Thank you for joining us. Mr. Nichols is President of the Financial Services Forum, an organization of CEOs of the largest financial institutions in the United States. Before joining the Forum, Mr. Nichols was Assistant Secretary of the Treasury for Public Affairs. He is a recipient of the Alexander Hamilton Award, the Treasury Department's highest honor. Before joining the Treasury, Mr. Nichols served as communications director for the Electronic Industries Alliance. Previously, he was communications director to former Senator Slade Gorton and press secretary to former Congresswoman Jennifer Dunn. A native of Seattle, Washington, Nichols is a graduate of the George Washington University. Welcome, Mr. Nichols.

Next we have the Honorable Patrick A. Mulloy. Thank you, Mr. Mulloy. Pat Mulloy served on the bipartisan U.S.-China Economic and Security Review Commission from April 2001 to December 2006 and was Acting Chairman from January of 2002 through May 2002. The Commission conducted hearings and reports to Congress on national security implications of our economic relations with the People's Republic of China. Its work examines trade and investment issues, political relations, technology transfers, and China's WTO compliance. Prior to assuming that role, Mr. Mulloy was Assistant Secretary for Market Access and Compliance in the Department of Commerce's International Trade Administration from 1998 to 2001. He also served 15 years on the staff of the Senate Banking Committee—welcome home, Mr. Mulloy—including as chief international counsel and general counsel. Mr. Mulloy is currently the Washington representative for the Alfred P. Sloan Foundation, which funds studies and programs regarding the forces impacting

America's industries and the standard of living of our citizens in an increasingly competitive global economy. He is also an adjunct professor of international trade at both Catholic University and George Mason University. A native of Pennsylvania, he holds a J.D. from George Washington University Law School and a master's from Notre Dame.

Mr. John Nolan. Thank you for joining us, Mr. Nolan. John Nolan is Vice President and General Manager of the Structural and Rail Division of Steel Dynamics in Columbia City, Indiana. Perhaps you detect a theme here today. During 1998 and 1999, John led Steel Dynamics' e-business strategies as well as the company's initiatives in East Asia. It was during his tenure in East Asia that John became acutely aware of the challenges presented to U.S. manufacturers by the mercantile policies and related currency practices of some of our trading partners. Since then, he has lobbied the administration and Congress for trade policies that support U.S. manufacturers and comply with existing U.S. trade law. He recently served on the U.S. Government's Industry Trade Advisory Committee on Steel. Mr. Nolan earned his degree in metallurgical engineering from Lafayette College in 1973.

Thank you all. Dr. Goldstein, we will begin with you.

STATEMENT OF MORRIS GOLDSTEIN, SENIOR FELLOW, PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS

Mr. GOLDSTEIN. Mr. Chairman, I appreciate the opportunity to testify before this Committee on the important issue of U.S. economic relations with China.

As you will have noticed, I am not Fred Bergsten. Fred has shaved off his moustache and beard. I have not. Fred still plays full-court basketball at least once a week. I do not. Fred is the Director of the Peterson Institute. I am not. But on the issue of China's inappropriate exchange rate policies and what to do about it, Fred and I have quite similar views. In my remarks, I want to highlight five points that are developed more fully both in Fred's written testimony and in my own recent congressional testimony and writings on China's exchange rate policies.

First, over the past 5 years, things have gotten much worse, not better, on China's external imbalance and its exchange rate policies. China's global current account surplus has grown without interruption over the past 5 years, mushrooming from about 1 percent of its GDP in 2001 to more than 9 percent of GDP last year. China now has the largest global current account surplus in the world in absolute dollar terms, and in the first quarter of 2007, China's global trade balance surplus ran about double the pace for the first quarter of 2006.

In short, the Chinese Government has been allowing China's global external imbalance to expand out of control. China's real effective exchange rate, widely regarded as a much better measure of China's overall competitive position than the nominal exchange rate between the dollar and the RMB, is actually weaker now than it was in either 2001 or at the dollar peak in February 2002.

Some would have you believe that because the RMB-dollar rate has appreciated by about 7.5 percent since June of 2005 we must be making real progress on the exchange rate front. The sad truth is that the RMB is now grossly undervalued, on the order of 30 percent or more against an average of China's trading partners and 40 percent or more against the dollar. The appreciation of the RMB that has taken place to date against the dollar is completely inadequate to make a real dent in this huge surplus. The recently announced increase in the daily fluctuation band between the RMB and the dollar is a very minor change that will in no way alter this broader conclusion. Here I could not agree more with the Chairman.

When it launched its much heralded currency reform in July 2005, the Chinese authorities said they intended to increase the role of market forces in the determination of the RMB. No such thing has happened. The Chinese authorities have continued to intervene in the foreign exchange market in massive amounts to keep the RMB from rising, and the amount of monthly intervention jumped yet further to about $45 billion a month in the first quarter of this year.

Second point, the international community is now operating without an enforced international code of conduct on exchange rate policies. Although China is a member of the IMF, Chinese authorities continue to assert that they do not accept the concept of currency manipulation. Simultaneously, the Fund's Managing Director has maintained repeatedly that he rejects a role for the Fund as global umpire of exchange rate policies. Meanwhile, the U.S. Treasury Department has ruled repeatedly in its reports to Congress that it cannot find China guilty of manipulation because it cannot prove intent to manipulate. The practical upshot of all of this is that we now have a free-for-all on exchange rates.

Point No. 3, this lack of progress on improving China's exchange rate policies is bad news for China, the United States, and the international monetary and trading system. China's seriously undervalued and manipulated exchange rate makes it much harder for China to move to a more balanced and consumption-driven growth path and to implement a more independent monetary policy. From the U.S. perspective, the failure of the RMB to appreciate significantly has limited the helpful contribution that exchange rate changes in Asia could make to bringing about an improvement in the U.S. global current account deficit and to reducing the risk of a dollar crash and a hard landing for the U.S. economy.

As Fred puts it in his written testimony, China's currency policy has taken much of Asia out of the adjustment process, and China's currency manipulation could lead to retaliatory trade responses in the United States and perhaps in Europe as well, much to the disadvantage of all parties.

Fourth point, several popular arguments that maintain it is neither feasible nor desirable for China to take faster and bolder action in reducing the undervaluation of the RMB are not persuasive. A significant appreciation of the RMB will not be disastrous for China's growth, employment, or social stability. China's economy grew by over 11 percent in the first quarter of this year. A 10-percent appreciation of the RMB would probably reduce that growth to 10 percent, hardly a disaster.

Point No. 5, a new U.S. stance toward China's currency policy is clearly needed. The U.S. Treasury should be pressing China to deliver right away a meaningful downpayment of a 10- to 15-percent appreciation of the RMB from its current level. Because China has waited so long to take the decisive action, the undervaluation of the RMB can no longer be eliminated in one go. A sizable up-front adjustment is needed if China is to escape from being so far behind the curve. A modest upward rate of crawl of the RMB relative to the dollar, say at 5 percent a year, is not going to get the job done.

Failure by China to drastically reduce its large-scale, one-way intervention in the exchange market should result in a finding of currency manipulation in the Treasury's next report to the Congress. The exchange rate should be placed and should be maintained at the top of the agenda for future meetings of the SED until greater progress is made. The United States should also be promoting an international effort to obtain an Asian Plaza agreement that would work on the needed appreciation of all major Asian currencies that are currently out of line. The U.S. should marshall support from industrial and large emerging economies for making the IMF the global umpire for exchange rate policies, and it should resist any watering down of the IMF's exchange rate surveillance guidelines.

Finally, the U.S. administration should quietly notify the Chinese that it will be unable to oppose responsible congressional initiatives in the event that China continues its failure to observe its international currency obligations. To ensure that the U.S. approach is evenhanded, the U.S. should indicate it is prepared to offer a new, longer-term plan for greater and more durable fiscal policy consolidation in the U.S.

Thank you, and I look forward to answering your questions.

Chairman BAYH. Thank you, Dr. Goldstein.

Senator Casey has very graciously agreed to await his comments for the end of the panel, so, Mr. Hartquist, we look forward to hearing from you.

STATEMENT OF DAVID A. HARTQUIST, COUNSEL, CHINA CURRENCY COALITION

Mr. HARTQUIST. Thank you, Mr. Chairman. I am David Hartquist of the law firm Kelley, Drye, Collier, Shannon, representing the China Currency Coalition, which is a group of basically manufacturing companies, trade associations, and the AFL–CIO that joined together to work on this issue about 3 years ago now.

I note, by the way, that in the press statements that came out of the SED discussions today, both Secretary Paulson's statement and the fact sheet that was issued by the Treasury Department describing the results of the negotiations, the word "currency" is not used one time.

In discussing the problem of undervalued currencies——

Chairman BAYH. Perhaps, Mr. Hartquist, that is because there was not much to report.

Mr. HARTQUIST. I expect that is the case, Mr. Chairman.

In discussing the problem of undervalued currencies, it is helpful to recall the perspective of those who were involved during and immediately after World War II in the creation of the institutions they designed for the post-war international monetary and trading systems. Weighing very much on their minds were the ordeal of the Great Depression of the 1930's, the damage done to international trade by competitive currency depreciation and exchange controls, and the need for orderly exchange arrangements to restore and facilitate international trade.

The words of Harry Dexter White, who was a primary architect of the IMF, along with John Maynard Keynes, whom you mentioned, Mr. Chairman, are particularly thoughtful, and I quote: "The difference between stability and rigidity in exchange rates is the difference between strength and brittleness. It is the difference between an orderly adjustment, if conditions warrant it, and eventual breakdown and painful adjustment."

And, again, in terms of lowering barriers to international trade, Harry Dexter White noted the following: It ". . . cannot be done until there is assurance of orderly exchange rates and freedom in exchange transactions for trade purposes. A depreciation in exchange rates is an alternative method of increasing tariff rates; and exchange restriction is an alternative method of applying import quotas."

These sentiments were heartfelt convictions born of terrible experience, so what might we take from them today in a time when the yuan and the yen and a number of other currencies are undervalued and monetary and trade imbalances triggered by such misalignment are becoming more pronounced at a rapid rate?

In the China Currency Coalition's judgment, the measures taken to address this situation will have the greatest chance of being effective if based upon a recognition of the hybrid nature of this situation. As White understood, balanced and mutually beneficial flows of international trade depend upon assurance of orderly exchange rates and freedom in exchange transactions for trade purposes. Article IV of the IMF Agreement and Article XV of the GATT reflect this attitude.

Consistent with their historical roots, therefore, it is to be hoped that the IMF and the WTO would work in tandem in these circumstances, especially as the IMF can rely, as Dr. Goldstein indicated, only upon moral suasion to encourage revaluation of the yuan and other undervalued currencies.

Currency manipulation in the IMF's terms, and exchange rate misalignment as a countervailable, prohibited export subsidy from the WTO's vantage point, are two sides of the same coin. In each case, there is an undervaluation of a foreign currency as a result of protracted, large-scale intervention by or at the direction of a governmental authority in the exchange market. Manipulation occurs if the foreign government's intent by such undervaluation is to prevent an effective balance-of-payments adjustment or to gain an unfair competitive advantage over other countries. But there is no requirement of intent under the WTO's Agreement on Subsidies and Countervailing Measures.

Treatment in U.S. domestic law of exchange rate misalignment as a countervailable, prohibited export subsidy is a reasonable interpretation and implementation of the SCM Agreement. During the Uruguay Round that led to the formation of the WTO, the definition of a countervailable, prohibited export subsidy was carefully amended and articulates three prerequisites that must be satisfied:

a government financial contribution, a benefit, and the subsidy must be specific—in this case, contingent upon export performance. We believe all these conditions are met.

The CCC filed a Section 301 case in 2004 urging the U.S. Government to take the China currency issue to the WTO. Members of Congress have filed similar 301 cases three times since then, most recently last week. The Bush administration turned down the first three cases. Ours was turned down only 4 hours after we filed a 250-page petition. We will see what they do with the current congressional case filed by 42 Members of the House—22 Democrats and 20 Republicans.

I agree that China's recent announcement of widening the daily trading band to half a percent is grossly insufficient. Since China's announcement in July 2005, nearly 2 years ago, that the yuan would be traded within a daily band of 0.3 percent, the Chinese Government has never for one single day permitted the yuan to increase by the allowed percentage. That dismal track record does not bode well for the future.

China's blatant actions also distort other currencies, especially those of China's Asian neighbors. As former Treasury Secretary John Snow told the Senate Finance Committee 2 years ago, "And, interestingly, China itself accounts for 43 percent of the non-petroleum trade deficit between our two countries"—43 percent. Congressional action we believe is needed and warranted. We strongly support S. 796, the Fair Currency Act, sponsored by several Members of the Banking Committee, including Senators Bunning and Bayh, Senator Casey and Senator Brown.

Thank you.

Chairman BAYH. Thank you, Mr. Hartquist.

Mr. Nichols.

STATEMENT OF ROBERT S. NICHOLS, PRESIDENT AND CHIEF OPERATING OFFICER, FINANCIAL SERVICES FORUM

Mr. NICHOLS. Mr. Chairman, thank you.

Chairman Bayh and Ranking——

Chairman BAYH. By the way, at least for our first two panels, you have been much more observant of the 5- to 7-minute timeframe than most Members of Congress are, so I salute you for that.

Mr. Nichols.

Mr. NICHOLS. Thank you, Mr. Chairman, Ranking Member Martinez, Senator Bunning, Senator Casey, thank you for the opportunity to participate in this important hearing on America's economic relationship with China and strategies regarding exchange rates and expanded market access. While not in attendance today, I do want to thank Chairman Dodd and Ranking Member Shelby for their leadership in this area as well.

I am here as the President and COO of the Financial Services Forum, the chairing organization of the ENGAGE CHINA Coalition, which is a partnership among eight financial services trade associations united in our support of continued economic engagement with China, reform of China's financial sector, and expanded market access for U.S. providers of financial services. I would like, if I may, to focus my brief opening comments on how increased market access for U.S. financial services firms and China's capital markets will benefit American workers, America, and our manufacturers.

A more effective and efficient financial sector in China is a prerequisite to successfully addressing the issues that have complicated the U.S.-China economic relationship, chief among them further currency reform and meaningfully reducing the trade imbalance.

Regarding the currency, as Chinese authorities have repeatedly argued—reasoning generally acknowledged by most foreign analysts—an immediate shift to a fully market-determined yuan is very difficult given the underdeveloped state of their capital markets. More specifically, China's banks, securities firms, and other businesses lack the expertise to develop and trade derivatives and other structured instruments used to hedge the risk associated with greater currency volatility. Sophisticated derivative products and hedging techniques provided by foreign financial services firms would clearly diminish such concerns. We would like to do that.

Turning to the trade deficit, reorienting the financial habits of China's population to achieve a better balance between savings and consumption—while progressively bringing more than 1 billion Chinese into the global economy—is in our view the most powerful remedy to the U.S.-China trade imbalance. Chinese households historically save from a third to as much as half of their income compared to the single-digit saving rates here in the United States and Europe. This pronounced propensity to save is related to a couple of things: the declining role of the state and the fact that most Chinese depend on their families and private savings to pay for retirement, health care, and the economic consequences of accidents or disasters. Activating the Chinese consumer requires the availability of financial products and services that we here in this room take for grants—personal loans, credit cards, mortgages, 401(k)s, pensions, and life, property, health insurance products, et cetera, that will eliminate the need for such precautionary savings and thus facilitate consumption.

Let me give you an example of how reducing this precautionary savings would profoundly help U.S. manufacturers, workers, and exporters.

Last year, the United States exported to Japan goods and services worth approximately $60 billion—the same amount, roughly, we exported to China. China's population of 1.3 billion, of course, is 10 times Japan's population of 127 million. If China's citizens were to eventually consume American-made goods and services at the same rate that Japan's citizens did last year, the U.S. would export more than $600 billion worth of goods and services to China, 11 times what we exported to China last year, an amount equivalent to 5 percent of our GDP, and more than twice what we imported from China last year.

A fifth of the world's population is currently not participating in the global marketplace and, therefore, not buying American goods and services. The integration of more than a billion people into the global economy will not only be the economic story of the 21st century, it will be one of the most significant events in the history of the world economy, and we must make sure that this profoundly important event takes place on terms that work for America.

Mr. Chairman, the fastest way for China to develop the modern financial system it needs to achieve more sustainable economic growth, allow for a more flexible currency, and increase consumer consumption is to import it—that is, by opening its financial sector to greater participation by foreign financial services firms. If you care about the currency issue, as we all do, and you care about the trade deficit, as we all do, you care about expanded access for financial services in China.

By providing the financial products and services that China's citizens and businesses need to save, invest, insure against risk, raise standards of living, and consume at higher levels, foreign financial institutions—including U.S. providers—would help create what every manufacturer and service provider here in the United States wants, and that is, an unleashed Asian tiger hungry for U.S. products.

Thank you very much for your time.

Chairman BAYH. Mr. Nichols, thank you very, very much.

Mr. Mulloy, it is always good to have an alumnus of the Banking Committee and of Notre Dame with us. We look forward to hearing from you.

STATEMENT OF PATRICK A. MULLOY, ADJUNCT PROFESSOR, GEORGE MASON SCHOOL OF LAW

Mr. MULLOY. Thank you, Mr. Chairman.

Chairman Bayh, Senator Bunning, and Senator Casey—being from Pennsylvania, I am delighted to see you, Senator—I want to thank you for giving me this opportunity to appear before the Committee.

I am honored, the fact that I am an alumnus of this Committee. I served in a bipartisan manner on this Committee for 15 years. During the formulation of the 1988 Omnibus Trade Act, this Committee developed the exchange rate provisions of that omnibus bill. I as general counsel was charged by Chairman Proxmire to be very involved in that whole process, and I was asked to come up here and give you a little background on why Congress did that, and then how the Treasury initially used that authority given to it by the Congress.

I should note that the views I am giving today are my own and not of my present employers.

The important thing to remember, under Article I, Section 8 of the Constitution it is the Congress, not the executive branch, which is in charge of foreign commerce and currency valuation. This is your authority, which you have delegated some of it to the executive branch in laws that were passed in the past. If they do not carry it out in a manner that you feel you want it carried out, take it back and do some other things with that authority.

Now, in 1987 the leadership of the Congress was very concerned about the fact that the United States was running these then large trade deficits, and it charged each Committee to develop portions of what would be an omnibus trade bill. This Committee, under the Standing Rules of the Senate, has jurisdiction over exchange rates, so this Committee developed the exchange rate provisions.

We reported that bill to the Senate on May 19, 1987—just about 20 years—and the Committee report said, "The cumulative trade deficits of over $500 billion, built up by the United States since 1982"—that was about $100 billion a year; right now we are running them about $800 billion a year. Then the Congress was concerned about this situation.

Each Committee then led its portions of an omnibus bill on the floor. We went to conference with the House. In that conference report, which is now law, the Congress found that policy initiatives of some of our major trading nations that manipulate the value of their currencies in relation to the United States dollar "continue to create serious competitive problems for United States industries." Now, that was found 20 years ago. That was a finding of the Congress.

Congress then told the Treasury in that law that you should go and analyze the currency practices of these other nations, and if they are manipulating their currencies, the law says you, the Treasury, shall undertake negotiations to get them regularly and promptly to end the practice.

Now, the conferees said in their report, "The success of the legislation hinges on the process of reporting and consultation by the Secretary of the Treasury with Congress." In other words, Congress was saying if Treasury does not carry this out the way they are supposed to, we are going to have a problem.

Now, then President Bush, this law was passed in—it went into effect I think August 1988. President Bush I was the first administration to have this really on the books, and they made good use of it. There was an Under Secretary of the Treasury named David Mulford, who is now our Ambassador to India. He exercised this authority. He identified Taiwan, Korea, and China as currency manipulators. He had no problem saying that, "The law does not permit me to do that. I have to go into intent." He used it. We got them to end the practices, and we got satisfaction.

Now, the important thing to remember, in those days we still had Section 301 on the books. We still have it on the books. Section 301 is the provision of law that permits the United States to identify unfair trade practices and impose tariffs or something on the other country to make them stop the practice.

When we joined the WTO, we essentially gave away 301 because now, even though it is on the books, we can only use that if we first win a WTO case.

Now, what has gone on here? Since 1994 the Treasury has not named one country a currency manipulator, when the facts are so clear that these other countries, including China, are engaged in massive currency intervention in markets to keep their currencies underpriced.

Now, China, I am told—oftentimes with the Chinese they say, well, we have a sovereign right. Well, they would have a sovereign right if they had not joined the IMF and the WTO. When you join these organizations—and the Chinese every day get enormous benefits. Right now if China was not in the WTO, we would not have to give them MFN. When we give them MFN, the average tariff on their goods coming into the United States is about 3 percent. If they did not get MFN, their average tariff would be over 40 percent. So they get an enormous benefit day after day after day. Meanwhile, they are acting completely contrary to Article XV of the

GATT and Article IV of the IMF. They are blowing off these legal obligations that they have in order—and we are sitting here year after year letting it happen to us.

Now, is this just some reason that China has—this is part of China's economic strategy. I have been on that China Commission for almost 6 years. I have really gotten into this. I understand what is going on here.

Once China got into the WTO and locked the U.S. market open and took away 301, they carried on this manipulation. What does it do? It gives American companies an incentive to move operations out of the United States and put them in China and ship back into this market. Sixty percent of China's exports are from foreign-invested companies.

They also provide subsidies and all other kinds of attractions to bring that investment into China, because they know that foreign investment and foreign technology transfer is the way to build their economic strength. China had a very bad 200 years. Their economy fell apart. Their policies fell apart. They are back in a major way. They tried a collectivist approach. It did not work. In 1978, they moved toward this foreign strategy of getting the foreign companies and get the foreign investors to come in.

Now, our companies go along. Why? They are focused on shareholder value. That is what they are supposed to be doing. But the Chinese permit them to make bigger shareholder value by moving production to China and shipping it back here. So there is a divergence that has come between the interests of the multinational corporations and the larger American entity.

Now, the reason this is such a serious problem for this country is that we are letting our economic base upon which is really our defense industrial base, we are letting it deteriorate, and not only manufacturing is going to China, but if you look, you will see now R&D and high-technology things are going to China as well.

So this currency manipulation is an enormous problem. This Committee has the jurisdiction over it. If the present law is not working and Treasury is not doing it properly, rethink that. You yourself could make this finding that China is a currency manipulator, and you could order the Treasury to take this case to the WTO.

I thank you very much for this opportunity and will be happy to field any questions.

Chairman BAYH. Thank you, Mr. Mulloy. I appreciate your perspective on this. You bring a rich sense of history to the subject.

Mr. Nolan, last but by no means least.

STATEMENT OF JOHN W. NOLAN, VICE PRESIDENT AND GENERAL MANAGER, STEEL DYNAMICS, INC.

Mr. NOLAN. Thank you very much, Mr. Chairman. I have to tell you that Mr. Mulloy is a tough act to follow this afternoon. I want to compliment you, Pat. Great job.

Mr. Chairman, Senator Bunning, Senator Casey, I have to say I am delighted to be here this afternoon to represent the great State of Indiana. I will tell you a little bit about my company. Steel Dynamics began its journey in 1994 as a "greenfield" flat-rolled steel producer in Butler, Indiana. Today, we are the fifth largest carbon steel producer in the United States, and we are an American company, with American values and interests. We have 8 production facilities in Indiana employing nearly 2,000 Hoosiers. We have bought or built 12 more facilities in the United States that, when combined with our Indiana operations, produce over 5 million tons of carbon steel products annually. And we are home to more than 3,500 American families.

The Chinese Government has actively intervened in the currency market, as you have heard already this afternoon, to gain export advantage for its manufacturers since 1994. The brilliant Chairman of the Federal Reserve, Ben Bernanke, also understands this economic reality because he has recognized and emphasized this significant point to which most economists agree today—that manipulation of the value of the Chinese yuan by the Chinese Government clearly constitutes an export subsidy for Chinese manufacturers.

Now, given that the Bush administration has failed during the past 6 years to directly confront this unfair trade practice via the WTO, I would like to focus my testimony today on the administration's additional failures to enforce trade laws passed by Congress—trade laws intended specifically to address surging imports from China that materially injure U.S. manufacturers.

Now, in 2001 Congress passed the China Permanent Normal Trade Relations Act. The centerpiece of this act was the inclusion of a China-specific safeguard that was only allowed in U.S. law for a period of no more than 12 years. To everyone's grave disappointment, the President of the United States has all but nullified this congressionally mandated statutory provision.

Since 2002, there have been four affirmative decisions by the International Trade Commission in Section 421 cases. Since the President denied relief in 2002 to U.S. producers of steel wire hangers, wire hanger imports from China surged by 800 percent, from 300 million hangers to 2.4 billion hangers a year. Thirteen of the fifteen U.S. plants producing these products have already shut down. In a March 5, 2007, article, Fortune Magazine reports that the last two steel wire hanger plants—one in Wisconsin and one in Alabama—will be shutting down soon. The Chinese will have gone from 15 percent of the U.S. market to 90 percent of the U.S. market with the rest supplied by other imports. About 2,500 workers lost their jobs in this industry, and the U.S. steel wire rod industry has permanently lost several hundred thousand tons of annual consumption due to the loss of this important downstream market.

Now, in a 2004 case on ductile waterworks fittings, the President again denied relief. In the 3 years since that case concluded, imports from China have more than tripled their market share, from 20 percent to approximately two-thirds of the U.S. market. Major foundries have been shut down in Chattanooga, Tennessee, and Aniston, Alabama. Partial foundry shutdowns occurred in Birmingham, Alabama. Another major productionsite, Tyler, Texas, will shutter its operation dwindle as its parent company ramps up a new foundry—guess where? China. In the very near future, our entire municipal waterworks infrastructure carrying water from every U.S. local water authority to every U.S. home or business will be entirely dependent upon imports from China.

Now, the last Section 421 case—and I emphasize that it will be the last ever 421 case unless Congress changes the law—was near and dear to Steel Dynamics. That case involved circular welded non-alloy steel pipe. The petitioners were many of the steel industry's largest customers. At the time the case was brought, imports from China had increased from 10,000 tons in 2002 to 290,000 tons in 2004. After the President said no to relief in late 2005, these imports soared to 680,000 tons in 2006 and are on pace for nearly a million tons in 2007. Now, for every ton of pipe from China that replaces a ton of pipe produced in the United States, it also takes a ton of steel sales away from SDI and from other U.S. sheet mills.

Now, as a company trying to create and maintain good jobs in the State of Indiana, I am also overwhelmed by the loss of manufacturing jobs in Indiana caused by increased imports from China. Most of these job losses are in the steel-using sectors with the hardest hit being the automotive parts industry. According to the 2007 Indiana Manufacturers Directory, in just the last 12 months Indiana lost 2.4 percent of our manufacturing jobs, 17,000 jobs. Now, remarkably, over 11,000 of those jobs were in the auto parts industry alone. Our State lost 12 percent of its auto parts jobs in 1 year.

Now, I believe that Indiana is representative of the United States job losses in the auto parts industry. More broadly, the Chicago Fed reported that there have been nearly 200,000 job losses in the auto parts industry in just the last 4 years. These job losses were directly attributed to the dramatic increase in auto parts imports from China, from US$1 billion in 2001 to over US$7 billion in 2006.

The Economic Policy Institute has also reported, Mr. Chairman, that Indiana was the hardest hit State in the Midwest in terms of job losses by reason of surging imports from China.

Now, the Commerce Department has refused to even investigate whether currency manipulation is an export subsidy. Mr. Chairman, Senator Bunning, Senator Casey, this is beyond the pale. Application of the countervailing duty law to China and mandating that the Department of Commerce defines currency manipulation as a countervailable subsidy will not result in massive trade disruptions with China. It will merely allow U.S. industries to fight for and obtain the elusive "level playing field" we have for so long sought.

Now, a lot of U.S. manufacturers are dying slowly, painfully, unfairly. Help them live to fight another day and not just because it is the right thing to do. Do it for our children, our grandchildren, their grandchildren, and for the opportunities that U.S. manufacturers represent to each of their futures. I ask this Committee to pursue every possible avenue to combat the damage of Chinese currency manipulation, and I urge the Finance Committee to fast track to the Senate floor provisions within Senator Rockefeller's trade bill S. 364, that would remove Presidential discretion from Section 421 enforcement and require the Department of Commerce to apply the countervailing duty law to Chinese currency manipulation.

With that, Mr. Chairman, thank you very much for this opportunity to appear today.

Chairman BAYH. Thank you very much, Mr. Nolan. We are grateful for your experience in the private sector and the practical perspective that you bring to this important debate.

Senator Casey, would you like to make any comments now?

Senator CASEY. Sure, if Senator Bunning already has.

Senator BUNNING. I have.

STATEMENT OF SENATOR ROBERT P. CASEY

Senator CASEY. OK. Thank you.

Chairman Bayh, thank you and I thank Senator Bunning as well for convening this hearing, as well as for both of your leadership on this issue, and so many others over many years. I want to thank the witnesses for appearing, and we want to get right to questions. I just have a couple of comments.

First of all, we have heard all the data—and there is more to talk about—about the currency manipulation and the impact it has had. I just want to make a few points about Pennsylvania.

Similar to the stories that have been related already, for a lot of people in our State, as is true, Mr. Nolan, in some of the testimony you provided about Indiana and some other States, this is not just some esoteric currency or financial data point. This is real life. Holes in the ground, literally, where not just job loss and people losing opportunity in a way to make a living, but sometimes adding insult to injury, so to speak, is the physical infrastructure of a plant that is literally lifted off the ground and taken away to make it even worse.

So we have got much to do, and I know that we are all looking forward to Secretary Paulson's report and the specific words in that report. Mr. Hartquist, I appreciate you pointing that out that there is a word missing, or two. But I think we are all getting pretty weary that what we might see in this report, frankly, or what we will not see is a lot of action or a lot of results that we can act upon, just more talk and more discussion and more pleas for more patience.

So I want to take the time now to listen to the questions by Senator Bayh and Senator Bunning, and I will have a few of my own.

Thank you.

Chairman BAYH. Thank you, Senator Casey.

Mr. Goldstein, I would like to begin with you. Is it your opinion that efforts to manipulate the value of a currency constitute an effective subsidy? Chairman of the Federal Reserve Bernanke in written remarks I think last December indicated that he felt so. What is your opinion?

Mr. GOLDSTEIN. I think it is an export subsidy and an import tax, so it is both those things. More generally, I think it is just hard to maintain open trade and investment if you have such problems on the currency end. We have got the WTO as one pillar to look at trade policy. We are supposed to have the IMF on the other end.

But the problem is the sheriff at the IMF says he does not want to do this. He just does not want to be an umpire for this. And in the meantime, the Treasury, as mentioned earlier, is not issuing any rulings of manipulation, even when the evidence is obvious. So then, you know, what do you do?

I do not consider it protectionist to take a response if another country is not abiding by its obligations. I just do not buy it. I think you need to have both ends, and if we do not get some more fairness on the currency end, we are not going to be able to maintain the openness that we all want on trade and investment. They are related. And I would like to see an investment in the infrastructure on the currency side that would match what we have on the trade policy side. And I wish Secretary Paulson would put the same emphasis on that as he has been doing recently on financial sector access.

Chairman BAYH. Thank you. I noted with some interest a commentary piece, I think it was yesterday's Wall Street Journal, by a former member of the Council of Economic Advisers who offered the opinion that even if China were to allow its currency to float freely and be determined by market forces, this would not really have any impact upon the current account imbalance because of low wage rates and that sort of thing in China.

Most other economic observers do not agree with that, and it does ignore part of what you mentioned, which is the effective barrier that the current currency peg presents to exports from our country into China.

But I would appreciate your thoughts, Dr. Goldstein, about that commentary and whether you think that is correct or not.

Mr. GOLDSTEIN. I do not think it is correct. I think if China were to implement significant revaluation of the RMB, and particularly if that were followed by revaluations of other Asian currencies, I think it would have a significant impact in reducing the U.S. current account deficit, the global current account deficit.

For example, if we were to get a 25-percent appreciation of all Asian currencies—and as a group they account for 40 percent in the dollar index—that would be equivalent to a 10-percent weighted average depreciation of the dollar. And that is worth about somewhere between, let's say, $130 and $180 billion improvement in the U.S. global current account deficit. That does not take us all the way to where we want to get to, but it would be an important contribution. So, no, I do not agree with Mr. Slaughter's conclusion.

Chairman BAYH. I have probably time for one more question here, but, gentlemen, do not think I am ignoring you. There is going to be another round, and I have got some questions for each of you. But, Dr. Goldstein, if I could just conclude with one more question to you, you ended your testimony by recommending that we attempt to persuade the Chinese to undertake a relatively immediate 10- to 15-percent revaluation of their currency. Is my memory correct in that regard? I think that is what you testified.

What would you suggest we do if they do not? Persuasion has not worked too well to date, and that is one of the questions I have raised at this hearing. I am all for dialog, but dialog without action does not really remedy the problem that exists. And so if the dialog does not lead to the sort of cooperative outcome that you outlined, what do you recommend that we do?

Mr. GOLDSTEIN. Well, I agree, dialog alone is not going to do the job. I would recommend first that we put much more pressure on the IMF to start doing its job. I would not approve their budget, I would not approve any initiatives that go forward until they start doing what they were established to do—namely, to be the umpire on exchange rate policies. So I would exhaust what we can do there.

But if we are not able to get anywhere on that front and the Treasury also continues to hide behind the intent to manipulate rationale and says no foul, no currency manipulation by China, after we have done that, then I think some congressional measures, including trade policy, if it is WTO compliant, we ought to have to consider that.

I regret to have to say to do that, but at some point we need to get something moving here, and it clearly is not moving.

Chairman BAYH. My time has expired, Dr. Goldstein, and Senator Bunning, I am going to turn to you next. But you have mentioned the IMF a couple of times, and they are supposed to be the referee here in this sort of thing. It is a part of their role. Countries are not allowed to try and manipulate trade flows through the artificial valuation of their currency. Do you believe that they have an effective instrument if they had the will and desire to actually referee this? What tangibly could they do in your opinion that would influence China's behavior other than just to say to them, look, you should not be doing what your doing? In other words, if we just replaced dialog with us with dialog with the IMF, what is it actually going to accomplish?

Mr. GOLDSTEIN. Well, I would not underestimate it. A ruling by the IMF, which is the international body responsible for that, I think would carry a lot of weight. As it is now, it emerges as a difference of opinion with China. We think they should go fast; they think they should go slow. Well, if it is a difference of opinion, they would prefer to take their own opinion. But if it is a decision by the body responsible for that that says, no, it is not just ill-advised, what you are doing is illegal, that I think provides a much firmer basis for any action that the United States would take subsequently, and I think it will increase pressure on them. We need to get them named as not carrying out their IMF obligations. I do not think it would just be nothing. I think it would have an effect.

Chairman BAYH. The last part of your point there was a good one, I think. You perhaps place more faith and moral suasion than do I, but if by first taking that step it lends greater international legitimacy to further steps that might be in order, it would be an undertaking well worthwhile.

Senator Bunning.

Senator BUNNING. Thank you very much.

Having been here when Mr. Mulloy and the Senate Committee acted, and I happened to be in the House of Representatives at the time, my patience has run out. I am tired of listening to Treasury tell the Members of this Committee and the Congress of the United States that China is not a currency manipulator. When they do not act, it is the responsibility of the Congress to act. And I think you mentioned that in your testimony, Mr. Mulloy.

I believe persuasion is part of the overall picture. We had Secretary Paulson before us, and I told him that he cannot negotiate with the Chinese because they do not understand that the Congress of the United States writes the laws. Whether they be trade, whether they be currency, or whatever we are dealing with now, TPA—all these things are interwound in our relationship with China.

So my question, first to Mr. Hartquist. Some have said that the approach of the Fair Currency Act, the one that we are talking about, labeling China's foreign exchange policy as an export subsidy, is inconsistent with our WTO obligations. Can you explain why this is not the case?

Mr. HARTQUIST. I would be happy to, Senator. We have done a lot of research on this, and, by the way, I heard a comment recently that a senior member of the administration in the Office of the United States Trade Representative indicated that no trade lawyer in Washington thought that your legislation was WTO compliant. I have not retired yet, and I know there are a number of my colleagues who also share my views about this.

We think it is clear. It is unprecedented, of course, because a case like this has never been brought in the WTO to test the issue, but we believe that under Article XV of the GATT, the frustration——

Senator BUNNING. Article IV in IMF.

Mr. HARTQUIST. And Article IV in the IMF, that the manipulation constitutes a violation of those agreements that, as has been pointed out, China subscribes to. And we also believe—and Fred Bergsten of the Institute where Dr. Goldstein resides gave the same testimony a couple of weeks ago before the tripartite hearing in the House of the Energy Committee, Ways and Means Committee, and Financial Services Committee.

We think this practice does constitute a subsidy. Fred testified that he wrote that agreement when he was at the Treasury Department about 30 years ago. So he knows what is a subsidy, and it is certainly his opinion that this does constitute a subsidy.

So I think when you put those two elements together, this is an issue that, as has been pointed out again and again, is not just an IMF issue, as Treasury wants to treat it. It is a trade issue that is drastically affecting our relationships between the United States and China. And we believe the legal authority is there to enforce these agreements.

Senator BUNNING. Do you believe the Administration understands the consequences of not naming China as a currency manipulator with the Banking Committee and the Finance Committee in dealing with trade? Because we are about to do some things and they are about to get some problems with their TPA that they are not expecting. We have talked and talked and talked with the Trade Representative, with the Secretary of the Treasury, with everybody else in the Administration, and they do not get it. And they understand the power that the Congress has in trade, in TPA.

But unless the Chinese understand it, we are not going to make any progress. As you heard, there is not one word in the Secretary of the Treasury's statement mentioning currency. Well, if that is the case, we are not having a real dialog with the Chinese on this major problem that we are dealing with.

Mr. HARTQUIST. Senator, I think certain elements of the administration do understand this, but the turf has been ceded entirely to the Treasury Department. We have made the argument to USTR, look, this is a trade issue, you are responsible for trade; it is going to come down on your heads if nothing is done about this problem because of the impact on our economy and jobs.

But they cede authority over currency matters entirely to the Treasury Department, and, therefore, the administration has made the decision that that is where it is going to end.

Senator BUNNING. But it will not end there. I just want you to know that because there are certain of us that sit on the Banking Committee and on Finance, and we are up to ears with the non-compliance. First of all, they passed all the WTO implementation laws, China did, and now they are not complying with them, whether it be on banking, whether it be on—whatever it is. All you have to do is walk down the street of Beijing, and you will know that intellectual property laws are not being enforced anywhere in the country. Just get to Beijing and walk down the street, and you will find anything you want to find; goods that are not complying with our intellectual property laws.

I have gone over my time, Mr. Chairman. I am sorry. But I feel so deeply about this, and being a free trader, I want to be a fair trader, but I do not want to get, you know, the short end of the stick in doing it. And that is what the United States is getting right now because of China's manipulation of their currency.

Chairman BAYH. Thank you very much, Senator Bunning. I appreciate your passion for this issue.

Senator Casey.

Senator CASEY. Thank you, Senator Bayh, and thank you for calling this hearing, again. And Senator Bunning once again demonstrates the passion that I think is consistent with and is rooted in the frustration that a lot of Americans feel when they almost feel powerless to be able to address this kind of issue.

I wanted to highlight the legislation that all three of us have supported, led by Senators Bunning and Bayh, and I am proud to cosponsor it. But I just wanted to highlight a couple of the headlines, so to speak, to refresh recollections.

Part of what the legislation does is provide that exchange rate misalignment by any foreign nation is a countervailable export subsidy. It also clarifies the definition of "manipulation." It expands the power of the International Trade Commission to impose countervailing duties on products from a country that has been provided a countervailable subsidy.

So that is a piece of legislation which represents part of, and maybe a significant part of, an action plan. And I wanted to probe a little deeper—and I hope we can do more on the second round—on some of the testimony here today.

First of all, I will start with Mr. Mulloy, only because you are from Pennsylvania. Otherwise, you would be in at the end of the alphabet, right? And I have to say you went to Kings College and you went to the same law school my father and my brother went to, so I will give you the easiest question.

I was struck by what you said in terms of the history of the Committee and your role in that as counsel, and I am just wondering, in light of what you have heard already, in light of what you have observed and seen in the news, and in light of the brief, albeit headline summary I gave you of Senate bill 796, what else should the U.S. Senate and, in particular, this Committee do? Some of it you addressed, but even by way of reiteration, if you would just tell us how you think we should grab hold of this if there is continuing reluctance by Treasury and the administration.

Mr. MULLOY. Senator, thank you for asking me, Senator. I maintain very close ties to my roots in Pennsylvania. In fact, I am going up there Memorial Day weekend. I have seen in Pennsylvania what happens when an economy begins to fall apart, and it is very damaging to families and communities, tax base, and everything else.

My worry is this can be precursor to this happening to the United States if we do not begin to have some different approaches to the way we do trade.

In my testimony, I have said this exchange rate is not just a silver bullet. This alone will not solve some of our trade problems. We need a more comprehensive, integrated approach to this globalization, and I put some comments in my testimony on it.

But one thing you have to understand—and this fits with Senator Bunning's question. You know, the National Association of Manufacturers, 90 percent of their companies may be small, and they were supporting the Bunning-Stabenow approach to this. When it got up to the final vote on that within the NAM, the big multinationals headed it off, saying it was somehow WTO illegal, even though they had two other law firms that said it was WTO legal.

So you have a group of companies in this country—and they are not being evil, but they are working to get shareholder profits, and they do it by maintaining the system the way it is going now.

I think it is a very short-term look on their part, but a lot of these corporate guys are in it for the short term. I think you have got a real problem on this divergence.

Now, on the currency issue, I am very much in favor of the Stabenow-Bunning bill to make this countervailable. But I think we should also be bringing a WTO case against China.

Now, why is the IMF very important in this? Under Article XV of the WTO, when you file that case, Senator, what will happen is under that rule they will immediately turn to the IMF for its advice on currency issues. So getting the IMF to take a position on this is very important.

Now, I have an article which I would like to put in the record of this hearing. This is an article from September 28, 2005, "IMF Chief Opposes United States on China." This article says that the IMF——

Chairman BAYH. Without objection, Mr. Mulloy, we will include[1] that with your testimony.

Mr. MULLOY. Thank you, Mr. Chairman.

The IMF is urging China to allow its currency to move upward. The IMF understands what is going on here. But listen to what they said. The head of the IMF says to Treasury, "Treasury itself has refrained from tagging China for manipulation in its own semiannual report on foreign exchange policy."

The IMF is hiding behind the fact that Treasury has not done its job. If Treasury will do its job, it makes the—and it is reality.

[1] The article referred to can be found on page 100 of this hearing.

They are underpricing their currency. Massive interventions in currency markets to do it. Increasing leverage over U.S. debt. They have got $1.2 trillion of foreign reserves now, many of them invested in U.S. Government bonds. This is an enormously building problem. So you have got to bring—do Bunning-Stabenow, but also bring the case into the IMF.

Then, third, begin to think about how we bring the divergence between the multinational corporations and the American national interest back into line. And I am working with a group called the Horizon Project, and we made a report to the Congress laying some of those issues out in that report that we did in February, Senator.

Senator CASEY. Thank you. I know I am out of time, but we will come back.

Chairman BAYH. I would like to follow up on Senator Casey's good question and your excellent answer, Mr. Mulloy. As you describe it, you recommend bringing a WTO case, but they will immediately turn to the IMF.

Mr. MULLOY. Right.

Chairman BAYH. Which is hiding behind the Secretary of Treasury, which, in your testimony, leads me to ask: You mentioned Mr. Mulford and the previous interpretation of the law that the first Bush administration had, that he had. Why is this administration taking so different an approach where, as you say, they have not even identified one currency manipulator in spite of the overwhelming evidence?

Mr. MULLOY. Well, this requires me to maybe say some things that I—I will give you my opinion.

Chairman BAYH. That is why you are here, Mr. Mulloy.

Mr. MULLOY. The guys in the Treasury are very close to the Wall Street crowd. The Wall Street crowd is making a lot of money running the system the way it is being run. And you will notice that Paulson pushed very hard to get more access for financial firms into China.

I was at a meeting a couple weeks ago where Paulson was talking about that, and one of the people in the audience from China, former head of—I was in Shanghai a couple years ago, and he was running—he was No. 2 in the Shanghai Stock Exchange. And he said, "If we did that, provided more access to your financial firms, would that take some of the heat off some of these other issues, including the exchange rate?"

So I think there is a split going on here in our society——

Chairman BAYH. They do not seem to have provided that access, even if the answer was yes.

Mr. MULLOY. Yes. There is a split going on between the interest of some of the folks on Wall Street and some of the multinational corporations who make a lot of money with this system going on. I hate to say this, but many people who leave the Treasury go work for these financial firms. So I think there is an inordinate influence, and that is why it is so important for the Congress to conduct the kind of oversight that Chairman Dodd and Chairman Shelby and others have been doing. You have got to put a lot of pressure on those guys.

Now, again, under the Constitution, if Treasury does not do it, it is your authority under the Constitution to deal with foreign commerce. And if you do not like what they are doing and they will not do it, give it to somebody else or do it yourself. Make that judgment. You can do it under the Constitution.

Chairman BAYH. Thank you, Mr. Mulloy. You have provided some key insights.

Mr. Hartquist, I would like to now turn to you, and based upon what Mr. Mulloy was saying and the advice that was rendered to a couple of the multinationals, apparently you are not the only lawyer in Washington who takes a similar view of the steps that Senator Bunning, Senator Casey, and I have proposed are WTO compliant.

As I understand, there is a three-part test, financial contribution benefit, but that the key element that seems to be the sticking point here is whether it is specific, company specific. So I would like to ask you about that. What in your opinion leads you to believe it is WTO compliant because the test of specificity is met?

Mr. HARTQUIST. Mr. Chairman, our answer to that is really a very simple one. It is because the benefit is contingent upon export performance. Essentially what happens is when the Chinese companies export to the United States, they get paid in dollars. If the currency were properly valued, they would get about five—the exchange rate would be about one dollar for five yuan. But under the current system, it is more like one dollar for eight yuan. So they qualify for it by exporting their goods. That is a very specific act that they must accomplish. And then they pocket an extra three yuan, about a 40-percent differential, because of the undervalued currency.

Chairman BAYH. Why the disconnect, in your opinion, or any of the other panelists, between the IMF's approach to this where they have concluded that this has a harmful effect upon global trade flows and that kind of thing, and yet the sort of this academic three-part test where, you know, Ben Bernanke says, sure, it is—I think the words he used—"effective subsidies." Dr. Goldstein says the practice effect is a subsidy. The IMF says that is bad and you have got, you know, this three-part test that seems academic in the extreme and divorced from the reality of the marketplace. Anybody hazard a guess as to why they have taken this interpretation?

Mr. HARTQUIST. I think, Mr. Chairman, that there are several things going on here. One is there is real fear that the Chinese banking system may simply collapse if this issue is not handled properly. The estimates are that there are about $800 billion in bad loans in the Chinese system, and a lot of that money has gone to setting up industries that are competing with us every day. We are supposed to compete with them one on one——

Chairman BAYH. Well, I hear that, and I appreciate that. But that is a different issue. I mean, we have got to get on the right path and then make sure it is sustainable from their standpoint as well. Nobody wants their banking system to collapse, but that is kind of a different issue, which I hope they have not derived this test just to obscure that. But please continue.

Mr. HARTQUIST. Well, I was going to make two other brief points, if I may. I think beyond that, the Chinese are almost frozen in time themselves. They are very concerned about their economy collapsing if they handle this wrong. They are concerned about the banking system. They are concerned about having to create tens of millions of jobs for their citizens every year. And they are concerned about retaining political power. Very concerned about that. The development of a middle class, a more independent class in China, is in many ways a threat to the regime in China. And I think that the U.S. Government is looking at these issues, too, and is saying if we get this wrong, there could be catastrophic consequences. But that is no excuse for not taking the actions that we can take under the law to get China to really get in gear here and start to make these changes.

Chairman BAYH. My time has expired here at the beginning of the second round, Mr. Hartquist, but I referenced some of that in my opening statement about the desire of the Chinese for stability in their country and, therefore, the need to maintain very high rates of growth. So I agree with what you said.

Dr. Goldstein, you were nodding your head, and I am going to get to Senator Bunning. Is there something you want to add here?

Mr. GOLDSTEIN. Well, I do want to make a comment, if I could have 2 minutes. Some of the language in a number of the currency bills I think is of a lot of practical import, and that is, the distinction between manipulation and misalignment. Some people simply think that misalignment is a politer word for manipulation, but it is not.

Manipulation means the government is taking a specific prohibited policy action to keep the exchange rate away from where it ought to be. Usually that is large-scale, protracted one-way intervention.

Misalignment just means the exchange rate is away from where it ought to be for whatever reason. It could be because of a Government policy action, or it could be because the market has got it wrong.

Now, what happens if you do this? If you do manipulation, there are three advantages. One advantage is it tells you who is at fault. If you are engaging in large-scale one-way intervention, you are at fault. So China is at fault. The U.S. is not doing that; we are not at fault.

The remedy is also clear. Stop doing the prohibited action. Stop intervening, and you get a relative limited list of offenders—in this case, probably China, Malaysia, Taiwan. You probably will not get Japan under that.

The disadvantage is you miss some cases where the exchange rate is out of line, but the country is not obviously doing something. But if you do misalignment, then you have got a real problem. It is misaligned, but why? The yen is misaligned because Japanese interest rates are too low or the U.S. interest rates are too high? You do not know who is at fault. You also do not know what the remedy is because it can be due to many things, and you get a very different list. In particular, the same people who are going to tell you the RMB is seriously misaligned are also going to tell you the dollar is misaligned, the dollar is overvalued.

So if the purpose of the legislation is to put the U.S. in the dock—which I did not think it was—misalignment will do that for you. Manipulation is different. If you do not like the word, call it something else. Call it destabilizing intervention. But you need to be careful about this because otherwise you get some unintended consequences and you get a recipe for inaction rather than, I think, what you want.

Chairman BAYH. Thank you, Dr. Goldstein.

Senator Bunning.

Senator BUNNING. Thank you.

Mr. Mulloy, I would like to follow up on some things. China recently announced plans to invest $3 billion in the Blackstone Group—the same company that recently attempted to buy Chrysler Corporation. Do you believe China has begun using its $1.2 trillion in foreign exchange reserves to buy United States companies using the Blackstone Group as a platform?

Mr. MULLOY. Thank you, Senator, for that. I was very fortunate to have been invited before this Committee to testify on CFIUS legislation about a year and a half ago. And, again, I was very involved when we wrote that legislation. That was part of the 1988 trade bill, again, Senator.

Senator BUNNING. We are trying to do it again, as you know.

Mr. MULLOY. And my concern then was when you are running massive trade deficits like the United States is, you are sending dollars out of the country. The other country, if they are not buying your goods, has those dollars.

Now, so far China has been investing those dollars in U.S. Treasuries, Fannie and Freddie. But in that testimony at that time, I said there will be a time when the Chinese are going to start buying major assets in the United States economy. And that is why it is very important for this Committee to have a good CFIUS process in place to understand the national security significance of what is going to happen. The cake is already baked. They have the money. The purchases are going to be coming.

Now, I have read speculation—and I have not analyzed it myself—that one way—and remember when they tried to buy Unical.

Senator BUNNING. Oh, yes, I sure do.

Mr. MULLOY. You know, that company, that was not a private sector Chinese company. That is a government-directed company, and that is the important thing to understand. Many of these Chinese companies, they are not private sector people. They are organized and controlled by the party and the Chinese Government.

So I have read speculation—and I do not know, and this Committee might want to do a hearing on it—to understand that they are going to use some other way because Congress reacted against the purchase of Unical. They may try these other back-door ways of getting major assets in the United States economy, which will be important, what we call "national security jewels" for the United States, which will end up being owned by the government of another country.

So I think it is very important that you have a good CFIUS process in place and do the kind of intelligence that needs to be done in looking at those kinds of purchases.

Senator BUNNING. Then you do believe, as most of the panel here, that the manipulation of the currency and the misuse or ill-fated use of their assets in bonds and/or government dollars, our dollars, could be used to undermine our own economy?

Mr. MULLOY. Well, let me say this: First, I went to China for the first time in 1981. I like the Chinese people. They are a wonderful people. I am not out to demonize China. And I always tell my Chinese friend, this imbalance in this economic relationship, if you let it go on, you are going to poison the political relationship. And we do not want to poison the political relationship with China because we have so much to work with them on—global warming, ocean pollution, energy, a lot of things.

But here, by permitting this situation—I think I would call it "metastasize." By permitting this to go on year after year, we are permitting the Chinese to gain enormous leverage over our economy and now have the assets to come in here and buy important parts of our economy.

Now, what will that do? It will give them even more political influence on our political system, because if they own major assets in the United States, those assets and those people are going to become more favorable toward China.

So this is very important that we begin to get this under control soon, and not let it just go on year after year.

Senator BUNNING. Well, then, do you believe that is one of the reasons Treasury and the current Administration is sitting there with their hands folded?

Mr. MULLOY. I do not know why the Treasury and the administration—I personally think they have gotten themselves preoccupied with another area of the world, and they are not understanding the significance of the global trends which are presently in place and which I saw as a member of that China Commission for 6 years. And the last 2 years of it, we had Senator Fred Thompson on that Commission, and he signed on to that last report. These are big problems, and we are letting them build and get bigger and bigger and more difficult to unwind. And that is why I am speaking so forcefully that these are important matters. And it does not mean you demonize the Chinese if you say to them no——

Senator BUNNING. None of us are trying to demonize the Chinese. We are trying to get at a problem that we will probably overcome us eventually if we do not overcome it. So I have no fight with the Chinese, except that we did take six members of the Trade Subcommittee to China to talk trade with the Chinese, and they would not meet with us. I find that, you know, astounding that the Trade Minister would not meet with six members of the Finance Committee. In other words, they do not understand the give and take that goes on in the United States. They dictate to their Congress what they want done. The administration cannot dictate to our Congress what they want done.

Mr. MULLOY. Let me just give you one last thing on this. A year ago, just about June of a year ago, 2006, I was in China with a group from the China Commission, and we had a meeting. The Consul General in Shanghai had a dinner for us, and he had a number of the American corporations doing business in China at the dinner. And there were two things that struck me about that dinner: one, how many of these corporations say these historical things, these historical flows are going to happen, in other words, the power and the economic wealth moving to Asia is going to happen; but at the same time, how terrified they were of the Chinese

Government. They do not want to be bucking the Chinese Government because there is no real rule of law in China. They are dependent upon favors for non-arbitrary treatment from the Chinese Government. So they can end up—and there is a good book called "The China Fantasy" by Jim Mann, who had the article in the Outlook section of the Washington Post this weekend, "The China Fantasy," where he says the Chinese in time can make American companies cheerleaders for their policies.

Senator BUNNING. Thank you, Mr. Chairman.

Chairman BAYH. Thank you, Senator Bunning.

Senator Casey, are you needing to leave? OK. Thank you for your attendance.

Gentlemen, just a couple more questions, and I appreciate your patience. Mr. Nichols, any effort to quantify if the Chinese really did open up—and I thought your testimony was excellent about how, you know, that would actually benefit Chinese consumers and help to promote U.S. exports and that kind of thing. But with regard to financial services in particular, are there any—have you made any estimations about how much business you think could be done there and how many jobs that might create here domestically? You know, they obviously have a comparative advantage in some aspects of the economy. Here is one where we have a comparative advantage. If they really did open up, what would our advantage be?

Mr. NICHOLS. Well, it would be significant, and I will answer that in just a couple of ways. Actually, I was asked here to talk a little bit today about market access. I want to complement a point he made and build on it a little bit. It is true that we are pushing for increased market access. That is absolutely the case. But we are trying to explain why that is good for America. So our coalition is aggressively pushing Treasury to focus on market access because of the impact we think it will have on currency, as well as the trade deficit.

There are some estimates that I have seen that suggest there is \$2 trillion in the pockets of Chinese families, essentially mattress money, that if increased access to financial services can help spring that and bring that here to America to our exporters and to our service providers—I do not know exactly how many jobs that would translate into or to the sort of GDP growth, but——

Chairman BAYH. We would not get the all the business, right? There are other competitors——

Mr. NICHOLS. Absolutely not. There would be some growth within China, certainly, as their economy transforms, as well as in the euro zone, but certainly here as well.

Chairman BAYH. Is part of their reluctance, do you think, related to the point Mr. Hartquist raised about the fragility of their financial system and perhaps some of their own domestic financial companies and players that are afraid if they just opened up, they would be forced out of business, that kind of thing?

Mr. NICHOLS. I suspect there is something to that. I would like to add to a broader point, that, you know, the U.S. financial services industry is not pleased with the pace of reform, and I would like to align myself with those who say there is greater risk in them moving more slowly than more quickly.

In terms of the pace of reform in China, it is not at a pace that we think is——

Chairman BAYH. And I concur with that. And, look, I am not insensitive for the need for there to be stability in China from a variety of perspectives. But this process of globalization and in our bilateral relationship we have certainly been willing to take on some domestic dislocations here.

Mr. NICHOLS. Right.

Chairman BAYH. That needs to be, you know, a two-way street so that the laws of comparative advantage and natural competitive factors can allocate resources, labor, and so forth.

Mr. NICHOLS. Right. In fact, Mr. Chairman, the Financial Services Forum—I am speaking outside of the ENGAGE CHINA Coalition, but with regard to my day job, we are taking a look at that. And, in fact, we have a study that we are working on right now that will help come up with a series of public and private sector responses to those who are not sharing, to individuals and families and communities that are not sharing in or feeling the full benefits of globalization. We have hired three economists—a Republican, a Democrat, and an Independent, including Matt, whom one of you mentioned Matt's op-ed yesterday in the Wall Street Journal. He is one of the three that we have employed. We think in terms of this broader trade debate——

Chairman BAYH. I am glad you have employed some others.

Mr. NICHOLS. You know, one of each. But I——

Chairman BAYH. Can I nominate Dr. Goldstein?

[Laughter.]

Mr. NICHOLS. But the point, though, is that there are dislocations, and those are not—entire communities, regions, families, individuals who are feeling in the full benefits and sharing in them. And it is important that both the public and private sector tackle that policy issue and help those people.

Chairman BAYH. It may be a bit soon, but do you have any reaction to the communique that came out at the end of the economic dialog? We have touched base with a few of your members, and at least from what we heard, I think the word "underwhelmed" perhaps could apply.

Mr. NICHOLS. Anticipating that, Mr. Chairman, we just met right before your hearing today, and we see the results today at this moment as there has been some progress, but there is much, much more to do in many areas, specifically regarding market access. So there is some progress, and we think we want to see more milestones. We appreciate the long-term structure of the Strategic Economic Dialogue, and we do think engagement with the Chinese is the right answer.

That said, some progress today. Much more to do.

Chairman BAYH. Said very diplomatically, Mr. Nichols. Thank you.

Mr. Nolan, perhaps can you share with us your perspective? As I understand it, in your particular industry the capacity to produce steel in China is expanding significantly. Is that accurate?

Mr. NOLAN. Mr. Chairman, it is extraordinary, is the word I like to use.

Chairman BAYH. And the concern is that even with the rapid rates of growth in China, the expansion of their steel production capacity is outstripping their projected domestic demand. Is that a fair characterization?

Mr. NOLAN. That is absolutely the case. They are the most underpriced market on the globe today, and it is a consequence of oversupply.

Chairman BAYH. And so if that is true and they continue to add capacity in excess of domestic requirements and that production then is put on the global market, the 40-percent currency distortion, if that is an appropriate word, what would that do to other global competitors and companies such as your own?

Mr. NOLAN. Well, I think the word that comes to mind is "tsunami." It would, I believe, put the world steel-producing community in a position where the potential to return any opportunities to shareholders would diminish to the point of becoming nonexistent.

Chairman BAYH. And just one last question, and then I will have 30 seconds of comments. And, again, I appreciate your testimony and your patience today. This has been very, very interesting. Getting back to the op-ed yesterday, which seemed to say that there were other competitive forces that would more than overcompensate for the currency issue, do you find in your markets, you know, is labor alone, is that a 40-percent—and you have got transportation costs, you have other costs, a lot of businesses out there where the competitive—we are within 40 percent, that is what I am trying to say, for a lot of companies. And if the currency thing were removed, there would be a lot of U.S. producers here that would be competitive, where otherwise that is not the case because of the currency issue? Is that a fair observation or no?

Mr. NOLAN. Senator, I have been waiting for you to ask that question. It was asked in a slightly different fashion just last week, and the question was: As an exporter, can I get to China? And I would tell you, at eight yuan to the dollar, as they used to say in Maine, I can't get "they-ah" from "hey-ah." We would struggle at six. But we would be there every day at four.

You know, I can do the financial math for you if you would like, but I think you can probably figure it out, you know, or staff can figure out for yourself. Clearly, there is enough standing capacity to support considerable demand in China. They do not have to build it themselves. All they need to do is to give us an opportunity to get there.

Chairman BAYH. Thank you, Mr. Nolan.

Well, I will conclude by associating myself with some comments that Mr. Mulloy made, and I think the rest of you would concur with, and that is, that China is a great nation in many respects, and they have a bright future. They have got hard-working, intelligent people. They have a rich culture. And it pains me to see these tensions in our relationship. We very much want a cooperative relationship with China. There are so many things that we can be working on together, and yet this is a source of disruption within what should be a more cooperative relationship. And we can no longer allow it to fester because there are adverse consequences to our Nation that, as a great country, we cannot sit idly by and allow it to occur. And so that is why a course of action on a sustainable timeframe, that is what really is required here, and this endless dialog leading nowhere is only going to lead to worsening relations, and that is not in China's interest, in the U.S. interest, or the world's interest. And that is why we have conducted these hearings today, and, gentlemen, that is why I am very grateful for your presence and for your thoughts.

Thank you all for attending. The hearing is adjourned.

[Whereupon, at 4:28 p.m., the hearing was adjourned.]

[Prepared statements supplied for the record follow:]

PREPARED STATEMENT OF SENATOR CHRISTOPHER J. DODD

I would like to thank Senator Bayh, Chairman of the Subcommittee on Security and International Trade and Finance, for holding this important and timely hearing on U.S. economic relations with China.

One of the very first actions that I undertook as Chairman-elect of the Banking Committee in December 2006 was to write a letter with then-Chairman Shelby to the Treasury Secretary on the occasion of the first Strategic Economic Dialogue ("SED"). In January 2007, I chaired a hearing with Secretary Paulson on exchange rates and the SED. At that hearing, Treasury Secretary Paulson testified that the SED is the "best chance to get some progress [on the currency issue]." The second session of the SED concluded in Washington this morning and I am eager to learn more about any progress made on both the currency and market access issues that the hearing today will address.

The issues of exchange rates and market access represent two significant hurdles in the U.S.-China economic relationship. China is a source of tremendous opportunity for the United States, but also a source of new challenges that must be overcome in order to reach the full potential of our economic relationship. Foremost among these challenges is the need to level the playing field for American firms doing business in China and for American workers and companies producing goods for sale at home and abroad. Currently, the trade of goods and services is tilted to advantage Chinese firms because of ongoing Chinese government intervention to keep the yuan undervalued and China's discriminatory treatment of American and other non-Chinese financial services firms.

The most recent Commerce Department data shows that the bilateral trade deficit increased from $47 billion in the first quarter of 2006 to $57 billion in the first quarter of this year, accounting for over thirty percent of the overall U.S. trade deficit. These numbers have very real consequences in terms of our nation's manufacturing base and the communities in which manufacturing firms are based. Nearly 22 percent of manufacturing jobs have been lost in my home state of Connecticut over the last ten years. Over the past six years alone, our nation has experienced the loss of three million manufacturing jobs.

To be sure, China's undervalued currency is not the sole, or even predominant, cause of this loss of American manufacturing jobs. But just as surely, China's devaluation of its currency is, in my view, a major contributor to the loss of U.S. manufacturing jobs and our bilateral trade deficit. Federal Reserve Chairman Ben Bernanke said as much last December when he referred to "the effective subsidy that an undervalued currency provides for Chinese firms that focus on exporting."

While China benefits from this export subsidy, they also enjoy open access to investment in America's markets. Over the weekend, the Chinese government announced its purchase of a 10 percent stake in the U.S. private equity firm, Blackstone. Far from being protectionist, this transaction demonstrates the openness of the American public and the American markets to foreign investment. Unfortunately, U.S. financial services firms are not afforded the same open treatment in China's markets. For too long, U.S. financial services firms have been denied the open access that our country provides for Chinese firms in the United States.

I welcome today's announcement from the SED on financial sector reform which will resume the previous practice of licensing foreign securities companies, raise the quota for Qualified Institutional Investors ("QFIIs"), permit foreign banks to offer domestic currency credit cards, and improve the application and licensing process for insurance companies.

However, significant discriminatory policies remain that protect China's financial sector from foreign competition. For example, today's announcement does not address China's restrictions on foreign bank branches' ability to offer full domestic currency services to Chinese individuals, including restrictions on domestic currency loans and deposits. China also restricts the operating structures under which foreign firms do business, limiting activities to branch offices instead of subsidiaries, and limiting the geographic reach of foreign firms. Because of these ongoing restrictions, only one American bank is fully incorporated in China. China also limits the foreign equity stake in state-owned banks to 25 percent, imposes unequal capital requirements on foreign banks, and maintains an onerous application and approval process for a range of financial services operations.

These policies hinder the ability of U.S. firms to compete in China and to expand their market presence among a consumer population in need of financial services, products, and expertise. I urge the Administration to continue to use all tools available to eliminate unfair trade advantages resulting from China's discriminatory policies. My hope is that American firms in China will soon experience the type of fair treatment and open access that the United States provides to the Chinese. As

Steve Bartlett, president of the Financial Services Roundtable recently stated, "if the Chinese government is allowed to invest in Blackstone, the Chinese people should be allowed to invest in Merrill Lynch or Raymond James."

Simply put, American workers and businesses are being forced to compete on tilted terrain, and our government must take action to level the playing field. Last week, Senator Shelby, who as Chairman of this Committee conducted vigilant oversight and numerous hearings on exchange rates, and I wrote a letter to Treasury Secretary Paulson urging him to take the necessary steps that will bring an end to the unfair currency practices and market access barriers that are contributing to the trade deficit and damaging the competitive position of American workers and businesses.

Adequately addressing these unfair trade practices may require steps beyond diplomacy and the Strategic Economic Dialogue, as Secretary Paulson's colleagues in the Department of Commerce and the Office of the United States Trade Representative have recently demonstrated. I believe that one such step should include citing China for currency manipulation in the upcoming International Economic and Exchange Rate Policy Report, which was due to this Committee on April 15th. This report is the only mechanism currently in place for the United States to publicly monitor and remedy unfair trade advantages resulting from currency manipulation.

Under a law passed by this Committee nearly two decades ago, the Treasury Department has a statutory obligation to use this reporting mechanism. The American public relies on the Treasury to ensure that countries who manipulate their currencies "regularly and promptly adjust the rate of exchange . . . to eliminate the unfair trade advantage." Given Treasury's current approach on currency manipulation, I look forward to learning from today's witnesses and others about additional strategies and options the United States should consider to better address the unfair trade advantage resulting from China's currency and discriminatory market access policies.

PREPARED STATEMENT OF SENATOR SHERROD BROWN

Good afternoon. Thank you, Senator Bayh, for holding this important hearing on U.S. economic relations with China. And thanks to those of you here to testify.

Our economic relationship with China is one of critical importance to the working men and women of Ohio, where we have lost 180,000 manufacturing jobs since 2001—including more than 50,000 jobs to China in the last decade alone. In a state where the economy is largely driven by manufacturing, the dramatic influx of Chinese manufactured products and the loss of jobs in Ohio are surely related.

We need to think carefully about where these trends are leading us. Manufacturing is not only important to our economy, its essential to our national security. What is happening in Ohio and in other manufacturing states has dramatic implications for our nation as a whole. I think most economists would agree that China's exchange rate manipulation has been a major contributor to our trade imbalance. China's RMB is undervalued by roughly 40 percent, due to the government's strong efforts to keep it artificially low. Partly as a result, imports from China have increased by 20 percent in the first quarter of this year and may hit yet another record high.

In the past few weeks, in preparation for the Strategic Economic Dialogue, the Chinese have decided to widen the daily trading band on the RMB from .03 percent to .05 percent. Gestures like this are certainly not substitutes for real concrete measures.

I'd like to take a minute today to discuss a few important issues with regard to the economic relationship between China and my home state of Ohio. Ohio's largest exports are in manufactured goods such as machinery, vehicles, and steel. For Ohio's workers and businesses to remain competitive in the global economy, we must ensure that other countries play by the rules. Our manufacturers cannot and should not have to battle Chinese currency manipulation and they cannot and should not lose out to unfair competition from firms in China that are propped up by heavy government support.

Approximately 30% of the Ohio's manufacturing activity is related to motor vehicle production. When you consider the indirect jobs related to the industry, it is the largest industry in Ohio's economic base. Nearly 10% of all Ohio workers—over 652,000—depend on the motor vehicle industry for their livelihood. This is also an industry that the Chinese government has explicitly targeted to promote.

The Chinese government is actively trying to increase exports of auto parts, many of which are fake or faulty. The auto parts industry loses $12 billion annually, including $3 billion in the U.S. alone to counterfeit auto parts—and China is responsible for about 75 percent of those fake products.

Moreover, the Chinese do not provide for equal treatment of U.S. auto parts in the Chinese market as they committed to do when they joined the WTO. Instead, they impose a 25 percent charge on imported auto parts. This is in clear violation of the basic commitment that all countries agree to when they join the WTO.

We often hear proponents of China talking about the complex challenges the country faces in moving towards a "responsible stakeholder." If it is unable or unwilling to simply apply national treatment to imports, I have reservations about our overall trade relationship.

Although the WTO cases recently filed against China's illegal industrial subsidies, as well as the IPR and auto parts cases, are steps in the right direction, manufacturing is too critical to Ohio's families and future to wait for the often several years it takes for the WTO to make it final determination. I look forward to hearing about the ways we can address these issues in the more immediate term. Thank you.

THE DOLLAR AND THE RENMINBI

Statement by
C. Fred Bergsten
Director, Peterson Institute for International Economics[1]

Before the Hearing on

US ECONOMIC RELATIONS WITH CHINA: STRATEGIES AND OPTIONS ON EXCHANGE RATES AND MARKET ACCESS

Subcommittee on Security and International Trade and Finance
Committee on Banking, Housing and Urban Affairs
United States Senate

May 23, 2007

The Central Role of China in the Global Imbalances

The US global merchandise trade and current account deficits rose to $857 billion in 2006. This amounted to about 6.5 per cent of our GDP, twice the previous record of the middle 1980s and by far the largest deficit ever recorded by a single country[2]. The deficits have risen by an annual average of $100 billion over the past four years.

China's global current account surplus soared to about $250 billion in 2006, more than 9 per cent of its GDP. Its trade surplus has doubled again in the first quarter of 2007, suggesting that its current account deficit will exceed $300 billion in 2007 – the largest ever recorded by any country. China has become by far the largest surplus country in the world, recently passing Japan and far ahead of all others. Its foreign

[1] Dr. Bergsten has been Director of the Peterson Institute for International Economics since its creation in 1981. He was previously Assistant Secretary of the Treasury for International Affairs (1977-81) and Assistant for International Economic Affairs to the National Security Council (1969-71). The latest of his 37 books is as co-author of *China: The Balance Sheet: What the World Needs to Know Now About the Emerging Superpower,* prepared jointly by the Center for Strategic and International Studies and the Institute for International Economics and published by Public Affairs Press in March 2006.

[2] I note with pride that, based on the work of my colleague Catherine L. Mann, I predicted precisely such an outcome for 2006 in the third paragraph of my testimony before the full Committee on May 1, 2002.

exchange reserves have also passed Japan's to become the largest in the world and now exceed $1 trillion, an enormous waste of resources for a country where most of the huge population remains very poor.

China's role in the global imbalances is even greater than these numbers might suggest. A substantial increase in the value of the Chinese currency is an essential component of reducing the imbalances but China has blocked any significant rise in the RMB by intervening massively in the foreign exchange markets. It has been buying $15-20 billion per month for several years to hold its currency down and its level of intervention jumped to a monthly average of $45 billion in the first quarter of this year.

By keeping its own currency undervalued, China has also deterred a number of other Asian countries from letting their currencies rise very much (if at all) against the dollar for fear of losing competitive position against China. Hence China's currency policy has taken much of Asia out of the international adjustment process. This is critical because Asia accounts for about half the global surpluses that are the counterparts of the US current account deficit, has accumulated the great bulk of the increase in global reserves in recent years and is essential to the needed correction of the exchange rate of the dollar because it makes up about 40 per cent of the dollar's trade-weighted index. The most obvious Asian candidates for sizable currency appreciation in addition to China are Japan, whose currency is also substantially undervalued despite the absence of intervention for over three years, Taiwan, Hong Kong, Singapore and Malaysia.

China has recently let the RMB rise marginally against the dollar. Since China continues to link its exchange rate to the dollar and the dollar has fallen against virtually all other currencies, however, the average exchange rate of the RMB is weaker now than in 2001 when China's current account surplus accounted for a modest 1 percent of its GDP. The world's most competitive economy has become even more competitive through a deliberate policy of currency undervaluation.

About one quarter of all of China's economic growth in the past two years has stemmed from the continued sharp rise in its trade surplus. China is thus overtly exporting unemployment to other countries and apparently sees its currency undervaluation as an off-budget export and job subsidy that, at least to date, has avoided effective international sanction.

The Risks for the US and World Economies

These global imbalances are unsustainable for both international financial and US domestic political reasons. On the international side, the United States must now attract about $8 billion of capital from the rest of the world every working day to finance our current account deficit and our own foreign investment outflows. Even a modest reduction of this inflow, let alone its cessation or a selloff from the $14 trillion of dollar claims on the United States now held around the world, could initiate a precipitous decline in the dollar. Especially under the present circumstances of nearly full employment and full capacity utilization in the United States, this could in turn sharply increase US inflation and interest rates, severely affecting the equity and housing markets and potentially triggering a recession. The global imbalances represent the single largest threat to the continued growth and stability of the US and world economies.

The domestic political unsustainability derives from the historical reality that sizeable dollar overvaluation, and the huge and rising trade deficits that it produces, are the most accurate leading indicators of resistance to open trade policies in the United States. Such overvaluation and deficits alter the domestic politics of US trade policy, adding to the number of industries seeking relief from imports and dampening the ability of exporters to mount effective countervailing pressures. Acute trade policy pressures of this type, threatening the basic thrust of US trade policy and thus the openness of the global trading system, prompted drastic policy reversals by the Reagan Administration, to drive the dollar down by more than 30 percent via the Plaza Agreement in the middle 1980s, and by the Nixon Administration, to impose an import surcharge and take the dollar off gold to achieve a cumulative devaluation of more than 20 percent in the early 1970s.

The escalation of trade pressures against China at present, despite the strength of the US economy and the low level of unemployment, is the latest evidence of this relationship between currency values and trade policies. With deep-seated anxieties over globalization already prevalent in our body politic, and the failure of the Doha Round to maintain the momentum of trade liberalization around the world, continued failure to correct the currency misalignments could have a devastating impact on the global trading system.

The Policy Implications

It is thus essential to reduce the US and China imbalances by substantial amounts in as orderly a manner as possible. The goal of the global adjustment should be to cut the US global current account deficit to 3-3 ½ percent of GDP, about half its present level, at which point the ratio of US foreign debt to GDP would eventually stabilize and should be sustainable. China's goal, already accepted in principle by its political leadership but without any significant policy followup, should be to totally eliminate its global current account surplus and stop the buildup of foreign exchange reserves.

The United States should take the lead in addressing the imbalances by developing a credible program to convert its present, and especially foreseeable, budget deficits into modest surpluses like those that were achieved in 1998-2001. Such a shift, of perhaps 3-4 percent of our GDP, would have two crucial payoffs vis-à-vis our external economic position: it would reduce the excess of our domestic spending relative to domestic output, which can only be met by additional net imports, and it would reduce the shortfall of our domestic savings relative to domestic investment, thereby cutting our reliance on the foreign capital inflows that drive up the value of the dollar and undermine our trade competitiveness. Fiscal tightening is the only available policy instrument that will produce such adjustments. Hence I strongly recommend that the new Congress take effective and immediate steps in that direction.[3]

China needs to adopt policies to promote an opposite adjustment, reducing its uniquely high national saving rate by increasing domestic consumption. China can increase domestic spending directly through higher government expenditures on health care, pensions and education. Such new government programs are needed for purely internal reasons because of the unrest in China that has resulted from the demise of state-owned enterprises that provided these benefits in previous times. They would also reduce the precautionary motive for household saving in China; this would boost private as well

[3] See my testimonies on that topic to the House Budget Committee on January 23 and the Senate Budget Committee on February 1. I suggest there that the external imbalances are in fact the most likely source of a crisis that could force the United States into precipitous and thus unpalatable budget adjustments if preemptive action is not taken.

as government demand, contributing importantly to the needed international adjustment.[4] A number of important Chinese policy goals, such as increasing employment and curbing energy consumption, would also be served by such shifts in the composition of China's growth strategy.[5]

Large changes in exchange rates will also have to be a major component of the adjustment process. The dollar will need to fall, hopefully in a gradual and orderly manner over the next several years, by a trade-weighted average of about 20 per cent. A change in China's currency policy, in both the short and longer runs, is thus by far the single most important issue in US-China economic relations.[6]

An increase of at least 20 percent in the average value of the RMB against all other currencies, which would imply an appreciation of about 40 percent against the dollar[7], and sizable appreciations against the dollar of other key Asian currencies, will be required to achieve an orderly correction of the global imbalances.[8] Such a change could be phased in over several years to ease the transitional impact on China.[9] It could be

[4] See Chapter 2 of *China: The Balance Sheet* and Nicholas Lardy, "China: Toward a Consumption-Driven Growth Path," Washington: Institute for International Economics, October 2006.

[5] See Daniel H. Rosen and Trevor Houser, "What Drives China's Demand for Energy (and What It Means for the Rest of Us)," in C. Fred Bergsten, Nicholas Lardy, Bates Gill and Derek Mitchell, eds. *The China Balance Sheet in 2007 and Beyond,* Washington: Peter G. Peterson Institute for International Economics and Center for Strategic and International Studies, April 2007.

[6] The short-term success of the new Strategic Economic Dialogue will be judged largely by whether it achieves effective resolution of this problem. The SED also has the long-term potential to foster a more constructive relationship between the two countries that will inevitably lead the world economy over the coming years and perhaps decades. It thus begins to implement the "G-2" concept proposed in my "A New Foreign Economic Policy for the United States" in C. Fred Bergsten and the Institute for International Economics, *The United States and the World Economy: Foreign Economic Policy for the Next Decade,* Washington: Institute for International Economics, 2005, pp. 53-4.

[7] See William R. Cline, *The United States as a Debtor Nation,* Washington: Institute for International Economics, 2005, especially Table 6.2 on page 242.

[8] I have studiously refrained from mentioning the very large Chinese bilateral trade surplus with the United States, which should not be a primary focus of policy because of the multilateral nature of international trade and payments. At present, however, the bilateral imbalance is a fairly accurate reflection of the global imbalances and is thus more relevant than usual.

[9] See Morris Goldstein and Nicholas Lardy, *A New Way to Deal with the Renminbi,* Financial Times, January 20, 2006.

accomplished either by a series of step-level revaluations, like the 2.1 percent change of July 2005 against the dollar but of much larger magnitudes and with a substantial initial "down payment" of at least 10-15 percent, or by a much more rapid upward managed float of the RMB than is underway at present. An increase of 40 percent in the RMB and other Asian currencies against the dollar would reduce the US global current account deficit by about $150 billion per year, more than one third of the total adjustment that is required.

Over the longer run, China should adopt a more flexible exchange rate that will respond primarily to market forces. These forces would clearly have pushed the RMB to much higher levels by now in the absence of China's official intervention. There is some justification, however, for China's fears that an abrupt move to a freely floating exchange rate now, particularly if accompanied by abolition of its controls on financial outflows, could trigger capital flight and jeopardize its economy in view of the fragility of its banking system. Full-scale reform of China's exchange rate system will have to await completion of the reform of its banking system, which will take at least several more years. Hence the adoption of a flexible exchange rate regime in China, which is essential to avoid re-creation of the present imbalances in the future, can be only a second stage in the resolution of the currency problem and the immediate need is for a substantial increase in the price of the RMB (especially against the dollar) through whatever technique is most feasible for the Chinese authorities.[10]

A US Strategy for the Renminbi

[10] This two-step approach was initially proposed by my colleagues Morris Goldstein and Nicholas Lardy, *Two-Stage Currency Reform for China,* Financial Times, September 12, 2003.

It is obvious that China is extremely reluctant to make the needed changes in its currency policy. It is equally obvious that US efforts on the issue over the past three years, whether the "quiet diplomacy" of the Administration or the threats of Congressional action, have borne little fruit to date. A new US policy is clearly needed.

One cardinal requirement is for the Administration and Congress to adopt a unified, or at least consistent, position. To date, there has been something of "good cop" (Administration) – "bad cop" (Congress, e.g., the threat of the Schumer-Graham legislation) bifurcation between the two branches. China has exploited these differences, essentially counting on the Administration to protect it from the Congress – a bet that, to date, has paid off.

I would therefore suggest a new five-part strategy for US policy on the currency issue.

First, it is clear that China has aggressively blocked appreciation of the RMB through its massive intervention in the currency markets and that the Treasury Department has severely jeopardized its credibility on the issue by failing to carry out the requirements of current law to label China a "currency manipulator."[11] The Treasury report of May 2005 indicated that "...if current trends continue *without substantial alteration* (italics added), China's policies will likely meet the statute's technical requirements for designation." The report of May 2006 sharply criticized China for its currency policies, clearly suggesting that there has been no "substantial alteration" in those practices, but inexplicably failed to draw the obvious conclusion of its own

[11] See Morris Goldstein, "Paulson's First Challenge," *The International Economy,* Summer 2006.

analysis.[12] The latest report, submitted last December, was much milder. Treasury has thus been reducing its criticism of China's currency practices even as the RMB has become increasingly undervalued and China's external surpluses have soared.

The Treasury policy needs to be changed sharply and quickly. The Administration should notify the Chinese that, if China fails to make a significant "down payment" appreciation of at least 10 percent prior to the release of Treasury's next semi-annual report, it will be labeled a "manipulator." This would trigger an explicit US negotiation with China on the currency issue.

Second, the Administration should notify its G-7 partners and the IMF that it plans to make such a designation in the absence of major preventive action by China. These other countries would prefer to avoid a US-China confrontation on the issue and could be brought into a multilateral effort on the issue, reducing its confrontational bilateral character, if they were convinced that the United States was serious about pursuing it. The objective of that international effort, hopefully spearheaded by the IMF[13], should be a "Plaza II" or "Asian Plaza" agreement that would work out the needed appreciation of all the major Asian currencies through which the impact on the individual countries involved (including China) would be tempered because they would not be moving very much vis-à-vis each other.[14] The Europeans have an especially large incentive to join the United States in such an initiative because their own currencies will

[12] Treasury (and the IMF) have justified their inaction on the grounds that there is insufficient evidence that China is manipulating its exchange rate with the "intent" of frustrating effective current account adjustment. This is of course ludicrous because it is highly unlikely that China (or any country) would admit such a motive and it is impossible to discern any other purpose for the policy. It might be desirable to amend US law, however, by replacing the controversial (and pejorative) term "manipulation" with the unambiguous (and emotionally neutral) term "intervention."
[13] Congress could direct Treasury to use the "voice and vote" of the United States to seek effective implementation by the IMF of its existing rules against competitive currency undervaluation.
[14] See William R. Cline's "The Case for a New Plaza Agreement," Washington: Institute for International Economics, December 2005.

rise much more sharply when the dollar experiences its next large decline if China and the other Asians continue to block their own adjustment (and perhaps to head off the incipient United States-China "G-2" implied by the Strategic Economic Dialogue).

Third, the Administration (with as many other countries as it can mobilize) should also take a new multilateral initiative on the trade side by filing a WTO case against China's currency intervention as an export subsidy and/or as a violation of the provision in Article XV (4) that member countries "shall not, by exchange action, frustrate the intent of the provisions of the Agreement." As Chairman Ben Bernanke indicated in his highly publicized speech in Beijing in December 2006, in connection with the first Strategic Economic Dialogue, China's exchange rate intervention clearly represents an effective subsidy (to exports, as well as an import barrier) in economic terms. It should be addressed as such.[15]

Fourth, if the multilateral efforts fail, the United States will have to address the China currency issue unilaterally. Treasury can pursue the most effective unilateral approach by entering the currency markets itself. It is impossible to buy RMB directly, because of its inconvertibility on capital account, so Treasury would have to select the best available proxies in the financial markets. The message of US policy intent would be crystal clear, however, and at a minimum there would be a further sharp increase in inflows into the RMB that would make it even more difficult for the Chinese authorities to resist their inflationary consequences and thus the resultant pressures to let the exchange rate appreciate. (All other undervalued Asian currencies, including the

[15] These ideas are analyzed in Gary Clyde Hufbauer, Yee Wong and Ketki Sheth, *US-China Trade Disputes: Rising Tide, Rising Stakes,* Washington: Institute for International Economics, August 2006, pp. 16-24. Congress could require the Administration to bring such a case or cases, once a country was found to be violating its currency obligations, in any legislation that it passed on these issues.

Japanese yen, could be purchased directly with immediate impact on their exchange rates against the dollar.)[16]

The United States has of course conducted such currency intervention on many occasions in the past, most dramatically via the Plaza Agreement in 1985 and most recently when it bought yen to counter the excessive weakness of that currency in 1998 (when it approached 150:1, about the same level in real terms as its current rate of about 120:1). All those actions have been taken with the agreement of the counterpart currency country, however, and usually in cooperation with that country. This would be the essence of the proposed "Plaza II" or "Asian Plaza" agreement, as suggested above, and the multilateral approach would be preferable and should be pursued vigorously by the Administration. Failing such agreement, however, the unilateral option is available and might have to be adopted.

Fifth, <u>the Administration should quietly notify the Chinese that it will be unable to oppose responsible Congressional initiatives to address the issue. Congress should then proceed, hopefully in cooperation with the Administration, to craft legislation that would effectively sanction the Chinese (and perhaps some other Asians) for their failure to observe their international currency obligations.</u>

Such unilateral steps by the United States, although decidedly inferior to the multilateral alternatives proposed above and as long as they are compatible with the rules of the WTO, could hardly be labeled "protectionist" since they are designed to counter a massive distortion in the market (China's intervention) and indeed promote a market-oriented outcome. Nor could they be viewed as excessively intrusive in China's internal

[16] Congress could write a requirement for such action, once a country was found to be violating its currency obligations, into legislation on these issues.

affairs, since they would be no more aggressive than current US efforts on intellectual property rights and other trade policy issues (including the filing of subsidy and other cases on such issues with the WTO). Such steps should therefore be considered seriously if China continues to refuse to contribute constructively to the needed global adjustments and if the Treasury Department continues to whitewash the Chinese policies by failing to carry out the clear intent of the law fashioned by this Committee almost two decades ago.

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HEARING BEFORE THE SENATE BANKING COMMITTEE'S SUBCOMMITTEE ON SECURITY AND INTERNATIONAL TRADE AND FINANCE

"U.S. ECONOMIC RELATIONS WITH CHINA: STRATEGIES AND OPTIONS ON EXCHANGE RATES AND MARKET ACCESS"
(May 23, 2007)

Prepared Statement of David A. Hartquist
On Behalf of the China Currency Coalition

Introduction

Good afternoon. Thank you for inviting me to participate in this hearing as counsel to the China Currency Coalition ("CCC"). The CCC consists of U.S. industry, agriculture, and labor organizations, and its purpose is to support the economy and security of the United States by working toward and achieving as promptly as possible a commercially realistic revaluation of China's undervalued yuan. The China Currency Coalition estimates that the yuan continues to be undervalued vis-à-vis the dollar by 40 percent or more.

Since 1994, when China abolished its dual-exchange-rate system, the yuan or renminbi has been pegged to the dollar and substantially undervalued. From the end of 1995 through mid-2005, the rate of exchange between the yuan and the dollar was approximately 8.28 to 1. On July 21, 2005, China announced that the yuan's peg to the dollar would be replaced with a basket of currencies, instituted a daily trading band of +/- 0.3 percent, and revalued the yuan by 2.1 percent to 8.11 yuan to the dollar. Currently, the yuan trades at approximately 7.66 yuan to the dollar, nominally a strengthening of the yuan of just 7.5 percent from its fixed rate of 8.28 yuan to the dollar before the modest revaluation in July 2005. Last week, China advised that the daily trading band would be widened to +/- 0.5 percent.

I think it is fair to say that there has been no significant shift in the Chinese leadership's basic position on the yuan. The weightings of the currencies in China's basket have never been revealed, and it certainly appears that the yuan effectively remains pegged to the dollar. In real terms, after relative rates of inflation are taken into account, the yuan has appreciated against the dollar by only 0.2 percent since April 2005, notwithstanding that the dollar has lost strength against other currencies. Had a truly market-driven system been in effect since July 2005's revaluation – even with the narrow, daily trading band of +/- 0.3 percent – a 40-percent revaluation of the yuan would have been achieved by late March 2006. In the CCC's judgment, in light of recent history, no meaningful appreciation of the yuan against the dollar should be expected from the modified daily band of +/- 0.5 percent.

As far as the United States is concerned, the ineffectiveness of China's revised system should come as no surprise. China has been very clear with both the International Monetary Fund ("IMF") and the World Trade Organization ("WTO") that China's currency policy is meant to foster economic growth for China, foreign direct investment in China, employment for the 20-30 million new entrants in China's job market every year, and macroeconomic, social, and financial-sector stability in China. China's accumulation of foreign reserves, including roughly $1.3 trillion as of this year, also has enabled China to fund purchases of raw materials from around the globe and military hardware for its growing navy and army, as well as to begin to act as a lender of funds regionally to other Asian countries particularly.

In short, China's apparently deep-seated conviction is that the best way of accomplishing its goals, while avoiding as much as possible depreciation of China's investment in dollar-denominated debt, is to enforce what amounts to a peg of the yuan to the dollar. It is reasonable to surmise that, from China's vantage, there seems to be no reason to alter this approach in the time ahead. The desired economic growth, foreign direct investment, and generation of employment are all being accomplished with the assistance of the undervalued yuan, and the yuan's incremental appreciation thus far has worked to prevent excessive losses for China's holdings of U.S. debt and curb social unrest. In the judgment of the CCC, however, the yuan's undervaluation is generating dangerous and increasingly damaging economic imbalances for the United States, for the global community, and for China itself.

The Undervalued Yuan's Impact on the U.S. and Global Economies

China's direct intervention in currency exchange as well as controls over capital movements, along with rigidities in its banking and financial sector, prevents market forces of supply and demand from determining an equilibrium exchange rate for the yuan. As a result, the dollar's value remains artificially high and the yuan's value artificially low. This skewing of the yuan's exchange rate is contributing to the loss by the United States of capital investment, research and development, and manufacturing capability in a variety of important industries and is causing skilled and unskilled jobs migrate to China at an unprecedented rate. China's accumulation of approximately $1.3 trillion in foreign reserves is one worrisome indicator of how imbalanced the U.S.-China trade relationship has become.

The yuan's undervaluation means that those U.S. companies that have not already gone out of business or relocated to China are able to export relatively little to China in the way of manufactured items. The yuan's weakness against the dollar serves as a formidable barrier to market access by increasing a would-be Chinese importer's cost of importing any goods from the United States into China in a compounded fashion: not only is the basic price of an item inflated in terms of yuan, but the cost to enter the item into China also is inflated in terms of yuan, notably China's ad valorem tariffs on imports.

With the yuan's undervaluation facilitating exports to the United States and curtailing imports from the United States, the U.S. bilateral trade deficit with China in 2005 hit a historic high of $203.8 billion and in 2006 hit another historic high of $235.4 billion. The pace thus far this year points to another record trade deficit in 2007 for the United States with China. U.S. exports to third countries also are diminished by the yuan's undervaluation. To a significant degree, the loss of U.S. sales to third countries can be attributed to underselling by imports into those countries from China.

The effect on the U.S. manufacturing sector has been severe. U.S. employment in manufacturing has declined by over 3 million jobs since early 2001 due to technological change, trade deficits with other countries generally, and other factors. In a study released earlier this month by Robert Scott and the Economic Policy Institute ("Costly Trade With China"), it is estimated that the loss of fully 1.8 million jobs can be attributed to the trade deficit of the United States with China, and approximately 1.3 million of those jobs were in manufacturing.

This sharp drop in U.S. manufacturing employment due to China has occurred as U.S. manufacturing in many sectors has slumped and not recovered from the recession at the turn of the century. Industrial machinery, electronic products including computers, communications equipment, electrical equipment, electric lighting, and batteries, and motor vehicles and parts are some of the sectors that have not fully recovered from the recession.

In this connection, it should be stressed that the increased imports into the United States from China are not merely displacing imports from other low-wage Asian countries that have chosen to send parts and components to China for final assembly before exportation of finished products to the United States. Under this line of thought, imports from China merely take the place of imports that would otherwise come to the United States from other countries, such that U.S. domestic output and employment are supposedly left unaffected by China's undervalued yuan.

This argument is not borne out by the facts, first and foremost that skilled U.S. manufacturing jobs are being lost at an alarming rate, as discussed above. Moreover, while China is being used to a significant degree by a number of Asian countries as a platform for exports to the United States and other destinations, the U.S. Census Bureau's data show that between 2001 and 2006 the value of imports into the United States from India, Malaysia, Taiwan, Singapore, South Korea, and Thailand significantly increased individually and by 40 percent collectively, jumping from an aggregate value of approximately $130 billion in 2001 to $181 billion in 2006. With imports into the United States increasing from each of these six countries as well as from China, the notion that China is simply displacing imports that would in any event enter the United States from elsewhere does not withstand scrutiny.

With China's foreign reserves and subsidization, the yuan's undervaluation also facilitates large purchases by China of needed raw materials in the United States and elsewhere. These raw materials are sent to China and then made by companies in China into value-added, downstream products for export by China to the United States and elsewhere. One notable example of this phenomenon is that of copper cathode and copper-based scrap, which are critical raw materials for a wide range of items important to the U.S. economy and national security, including parts incorporated in printed circuit boards for commercial and defense applications and cartridge brass for ammunition. In prior decades, far more of these raw materials than is the case now was fabricated into finished and semi-finished products in the United States.

Reduced income and revenues for U.S. workers and companies mean erosion of the U.S. tax base and greater difficulty for state and local governments particularly to fund basic, much-needed infrastructural projects.

With its ever-rising foreign reserves noted above, thanks to the undervalued yuan, the Chinese government is using foreign exchange to purchase U.S. government and quasi-government debt. This situation bears close monitoring, as Chairman Bernanke commented earlier this year, but as matters stand now China and Japan – as the two countries with the largest shares of U.S. debt – are not yet in a position to trigger dangerous financial disruptions by selling off their holdings of U.S. debt. A recent White Paper by the CCC on this subject is attached.

With its excessive foreign reserves and the printing and sterilization of enormous amounts of yuan that keep the yuan undervalued, China's government has been engaged in increasing the money supply in China's banking system, which in turn lends funds to Chinese businesses that are creating further excess capacity. Much of these bank loans is applied to underwrite debt or otherwise subsidize China's state-owned banks and other favored industries in China to the detriment of U.S. firms.

The yuan's undervaluation additionally acts artificially to stimulate foreign direct investment in China. In 1994, when the yuan was first devalued, China's total utilized foreign direct investment was $33.77 billion, according to the data of China's Ministry of Commerce. Since then, with small aberrations in 1999, 2000, and 2005, foreign direct investment in China has steadily increased and in each of the last several years has topped $60 billion. With this shifting of investment to China, there has also been a relocation of research and development from the United States to China. This trend is especially worrisome from the standpoint of the ability of the United States to maintain the technological innovation that is so vital to the national economy and security.

The situation is made worse because other Asian countries, particularly Japan, Taiwan, and Malaysia, also maintain undervalued currencies in order to compete with Chinese companies in China and global markets.

From a global standpoint, a similar picture emerges. According to the official trade data of China's 39 largest trading partners (among them the United States), China has enjoyed a global trade surplus since at least 1999, rising from $140.6 billion in that year to $470.1 billion in 2006. After adjustment for Hong Kong's re-export trade, China's global trade surplus with its 39 largest trading partners was still $464.2 billion in 2006. It should be noted that China's official trade data consistently have overstated the value of China's imports and consistently have understated the value of China's exports, such that China has substantially under-reported not only its bilateral trade surpluses with the United States and other countries, but also its global trade surplus for years.

In summary, China's undervalued currency is creating various serious imbalances that threaten the global financial system as well as the U.S. economy and national security.

The Yuan's Undervaluation Is A Prohibited Export Subsidy That Should Be Countervailed If China Insists on Continuing to Undervalue the Yuan

In terms of what options and strategies are available to the United States to address China's undervaluation of the yuan, the China Currency Coalition believes that the most promising and appropriate step that can be taken is amendment of the U.S. countervailing duty law to treat undervalued-exchange-rate misalignment by China or by any other country as a countervailable prohibited export subsidy. Such exchange measures are a hybrid by nature, having both monetary and trade aspects, and so fall under the jurisdiction of the IMF and under the jurisdiction of the WTO.

On the one hand, under the IMF's guidelines in Article IV(1)(iii) of its Articles of Agreement and a 1977 Surveillance Decision on this topic, currency "manipulation" is defined as manipulation of exchange rates or the international monetary system "in order to" prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members. The language in the IMF's Articles of Agreement, as reflected in 22 U.S.C. § 5304(b), has been interpreted by the Treasury Department as containing an element of intent that the foreign government must undervalue its currency "for purposes of preventing effective balance of payments adjustments or gaining unfair competitive advantage in international trade" before a finding of currency "manipulation" is justified.

On the other hand, there is no such element of intent in the WTO's agreements on prohibited export subsidies. In particular, as long as a prohibited export subsidy exists under Articles 1, 2, and 3 of the WTO's Agreement on Subsidies and Countervailing Measures ("the SCM Agreement"), and as long as a U.S. domestic industry can demonstrate that it is being materially injured or threatened by material injury by reason of subsidized imports, relief in the form of countervailing duties on subsidized imports entering the United States to offset the amount of subsidization is warranted.

The question, then, is whether exchange-rate misalignment – which borrows from the IMF's concepts apart from the element of intent, and which is defined as the undervaluation of a foreign currency as a result of protracted large-scale intervention by or at the direction of a governmental authority in the exchange market – is a countervailable prohibited export subsidy within the meaning of the WTO's provisions. As turned to next, the CCC believes that the answer to this question is yes and that the U.S. in a WTO-consistent manner should amend the U.S. countervailing duty statute at 19 U.S.C. § 1677(5) accordingly.

In its Accession Agreement with the World Trade Organization, China unqualifiedly committed to cease all export subsidies by all levels of government by the time of accession, December 11, 2001. Despite this pledge, China has persisted in its undervaluation of the yuan. Although the precise issue has never previously arisen in dispute settlement or apparently otherwise, the China Currency Coalition submits that the yuan's undervaluation is a prohibited export subsidy in violation of Articles 1, 2, and 3 of the WTO's SCM Agreement and the parallel Articles 3, 9, and 10 of the WTO's Agreement on Agriculture that build on the SCM Agreement's provisions.

Under Articles 1, 2, and 3 of the SCM Agreement, a measure must satisfy three criteria in order to be considered a prohibited export subsidy. In essence, there must be a governmental financial contribution (Article 1.1(a)(1)), a benefit must thereby be conferred (Article 1.1(b)), and such a subsidy must be specific by virtue of being contingent in law or in fact upon export performance (Articles 1.2, 2.3, and 3.1(a)). The yuan's enforced undervaluation by the Chinese government meets each of these criteria.

In a typical export transaction, having been paid for goods sold to a customer in the United States, the exporter in China must transfer the U.S. dollars received to the Chinese government in return for yuan at the undervalued exchange rate in effect.

In this sequence of events, the Chinese government first provides a financial contribution to the exporter by means of a direct transfer of funds and through the service of converting U.S. dollars into yuan.

Second, a benefit is conferred by this governmental financial contribution that is equal to the difference between what the yuan would be worth if its value were set by the market and its artificially low value as the result of China's undervaluation of the yuan. With the yuan undervalued by approximately forty percent, therefore, for each U.S. dollar earned by the sale of goods to the United States the Chinese exporter will receive approximately 7.6 yuan rather than 4.6 yuan. As this illustration demonstrates, the exporter in China is "better off" as the result of being given more yuan than if there were no undervaluation.

Third, and lastly, this subsidy is contingent upon export performance. Only after the exporter has been paid in U.S. dollars for the goods that have been exported to the United States is the exporter required and able to convert those proceeds into yuan.

The setting forth in these straightforward terms of why the yuan's undervaluation should be seen as a countervailable prohibited export subsidy is not intended to overlook various underlying and, in some instances, arguably contrary points that add complexity to the analysis. At least a few should be mentioned at this stage, therefore, and there are perhaps others that might be advanced. Also importantly, due to incomplete transparency by China, not all facts and details are known about exactly how China's system functions. At the same time, however, in the China Currency Coalition's opinion the evidence that is available is more than adequate to support the conclusion that the yuan's enforced undervaluation is a countervailable prohibited export subsidy.

For instance, with respect to the criterion that there be a governmental financial contribution under Article 1.1(a)(1) of the SCM Agreement, such a finding can rest on one or more of several grounds. As suggested above, the Chinese government's exchange of yuan in return for U.S. dollars can properly be viewed as "a government practice {that} involves a direct transfer of funds," in line with Article 1.1(a)(1)(i). The yuan's undervaluation might also be considered a governmental provision of services under Article 1.1(a)(1)(iii), inasmuch as the Chinese government both exchanges the yuan for U.S. dollars and then "sterilizes" the issued yuan in order to avoid inflation and loss of value by the yuan within China. These services by China are financial contributions integral to the yuan's undervaluation relative to the dollar. Further, to the extent that the Chinese government entrusts or directs private bodies to conduct the exchanges and "sterilizations" of yuan, that activity likewise can reasonably be seen as a governmental financial contribution under Article 1.1(a)(1)(iv).

Also on the criterion of a governmental financial contribution, there are some who urge that a government's undervaluation of its currency constitutes a general infrastructural measure that cannot properly be deemed a subsidy. As the U.S. Department of Commerce indicated in its final rule in 1998 implementing the countervailing duty sections of the Uruguay Round Agreements Act, however, governmental financial contributions to the general infrastructure include the provision of such services and items as highways and bridges, schools, health care facilities, sewage systems, port facilities, libraries, and police protection that are for the public good and broad social welfare of a country, region, state, or municipality and that are available to all citizens or to all members of the public. As a macroeconomic policy, exchange-rate misalignment is a governmental financial contribution that does not directly build up a community's basic, functional features of the kinds just recounted, and is accessible to just those persons who are in a position to deal with foreign currencies.

With respect to the prerequisite of a benefit, there is a widespread, although not unanimous, consensus that the yuan is undervalued, but opinions vary as to how to measure the undervaluation. To the extent there is no private exchange market in China that can serve as a trustworthy benchmark to determine the amount of the yuan's undervaluation, the CCC believes that a methodology should be employed for this purpose that is objective and consistent with widely recognized macroeconomic theory and that incorporates governmentally published and other publicly available and reliable data. A benchmark arrived at in this unprecedented fashion to measure the amount of the yuan's undervaluation admittedly would be open to challenge at the WTO by China.

In cases involving Korean DRAMS and Canadian softwood lumber, however, the United States has been upheld in the past at the WTO on other important, first-time interpretations of the SCM Agreement. In the case of Korean DRAMS, the U.S. Department of Commerce was affirmed in finding indirect governmental financial contributions through the Korean government's entrustment to private Korean banks of preferential loans, equity investment, and debt forgiveness for a Korean producer of DRAMS. In the case of Canadian softwood lumber, the agency was upheld in its reliance upon benchmarks outside the subsidizing government's territory to measure the benefit from undervalued Canadian stumpage rights. In the CCC's judgment, measurement of exchange-rate misalignment of the yuan by a responsible methodology could similarly be defended and affirmed on very solid grounds in dispute settlement at the WTO.

As to whether the subsidy due to the yuan's undervaluation is contingent, in law or in fact, upon export performance, and so is "specific" under Articles 1.2, 2.3, and 3.1(a) of the SCM Agreement and countervailable, it is evident that this subsidy in fact is tied to actual or anticipated exportation or export earnings within the meaning of the SCM Agreement's Article 3.1(a) n.4. It is also possible that Chinese law and regulations might expressly provide that this subsidy is contingent upon exportation, but China's lack of transparency is an impediment to ascertaining the actual circumstances in this regard.

Another aspect as to whether this subsidy is specific and export-contingent concerns its availability also to persons and entities in China that have obtained U.S. dollars by means other than through the export of goods or services to the United States. On at least two occasions, however, in dispute settlement at the WTO (United States – Upland Cotton and United States – Tax Treatment for Foreign Sales Corporations), the WTO's Appellate Body has recognized that the granting of a subsidy under conditions apart from exportation does not undercut the de facto export-contingent nature of the subsidy when the grant is tied to exportation. As long as it can be established, therefore, that there is a clear distinction between the eligible domestic recipients and the eligible exporters and different conditions for each group to receive the subsidy, the prerequisite of specificity for a countervailable prohibited export subsidy should be met.

From a broader standpoint, there is the question of whether responsibility and authority over exchange-rate problems lies with the IMF or the WTO or is shared by these two international organizations. Opinions vary. In early 2006, the WTO's Director-General was quoted as saying that to his knowledge currency manipulation does not belong to the WTO's legal order. This remark, however, does not seem to consider that prohibited export subsidies fall within the bailiwick of the WTO and that undervaluation of a currency like the yuan can be a countervailable prohibited export subsidy under the WTO's provisions without necessarily comprising currency "manipulation" within the IMF's definition of that term.

The Director-General's comment additionally appears not to take into account relevant portions of Article XV, notably Article XV:4, of the General Agreement on Tariffs and Trade, the gist of which is that member states shall not, by exchange action, "frustrate" the intent of the

GATT and shall not, by trade action, "frustrate" the intent of the IMF's Articles of Agreement. An addendum to Article XV:4 elaborates by examples as to what is intended by use of the word, "frustrate." More exactly, this addendum notes that infringements of the letter of any of the GATT's Articles by exchange action shall not be viewed as a violation of the GATT if, in practice, there is "no appreciable departure from the intent of the Article." Also pertinent, Article XV:9(a) of the GATT holds that nothing in the GATT shall preclude a member state's use of exchange controls or exchange restrictions in accordance with the IMF's Articles of Agreement.

The purpose of Article XV generally may be said to be the harmonious working in tandem of the IMF's Articles of Agreement with the GATT and the WTO's other agreements. What is deemed by one organization as consistent with its charter should not be found violative of the other organization's charter if at all possible and *vice versa*. Toward this end, Article XV:2 of the GATT stipulates in pertinent part that in all cases in which the WTO is called upon to consider problems concerning monetary reserves, balances of payments or foreign exchange arrangements, the WTO's Member States shall consult fully with the IMF and shall accept the IMF's determination of whether action by a member state in exchange matters is in accordance with the IMF's Articles of Agreement.

It is apparent that the drafters of the GATT and the IMF's Articles of Agreement recognized that trade action and exchange action can overlap and that coordination on such occasions is desirable. As Professor Lowenfeld observes at page 501 n.5 of his book, "International Economic Law," there was an acute awareness on the part of the United States and other countries after World War II that the 1930s had seen frequent resort to many monetary devices, including use of exchange controls and competitive currency depreciation, that had undercut recovery in international trade.

Over the years, there has indeed been a need for international monetary-trade coordination, for example, with issues concerning restrictions on imports due to problems with balance of payments. On the other hand, there has been little or no discussion or occasion of relevance calling for coordination on issues of currency "manipulation" or undervaluation.

In November 1996, consistent with this historical background, the IMF and the WTO entered into an agreement (the Fund-WTO Cooperation Agreement, dated November 25, 1996) acknowledging the increasing linkages between the various aspects of economic policymaking and designed to facilitate linkages between the IMF and WTO. More precisely, paragraph 8 of this agreement provides that the IMF shall inform in writing the relevant WTO body (including dispute settlement panels) that is considering exchange measures within the Fund's jurisdiction whether such measures are consistent with the IMF's Articles of Agreement. Paragraph 9 of this agreement also directs that the WTO's Director-General and the IMF's Managing Director shall ensure cooperation between the staffs of their two institutions and shall agree on appropriate procedures toward that end, including access to databases and exchanges of views on jurisdictional and policy issues. Article 10 of the Agreement obligates the staffs of the WTO and the IMF to consult with each other on issues of possible inconsistency between measures under discussion with a common member under the WTO's and IMF's agreements.

What these provisions might mean for China's enforced undervaluation of the yuan remains to be seen. The answer to this question depends in good part on whether this situation is viewed purely as a trade matter or purely as a monetary matter or, as mentioned above, as a hybrid of the two. If, as the China Currency Coalition believes should be the case, the yuan's undervaluation is considered to be a hybrid by virtue of being a measure that is both monetary and trade in nature with serious ramifications for international trade, it is to be hoped that the WTO and the IMF would effectively work in tandem under the terms of their 1996 agreement.

In sorting through this situation, it will perhaps also be helpful to keep in mind the earlier comment that currency undervaluation that is a countervailable prohibited export subsidy in the WTO's eyes is not necessarily currency "manipulation" in the IMF's judgment, because the latter is concerned with the issue of intent whereas the former is not. Consideration of the problem of undervalued currencies as exchange-rate misalignment under the WTO's trade rules is especially important, because the IMF has no dispute settlement mechanism and, as a practical matter, no means at its disposal other than moral suasion to address the issue.

In this way, even if the IMF were to continue to be reluctant to find currency "manipulation" by China for lack of a showing of the requisite intent under the IMF's Articles of Agreement, recognition of the yuan's undervaluation as a countervailable prohibited export subsidy could legitimately and reasonably assist U.S. companies and workers in a WTO-consistent manner to weather the storm and perhaps act both as a spur to China to revalue the yuan more quickly and realistically than it has to this juncture and as a deterrent to undervalued-exchange-rate misalignment by countries generally now and in the future.

Thank you for inviting me to appear before you today.

KELLEY DRYE
COLLIER SHANNON

May 30, 2007

VIA E-MAIL

The Honorable Evan Bayh
Chairman
Subcommittee on Security and
International Trade and Finance
United States Senate
131 Russell Senate Office Building
Washington, D.C. 20510

Re: Supplemental Submission for the Record of the Hearing on May 23, 2007, "U.S. Economic Relations with China: Strategies and Options on Exchange Rates and Market Access"

Dear Senator Bayh:

With reference to the Subcommittee's May 23rd hearing and on behalf of the China Currency Coalition, we request that this supplemental submission be included in the record.

Toward the end of the hearing and in response to a question that you posed, Morris Goldstein distinguished between "currency manipulation" and "exchange-rate misalignment." From his perspective as an economist, we understand that he made his observations based upon a definition of "exchange-rate misalignment" that is commonly recognized and used by economists generally. However, the legal concept of "exchange-rate misalignment" as defined in S. 796, "The Fair Currency Act of 2007," is carefully distinguished from the common usage of that term by economists.

In the view of the China Currency Coalition ("CCC") and under S. 796, protracted large-scale intervention in the exchange market directly or indirectly by a foreign government that results in undervaluation of that government's currency is "exchange-rate misalignment" and should be actionable under law as a countervailable prohibited export subsidy. Moreover, relief under the countervailing duty law should be available against such subsidization even if the foreign government does not intend by means of the undervaluation to gain an unfair competitive

KELLEY DRYE
COLLIER SHANNON

The Honorable Evan Bayh
May 30, 2007
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advantage or prevent effective balance of payments adjustment and so is not engaged in "currency manipulation" as that concept is set forth in Article IV of the International Monetary Fund's Articles of Agreement.

In contrast to S. 796's definition, our impression is that from Mr. Goldstein's perspective "exchange-rate misalignment" – as that term is commonly defined by economists – could, but need not be, the result of protracted long-term intervention in the exchange market by a foreign government; the source is not necessarily clear. Put otherwise, such "misalignment" is a deviation of a currency from the market equilibrium for whatever reason. Furthermore, it is likely that at any given time the currencies of several dozen or more countries, including perhaps the U.S. dollar, will be "misaligned."

With "exchange-rate misalignment" as defined under S. 796, however, it is known who and what are responsible for a foreign currency's undervaluation, and such risky and unsettling behavior by foreign governments is fortunately relatively rare. The injurious impact on U.S. domestic industry of this protracted and large-scale governmental intervention and the undervaluation that follows accordingly should and can be offset under the trade laws by treating this protectionist measure as a countervailable prohibited export subsidy. The CCC submits that this approach should be found to be consistent with the World Trade Organization's agreements. Moreover, as noted above, such remedial action to counter "exchange-rate misalignment" should not entail an element of intent as "currency manipulation" does.

The bottom line is that, were it enacted, S. 796, "The Fair Currency Act of 2007," would not be applicable to any misaligned currency unless the foreign government used protracted large-scale intervention in the exchange market to sustain the undervaluation for a significant period of time.

Thank you very much again for your attention to this letter and for inviting the China Currency Coalition to participate in the Subcommittee's hearing.

Very truly yours,

David A. Hartquist

David A. Hartquist
Jeffrey S. Beckington
Counsel to the China Currency Coalition

Copies to:

Senator Jim Bunning
Senator Debbie Stabenow

ATTACHMENT

CHINA CURRENCY COALITION
WASHINGTON, D.C.
www.chinacurrencycoalition.org

White Paper

U.S. Indebtedness to China and Japan Should Spur, Not Delay or Deter,
Efforts to Offset Trade Imbalances Aggravated
By Exchange-Rate Misalignment of the Undervalued Yuan and Yen
(April 20, 2007)

Concerns have been expressed by some that the United States is so indebted to China and Japan that it would be unwise of the United States to enforce existing trade agreements by treating these and other countries' undervaluation of their currencies as a countervailable prohibited export subsidy. Underlying this view is the thought that such corrective measures might lead China and Japan to respond in a retaliatory fashion by liquidating their U.S. debt securities and diversifying large amounts of their dollar holdings into other investments elsewhere. The fear is that the result of this action would cause a dangerous run on the dollar, dramatically raise U.S. interest rates to the serious detriment of the U.S. economy, and perhaps create a global financial crisis.

These anxieties are not borne out by the facts and practicalities. It is true that U.S. indebtedness to foreign lenders is large, and the trend-lines are troubling and indicative that U.S. indebtedness likely will continue to increase unless remedial steps are taken. China and Japan, however, finance a relatively small portion of overall U.S. foreign-held debt and a much smaller portion of U.S. credit market debt. Moreover, the dollar has a broad, deep, and competitive market based upon confidence in the United States and its economy. As Secretary Paulson observed in a hearing before the Senate Banking Committee on January 31, 2007, the dollar provides the best risk-adjusted return available for investors' money. China and Japan, as significant holders of U.S. debt, presumably concur in this assessment and do not want to act in a way that would cause the dollar to weaken and the value of their investments in U.S. dollars to decrease. Under these circumstances, it is reasonable to conclude that the United States is not beholden to China and Japan for financing U.S. debt. Even if China and Japan were to shift some portion of their investments from the dollar to other currencies, it could be expected that other lenders would take their place.

With more particular regard to the value of holdings in U.S. securities by China, Japan, and other foreign countries, attached are three tables derived from recent reports by the U.S. Treasury Department and the U.S. Federal Reserve: Table 1A contains data as of June 2005 and June 2006 on the composition of foreign holdings of U.S. debt securities by the largest 25 lending countries and overall; Table 1B shows U.S. credit market debt for all sectors and by instrument as of June 2005 and June 2006; and Table 2 provides data on the 25 countries that are the largest foreign holders of U.S. credit and their shares of total market debt as of June 2006. A number of points from these reports are worth highlighting.

First, as noted in Table 1A, China held approximately $298 billion and Japan held approximately $666 billion, for a total of $964 billion, of U.S. Treasury short- and long-term securities as of June 2005. The preliminary data from June 2006 show China's number growing to $372 billion and Japan's number falling to $614 billion, for a total of

$986 billion. China and Japan together have accounted over the last two years for about half of the roughly $2 trillion in foreign-held U.S. Treasuries.

But foreign-held U.S. Treasuries are less than half of total U.S. Treasury debt. As shown in Table 1B, from June 2005 to June 2006, the total of U.S. Treasury securities outstanding grew from $4.49 trillion to $4.76 trillion. China's and Japan's cumulative share of U.S. Treasuries thus increased from 20.3 percent as of June 2005 to 20.7 percent as of June 2006.

As summarized in Table 1A, in June 2005 China held $527 billion and Japan held $1,091 billion in U.S. credit market debt, which includes U.S. Treasuries, U.S. government agencies' debt, municipal debt, corporate and other privately-issued debt, and equities. As of June 2006, the comparable figures were $699 billion for China and $1,106 billion for Japan.

When compared, therefore, with total U.S. credit market debt outstanding, which Table 1B records grew from $39.2 trillion in June 2005 to $42.7 trillion in June 2006, China's share was 1.3 percent as of June 2005 and 1.6 percent as of June 2006. Japan's share of total U.S. credit market debt outstanding was 2.8 percent as of June 2005 and 2.6 percent as of June 2006. Thus, in the very large total U.S. credit market, Japan and China held about 4.1 percent of outstanding credit as of mid-2005 and about 4.2 percent of outstanding credit as of mid-2006, and only a fraction of this debt has been held by their governments.

As reported in Tables 1A, 1B, and 2, from June 2005 to June 2006, credit held by foreigners increased $915 billion, from $6.86 trillion to $7.78 trillion. China and Japan accounted for $187 billion, or 20 percent of this increase, while 109 other entities also increased their holdings of U.S. debt, and 35 entities divested part of their holdings.

On February 28th, appearing before the House Budget Committee, Federal Reserve Chairman Ben Bernanke was asked to comment on what might happen to the market for U.S. debt securities if a foreign buyer like China or Japan were to sell off a significant portion of its holdings. Chairman Bernanke responded:

> It's not in the interest of China or Japan to dump treasuries on the market. They would themselves -- would suffer capital losses from doing that. I do think if there were -- and I should be very clear, I have no information or expectation this is going to happen, but if there were significant sales by foreign central banks, for example, that there would be some short-run effect on the market in terms of the currency and interest rates, probably. I think the longer-term effect would be somewhat less because the market would adjust -- it is a liquid market and the holdings of, say, China of U.S. debt securities, including both public and non-public, is only about 5 percent of the total credit market outstanding. So

obviously we're watching that very carefully. I don't see that as a major threat to our financial system or our economy.

Chairman Bernanke's evaluation echoes that of Secretary Paulson and is substantiated by the data just reviewed. Japan and China, individually and collectively, are important purchasers of U.S. debt, but as matters stand now are not in a position to trigger the sort of financial disruptions noted earlier by selling off their holdings. In the first place, as seen, those holdings are not that great in comparison with the total U.S. credit market debt outstanding, and the market would be able to adjust due to its liquidity.

In addition, as suggested by Chairman Bernanke, a reduction by China and Japan of the amount of their holdings of U.S. debt would entail capital losses for them. This factor was underscored recently in a report by the Associated Press that Stephen Green, Chief Economist at Standard Chartered Bank in Shanghai, calculated that China's central bank made a net profit of $29 billion on its reserve holdings. Japan also likely has realized sizable profits on its U.S. debt holdings. In the final analysis, Japan and China have too much at stake to jeopardize their trading relationships with the United States.

At the same time, if Congress does not take action to remedy the impact of exchange-rate misalignment on U.S. producers, the stability and strength of the U.S. economy will be eroded further and probably more quickly than has been the case to date. The trade and financial imbalances generated by protracted undervaluation of currencies will almost certainly be so extensive and devastating as to be extremely damaging to the national economy and security not only of the United States, but also of the countries that indulge in the undervaluation and of the global community.

In summary, the risk is rather slight at this juncture of financial turmoil resulting for the United States or any other country from a statutory declaration that undervalued exchange-rate misalignment is a countervailable prohibited export subsidy. Doing so now actually should help to avoid severe economic fluctuations and debilitation. The real risk will be run down the road if amendment of the U.S. countervailing duty law is delayed. Calling a halt to tolerance of the protectionist policy of undervalued exchange-rate misalignment is very much necessary.

TABLE 1A – FOREIGN HOLDINGS OF U.S. DEBT SECURITIES BY TOP 25 LENDING COUNTRIES, JUNE 2005 AND JUNE 2006

		Foreign holdings of debt securities by country as of preliminary June 2006 (top 25) ($Millions)						Foreign holdings of debt securities by country as of June 2005 ($Millions)					
No.	Country	Total	Equity Holdings	Short-Term & Long-Term Debt	U.S. Treasury Short- & Long-Term	Gov't Agency Short- and Long-Term	Corporate Short- and Long-Term	Total	Equity Holdings	Short-Term & Long-Term Debt	U.S. Treasury Short- & Long-Term	Gov't Agency Short- and Long-Term	Corporate Short- and Long-Term
1	JAPAN	1,106,396	194,542	911,855	613,915	188,519	109,421	1,091,430	177,674	913,757	666,440	142,469	104,847
2	CHINA, MAINLAND	698,929	3,818	695,111	372,234	263,878	58,999	527,275	2,542	524,733	297,811	190,347	36,575
3	UNITED KINGDOM	639,587	299,700	339,887	51,779	29,679	258,429	559,838	260,364	299,474	50,443	25,257	223,774
4	LUXEMBOURG	549,016	193,061	355,955	58,833	42,002	255,120	460,212	150,639	309,573	38,760	43,481	227,331
5	CAYMAN ISLANDS	485,044	178,083	306,961	24,513	45,255	237,193	429,983	152,204	277,779	37,208	50,361	190,211
6	CANADA	381,891	273,815	108,077	21,973	4,334	81,770	307,872	220,504	87,368	19,598	5,256	62,514
7	BELGIUM	330,776	21,415	309,361	13,710	43,763	251,888	334,886	18,062	316,824	15,619	51,244	249,962
8	NETHERLANDS	280,415	158,359	122,056	19,326	19,706	83,024	262,246	160,875	101,370	19,586	19,461	62,324
9	SWITZERLAND	261,939	144,511	117,427	39,171	10,250	68,006	238,236	129,159	109,077	36,373	10,693	62,011
10	MIDDLE EAST OIL-EXPORTERS	242,800	110,588	132,211	94,683	19,383	18,146	160,916	82,472	78,444	54,639	14,082	9,722
11	IRELAND	231,978	68,550	163,428	13,690	28,088	121,650	191,392	57,730	133,662	22,237	16,610	94,814
12	COUNTRY UNKNOWN	213,663	170	213,493	17	20	213,456	196,135	1,979	194,155	163	447	193,545
13	GERMANY	211,169	72,804	138,365	41,758	16,069	80,538	200,034	82,783	117,251	46,081	15,277	55,893
14	BERMUDA	205,610	60,033	145,577	28,749	30,885	85,943	201,895	59,054	142,841	27,991	30,476	84,374
15	FRANCE	164,216	95,324	68,892	25,888	6,287	36,717	122,138	71,331	50,807	24,776	2,455	23,576
16	SINGAPORE	162,766	100,662	62,104	35,174	6,854	20,077	144,165	88,715	55,450	34,258	6,380	14,812
17	TAIWAN	135,210	7,317	127,893	63,394	53,022	11,477	126,008	6,688	119,320	67,770	41,106	10,444
18	KOREA, SOUTH	124,213	1,323	122,890	65,578	45,924	11,388	118,257	1,132	117,125	62,933	45,075	9,117
19	RUSSIA	110,850	237	110,612	4,533	106,058	22	76,382	227	76,155	1,297	74,835	23
20	HONG KONG	110,113	22,098	88,015	48,604	26,538	12,873	95,925	23,347	72,577	44,336	20,340	7,901
21	AUSTRALIA	109,171	64,497	44,674	5,681	21,224	17,769	92,191	56,541	35,650	4,869	21,806	8,975
22	MEXICO	98,085	14,961	83,124	46,121	27,054	9,948	79,923	13,111	66,812	29,172	28,504	9,136
23	SWEDEN	81,065	47,780	33,284	13,296	4,872	15,116	84,198	49,397	34,802	16,874	4,601	13,326
24	BRITISH VIRGIN ISLANDS	77,707	46,120	31,587	11,978	3,723	15,886	75,094	46,692	28,402	10,938	2,890	14,573
25	NORWAY	74,707	42,633	32,075	3,118	5,394	23,562	68,211	37,317	30,894	8,484	5,922	16,488
TOTALS	TOP 25 + ALL OTHERS	7,779,249	2,431,201	5,348,048	1,980,140	1,131,467	2,236,442	6,864,260	2,143,885	4,720,375	1,882,379	940,631	1,897,364

Source: U.S. Department of Treasury Report On Foreign Holdings of U.S. Securities (Mar. 30, 2007).

TABLE 1B

For use at 12:00 p.m., eastern time
Thursday
December 7, 2006

FEDERAL RESERVE statistical release

Z.1

Flow of Funds Accounts of the United States

Flows and Outstandings
Third Quarter 2006

Board of Governors of the Federal Reserve System, Washington DC 20551

L.4 Credit Market Debt, All Sectors, by Instrument

Billions of dollars; amounts outstanding end of period, not seasonally adjusted

		2001	2002	2003	2004	2005 Q1	2005 Q2	2005 Q3	2005 Q4	2006 Q1	2006 Q2	2006 Q3	
1	**Total**	29257.9	31726.6	34614.0	37703.7	38372.8	39181.3	39941.3	41041.4	41891.5	42712.0	43467.4	1
2	Open market paper	1571.1	1507.6	1432.5	1567.2	1606.2	1668.5	1744.1	1833.9	1901.3	1960.9	2090.4	2
3	Treasury securities	3352.7	3609.8	4008.2	4370.7	4535.6	4493.1	4566.0	4678.0	4834.4	4759.6	4803.2	3
4	Agency- and GSE-backed securities	4989.1	5536.3	6108.1	6225.6	6177.9	6177.3	6165.0	6275.8	6387.2	6526.7	6557.7	4
5	Municipal securities	1603.5	1762.9	1900.5	2031.0	2085.7	2134.2	2176.1	2225.6	2254.9	2305.7	2337.5	5
6	Corporate and foreign bonds	5487.4	6121.5	6890.6	7675.0	7857.6	8082.9	8162.1	8358.4	8518.7	8721.3	8872.6	6
7	Bank loans n.e.c.	1424.3	1344.2	1283.9	1332.4	1353.5	1398.9	1423.9	1491.4	1547.3	1583.0	1623.7	7
8	Other loans and advances	1444.5	1464.7	1499.2	1590.2	1604.8	1666.5	1664.8	1707.2	1702.9	1760.4	1763.0	8
9	Mortgages	7485.6	8366.6	9373.9	10677.8	10935.7	11319.7	11751.1	12145.8	12450.8	12765.5	13033.1	9
10	Consumer credit	1899.6	2013.0	2117.0	2233.9	2215.8	2240.1	2288.1	2325.3	2293.9	2328.8	2386.2	10
	Memo:												
	Selected claims not included above:												
11	Corporate equities	15310.6	11900.5	15618.5	17389.3	17002.3	17185.9	17914.7	18277.0	19140.8	18668.9	19306.3	11
12	Mutual fund shares	4135.4	3638.4	4654.2	5436.3	5471.6	5595.7	5874.4	6048.9	6464.1	6420.0	6625.8	12

L.5 Total Liabilities and Its Relation to Total Financial Assets

Billions of dollars; amounts outstanding end of period, not seasonally adjusted

		2001	2002	2003	2004	2005 Q1	2005 Q2	2005 Q3	2005 Q4	2006 Q1	2006 Q2	2006 Q3	
1	**Total credit market debt (from table L.4)**	29257.9	31726.6	34614.0	37703.7	38372.8	39181.3	39941.3	41041.4	41891.5	42712.0	43467.4	1
2	Official foreign exchange	46.8	55.8	62.3	62.2	56.3	54.3	52.0	45.9	46.0	48.3	46.5	2
3	SDR certificates	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2	3
4	Treasury currency	24.5	25.5	26.0	26.7	26.9	27.2	27.4	27.5	27.6	27.8	28.1	4
5	Foreign deposits	810.1	831.1	867.8	957.7	1062.7	1010.0	1032.9	1044.5	1101.8	1161.7	1185.8	5
6	Net interbank liabilities	191.4	206.0	193.3	212.2	196.6	207.6	204.3	220.3	198.1	154.5	151.3	6
7	Checkable deposits and currency	1360.2	1351.9	1432.0	1521.8	1499.7	1514.6	1481.9	1525.0	1508.6	1538.5	1493.4	7
8	Small time and savings deposits	3370.5	3695.9	4001.7	4284.6	4376.0	4408.5	4523.7	4599.4	4688.7	4733.0	4791.4	8
9	Large time deposits	1121.0	1171.0	1232.8	1504.9	1575.4	1637.1	1738.0	1776.0	1876.1	1949.0	2053.7	9
10	Money market fund shares	2240.6	2223.9	2016.4	1879.8	1841.0	1831.5	1876.7	2006.9	2014.1	2067.4	2166.5	10
11	Security RPs	1233.7	1340.3	1567.5	1650.7	1782.8	1911.3	1983.9	2005.6	2127.7	2221.8	2371.4	11
12	Mutual fund shares	4135.4	3638.4	4654.2	5436.3	5471.6	5595.7	5874.4	6048.9	6464.1	6420.0	6625.8	12
13	Security credit	825.9	738.8	871.3	1037.9	1051.5	1064.5	1068.0	1030.2	1105.2	1147.9	1180.7	13
14	Life insurance reserves	880.0	920.9	1013.2	1060.4	1059.4	1067.2	1077.7	1082.6	1091.6	1092.6	1103.1	14
15	Pension fund reserves	8766.4	8068.0	9672.7	10636.8	10461.7	10666.5	10954.2	11176.7	11393.8	11271.4	11633.8	15
16	Trade payables	2372.3	2460.2	2485.2	2674.6	2721.6	2783.4	2867.6	2914.2	2950.5	3030.0	3087.5	16
17	Taxes payable	219.2	241.4	240.5	268.1	285.0	287.7	295.8	295.7	311.6	311.8	321.1	17
18	Miscellaneous	11281.6	11976.1	12431.7	13877.4	13895.1	14106.8	13878.6	13982.4	13807.0	13807.1	14043.7	18
19	**Total liabilities**	68139.7	70674.1	77384.5	84798.0	85738.2	87357.6	88880.3	90825.3	92606.1	93697.0	95753.3	19
	+ Financial assets not included in liabilities:												
20	Gold and SDRs	21.8	23.2	23.7	24.6	22.6	22.3	19.3	19.3	19.4	19.7	19.7	20
21	Corporate equities	15310.6	11900.5	15618.5	17389.3	17002.3	17185.9	17914.7	18277.0	19140.8	18668.9	19306.3	21
22	Household equity in noncorp. bus.	4805.7	4970.0	5399.6	5957.7	6133.1	6357.7	6555.0	6739.9	6942.3	7055.0	7140.9	22
	- Liabilities not identified as assets:												
23	Treasury currency	-8.6	-9.1	-9.5	-9.7	-9.6	-9.4	-9.0	-9.1	-10.3	-10.2	-10.0	23
24	Foreign deposits	630.9	652.5	705.9	767.9	864.1	803.3	808.9	813.2	873.9	941.0	972.1	24
25	Net interbank transactions	11.1	15.5	12.6	27.3	35.7	23.3	27.5	38.5	44.0	44.4	45.5	25
26	Security RPs	390.6	426.6	402.6	258.8	361.1	427.7	413.5	389.8	461.9	551.3	636.6	26
27	Taxes payable	93.3	126.3	69.3	96.2	91.9	97.0	80.8	95.4	93.1	74.3	56.7	27
28	Miscellaneous	-3450.2	-3269.9	-3026.9	-2878.7	-3117.5	-3104.3	-3451.4	-3378.6	-3599.6	-3853.0	-3827.7	28
	- Floats not included in assets:												
29	Checkable deposits: Federal govt.	-12.3	-11.7	-17.9	11.2	4.9	1.7	2.8	1.8	1.5	1.5	2.7	29
30	Other	21.6	20.9	20.8	20.6	16.4	19.6	12.4	20.6	16.4	19.7	12.4	30
31	Trade credit	-140.5	25.3	64.9	58.9	-3.5	-34.9	-19.6	39.7	-11.3	-29.3	-24.8	31
32	**Totals identified to sectors as assets**	90742.0	89591.5	100204.4	109817.1	110652.5	112699.3	115503.3	117858.0	120838.9	121700.8	124356.7	32

TABLE 2 -- 25 LARGEST FOREIGN HOLDERS OF U.S. CREDIT MARKET DEBT (MILLION $), PRELIMINARY JUNE 2006 DATA

No.	Country	% Holdings of U.S. Credit Market Debt Outstanding	Increase In U.S. Debt Holdings June 2005 - June 2006	% Increase In U.S. Debt June 2005 - June 2006	% Holdings Of U.S. Treasury Securities
1	JAPAN	2.6%	14,966	1%	13%
2	CHINA, MAINLAND[1]	1.6%	171,653	33%	8%
3	UNITED KINGDOM	1.5%	79,749	14%	1%
4	LUXEMBOURG	1.3%	88,804	19%	1%
5	CAYMAN ISLANDS	1.1%	55,060	13%	1%
6	CANADA	0.9%	74,019	24%	0%
7	BELGIUM	0.8%	-4,110	-1%	0%
8	NETHERLANDS	0.7%	18,169	7%	0%
9	SWITZERLAND	0.6%	23,703	10%	1%
10	MIDDLE EAST OIL-EXPORTERS[3]	0.6%	81,883	51%	2%
11	IRELAND	0.5%	40,586	21%	0%
12	COUNTRY UNKNOWN	0.5%	17,528	9%	0%
13	GERMANY	0.5%	11,136	6%	1%
14	BERMUDA	0.5%	3,715	2%	1%
15	FRANCE	0.4%	42,077	34%	1%
16	SINGAPORE	0.4%	18,601	13%	1%
17	TAIWAN	0.3%	9,201	7%	1%
18	KOREA, SOUTH	0.3%	5,956	5%	1%
19	RUSSIA	0.3%	34,468	45%	0%
20	HONG KONG	0.3%	14,188	15%	1%
21	AUSTRALIA	0.3%	16,980	18%	0%
22	MEXICO	0.2%	18,162	23%	1%
23	SWEDEN	0.2%	-3,134	-4%	0%
24	BRITISH VIRGIN ISLANDS	0.2%	2,614	3%	0%
25	NORWAY	0.2%	6,497	10%	0%
TOTALS	TOP 25 + ALL OTHERS	18%	914,989	13%	42%

Source: U.S. Department of Treasury Report On Foreign Holdings of U.S. Securities (Mar. 30, 2007); and U.S. Federal Reserve Statistical Release, Flow of Funds Accounts of the United States (Dec. 7, 2006).

Statement of the Robert S. Nichols
President and COO
The Financial Services Forum

Testimony Before the
Committee on Banking, Housing, and Urban Affairs
Subcommittee on Security and International Trade and Finance

May 23, 2007

Introduction

Chairman Bayh and Ranking Member Martinez, thank you for the opportunity to participate in this important hearing on America's economic relationship with China and strategies regarding exchange rates and expanded market access.

I am here as President and chief operating officer of the Financial Services Forum, the chairing organization of the **ENGAGE CHINA** coalition – a partnership among eight financial services trade associations united in our support of the goals of the U.S.-China Strategic Economic Dialogue (SED).[1] By providing an overarching framework for the examination of long-term strategic issues, as well as coordination of ongoing bilateral policy discussions, the SED greatly enhances economic cooperation between the United States and China – to the betterment of the people of both nations.

The members of the Financial Services Forum and the **ENGAGE CHINA** coalition share Congress' commitment to maintaining a strong U.S. economy, enhancing savings, and opening world markets to American products and services. Among the array of policies necessary to achieve those goals is for the currencies of our major trading partners to be determined by the markets. At the same, we should not allow currency issues to overshadow our broader economic relationships with our trading partners. In the case of China, the issue of expanded market access – particularly with regard to financial services – is of far greater significance to the policy goals of maintaining strong U.S. economic growth and job creation.

The Importance of Market-Determined Exchange Rates

An exchange rate is just a price, the price of one currency in terms of another. As with any other commodity in a free market, the price of a currency should be determined by the interplay of supply and demand based on economic fundamentals. By reflecting investors' interest in holding assets denominated in one currency over assets denominated in another, market-determined currencies – just like standard prices in any economy – help direct scarce

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[1] American Bankers Association, American Council of Life Insurers, American Insurance Association, The Council of Insurance Agents & Brokers, The Financial Services Forum, The Financial Services Roundtable, Investment Company Institute, and the Securities Industry and Financial Markets Association.

resources to their most productive uses. Market-determined currencies also have the benefit of serving as a correction mechanism for the global economy – as a falling currency helps stimulate demand for the products of a slumping economy, and a rising currency helps cool demand for the products of a booming economy.

As the members of this subcommittee know very well, one of our most important trading partners is China – currently the world's fourth largest economy and soon to become the third largest. Since China's accession to the World Trade Organization (WTO) in December of 2001, trade between the United States and China has nearly tripled, exports to China have grown at five times the pace of U.S. exports to the rest of the world, and China has risen from our 9th largest export market to our 4th largest.

Fair and competitive access to China's fast-growing middle class and business sector represents an unprecedented commercial opportunity for U.S. manufacturers, farmers, and services providers, with profound implications for U.S. economic growth and job creation. But to continue growing – and for the yuan to float freely according to market forces – China needs a more open, competitive, and effective financial system. The fastest way for China to develop the modern financial system it needs is to import it – that is, by opening its financial sector to greater participation by foreign financial services firms. I'll have more to say about this in a few moments.

China and the Yuan

In recent years the discussion in Washington regarding the U.S.-China economic relationship has focused in large part on China's currency policy. Many policymakers assert that an undervalued yuan makes cheap Chinese exports even cheaper, giving Chinese producers an unfair advantage over American companies and contributing to the U.S. trade deficit with China.

A market-determined yuan is important – for the United States and especially for China. Foreign exchange market intervention by the People's Bank of China – buying dollars with yuan – has boosted liquidity in China's economy, thwarting government efforts to scale back excessive bank lending and fixed investment. Speculative money flowing into China in anticipation of a revaluation is also undermining government objectives. Finally, allowing the yuan to more fully float according to market forces would free the PBOC to pursue monetary policies that advance China's macroeconomic goals. For these reasons – as well as the priority of a more fair and transparent trade relationship – U.S. policymakers should continue to press China to accelerate progress toward a market-determined yuan.

For years, the United States has worked with China toward achieving a yuan whose value is determined by market forces. Indeed, shortly after taking office, the Bush Administration committed to helping China develop the capital markets know-how and expertise necessary to end the yuan's peg to the dollar, providing massive technical assistance. And those efforts have begun to bear fruit. In July of 2005, China revalued its currency upward by 2 percent. Since mid-2006, the pace of appreciation has accelerated, averaging about 4.9 percent a month at an annualized rate, and quickening to around 5.4 percent in the first few months of 2007, as China has become more confident about the resilience of its economy. In total, the yuan has appreciated by about 8 percent since July of 2005.

This is important progress – but, clearly, much more progress is needed. Given the importance of a market-determined yuan to the economic objectives of both countries, the United States should continue to press China to redouble its reform efforts and accelerate movement toward a freely floating yuan.

But even as we continue to press China on the yuan, we should not allow the currency issue to overshadow the broader potential of the U.S.-China economic relationship. Indeed, it should be noted that the short term effect of a significant appreciation in the yuan would likely be to make the trade deficit *worse*. Because a higher-valued yuan would mean higher prices for imported Chinese goods, and because the process of finding cheaper alternatives to more expensive Chinese goods takes time, the trade deficit would likely get worse before getting better – a phenomenon economists call the J-curve effect.

Of far greater significance to the policy goals of maintaining strong U.S. economic growth and job creation is for China to achieve a more sustainable model of continued economic growth and for its population of 1.3 billion – a fifth of the world's population – to begin consuming at higher levels. Both goals require reform and modernization of China's financial sector.

Critical Importance of Financial Sector Reform in China

Capital is the lifeblood of any economy's strength and well-being, enabling the investment, research, and risk-taking that fuels competition, innovation, productivity, and prosperity. The financial system can be thought of as an economy's cardiovascular system – the institutional and technological infrastructure for the mobilization and allocation of the economy's lifeblood, investment capital.

Given the unique and critical role an effective and efficient financial sector plays in any economy, reform of China's financial sector is a *prerequisite* to China achieving its own economic goals of: 1) maintaining high rates of growth and job creation; 2) encouraging a structural shift from industry to services; 3) promoting the development of domestic consumer demand; 4) reducing poverty; and, 5) ensuring a more equitable distribution of opportunity and prosperity.

Financial sector reform is also a prerequisite to meaningfully addressing issues that have complicated the U.S.-China economic relationship, particularly greater currency flexibility and reducing trade imbalances.

<u>Achieving China's Economic Priorities</u>

- *Maintaining High Rates of Growth and Job Creation*: Maintaining exceptional rates of economic growth and job creation in China increasingly depends on an effective system for mobilizing investment capital. At present, China's weak banking system intermediates nearly 75 percent of the economy's total capital, compared to about half in other emerging economies and less than 20 percent in developed economies. Despite some improvements in recent years, Chinese banks' credit analysis, loan pricing, risk management, internal controls, and corporate governance practices remain inadequate. Meanwhile, China's equity and bond markets are among the smallest and least developed in the world. More fully developed capital markets would provide healthy competition to Chinese banks and facilitate the development and growth of alternative retail savings products such as mutual funds, pensions, and life insurance products. And by broadening the range of funding alternatives for emerging companies, more developed capital markets would greatly enhance the flexibility and, therefore, the stability of the Chinese economy.

- *Shifting from a Manufacturing-for-Export to a Services-Based Economy*: Facilitating China's desired transition to a more services-based economy will require that competitively priced capital and credit be channeled to the most promising emerging service businesses, and that the array of financial products and services emerging businesses require – loans, letters of credit, accounts management services, asset management, and insurance products – be made available.

- *Activating the Chinese Consumer*: Chinese households historically save as much as a third of their income, as compared to single-digit savings rates in the United States and Europe. This pronounced propensity to save is related to the declining role of the state and the fact that most Chinese depend on their families and private savings to pay for retirement, healthcare, and the economic consequences of accidents or disasters. Activating the Chinese consumer requires the availability of financial products and services – personal loans, credit cards, mortgages, pensions, insurance products, and insurance intermediary services – that will eliminate the need for such "precautionary savings" and facilitate consumption.

Meaningfully Addressing Issues with the United States

A more effective and efficient financial sector in China is also a prerequisite to successfully addressing issues that have complicated the U.S.-China economic relationship, particularly further currency reform and meaningfully reducing the trade imbalance.

- *Market-determined exchange rate*: A Chinese authorities have repeatedly argued – reasoning generally acknowledged by most foreign analysts – that a more rapid shift to a market-determined yuan is not possible given the underdeveloped state of China's capital markets. More specifically, China's banks, securities firms, and other businesses lack the expertise to develop and trade derivatives and other structured instruments used to hedge the risk associated with greater currency volatility. Sophisticated derivative products and hedging techniques provided by foreign financial services firms would clearly diminish such concerns.

- *Reduction of trade deficit*: Reorienting the financial habits of China's population from precautionary savings to a better balance between savings and consumption – while progressively bringing more than a billion Chinese into the global economy – is the most powerful remedy to the U.S.-China trade imbalance. Last year, the United States exported to Japan goods and services worth $60 billion – approximately the same amount exported to China ($55 billion). But China's population of 1.3 billion is ten times Japan's population of 127 million. If U.S. exports are expressed in relation to population, the U.S. sold the equivalent of $472 worth of goods and services to every citizen of Japan last year, but only about $40 worth of goods and services to every Chinese citizen. If China's citizens were to eventually consume American-made goods and services at the same rate that Japan's citizens did last year, the United States would export more than $600 billion worth of goods and services to China, 11 times what America exported to China last year, an amount equivalent to 5 percent of America's GDP, and more than twice what we imported from China last year – replacing the trade deficit with a significant surplus.

Status of Financial Sector Reform in China

In addition to working to meet its WTO commitments, China has also taken important steps to liberalize its financial sector and improve financial regulation. For example:

- The financial sector has been transformed from a single-bank system to a more diversified system with a central bank at the helm.
- Meaningful steps have been taken to eliminate state-directed policy lending, and amendments to the Law on Commercial Banks and the Law on the Peoples Bank of China have laid the foundations for commercially viable lending.
- The China Banking Regulatory Commission (CBRC) was established in April of 2003 to oversee all banks in China, investigate illegal banking operations, and punish violations of law.
- Interbank, equity, and foreign exchange markets have been established and important progress made toward implementing monetary policy through market mechanisms rather than by government fiat.

Despite these significant achievements, China's financial sector still faces serious challenges:

- Non-commercial lending to state-owned enterprises continues, although on a diminishing scale.
- The stock of nonperforming loans on banks' balance sheets remains high.
- Banks are undercapitalized and lending practices, risk management techniques, new product development, internal controls, and corporate governance practices remain inadequate.
- Prudential supervision and regulation of the financial sector is opaque, applied inconsistently, and lags behind international best practices.

- China's equity and bond markets remain small and underdeveloped.

With these problems in mind, efforts to build on the progress achieved to date should focus on:

- The critical importance of open commercial banking, securities, insurance, pension, and asset management markets to promoting the consumption-led economic growth that China's leaders seek;

- The clear benefits to China of increased market access for foreign financial services firms – namely the introduction of world-class expertise, technology, and best practices – and the importance of removing remaining obstacles to greater access.

  Foreign investors in Chinese banks remain limited to 20 percent ownership stakes, with total foreign investment limited to 25 percent. The China Securities Regulatory Commission (CSRC) continues to limit foreign ownership of Chinese securities firms to 33 percent and foreign ownership of Chinese asset management companies to 49 percent. Worse, since December of 2005 has imposed a de facto moratorium on foreign investments in Chinese securities firms. The moratorium is inconsistent with the letter, and certainly the spirit, of China's WTO commitments. Foreign life insurance companies remain limited to 50 percent ownership in joint ventures and all foreign insurers are limited to 25 percent equity ownership of existing domestic companies.

  While these caps were agreed to in the course of WTO accession negotiations, the limitations are among the most restrictive of any large emerging market nation and stand in the way of a level playing field for financial service providers. Most importantly, they limit access to the products, services, know-how, and expertise that China needs to sustain high rates of economic growth, and that China's businesses and citizens need to save, invest, and create and protect wealth. For these reasons, the United States and other WTO members have urged China to relax these limitations.

  China also continues to restrict access by foreign credit card companies. Banks in China are permitted to issue a credit card with a foreign logo only if the card is co-branded with the logo of China Union Pay (CUP), an entity created by the People's Bank of China (PBOC) and owned by participating Chinese banks. In addition, all yuan-denominated transactions must be processed through CUP's network, while the network of the foreign credit card company is used only to process foreign currency transactions.

- Non-discriminatory treatment with regard to licensing, corporate form, and permitted products and services.

- Non-discriminatory treatment with regard to regulation and supervision.

- Regulatory and procedural transparency.

- Attracting sophisticated institutional investors to China's capital markets through the expansion of the Qualified Foreign Institutional Investor (QFII) and Qualified Domestic Institutional Investor (QDII) programs.

- Priority issues from the Transitional Review Mechanism that remain unresolved.[2]

Conclusion

Mr. Chairman, the fastest way for China to develop the modern financial system it needs to achieve more sustainable economic growth, allow for a more flexible currency, and increase consumer consumption is to import it – that is, by opening its financial sector to greater participation by foreign financial services firms. Foreign institutions bring world-class expertise and best practices with regard to products and services, technology, credit analysis, risk management, internal controls, and corporate governance. In addition, the forces of competition brought by foreign institutions would accelerate the development of modern financial techniques and methodologies by China's financial institutions.

By providing the financial products and services that China's citizens and businesses need to save, invest, insure against risk, raise standards of living, and consume at higher levels, foreign financial institutions – including U.S. providers – would help create what every U.S. manufacturer and service provider wants – an unleashed Asian tiger hungry for U.S. products.

Thank you very much for the opportunity to appear at this important hearing.

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[2] China's WTO accession included the Transitional Review Mechanism (TRM) as a means for ongoing review of China's compliance with its obligations, and to provide those elements of the Chinese government supportive of further economic reform with information and evidence to urge full compliance with China's WTO commitments.

TESTIMONY OF PATRICK A. MULLOY
BEFORE THE SUBCOMMITTEE ON INTERNATIONAL TRADE AND FINANCE
SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
HEARING ON U.S. ECONOMIC RELATIONS WITH CHINA: STRATEGIES AND OPTIONS ON EXCHANGE RATES AND MARKET ACCESS

MAY 23, 2007

Introduction

Chairman Bayh, Ranking Member Martinez, and members of the Subcommittee, thank you for providing me with this opportunity to speak before you today on these important matters.

My name is Patrick Mulloy and I served as a member of the twelve person bipartisan, bicameral United States-China Economic and Security Review Commission from its creation in early 2001 through the end of 2006. I presently serve as the Washington Representative of the Alfred P. Sloan Foundation and also teach International Trade Law and Public International Law as an Adjunct Professor at the law schools of George Mason University and Catholic University.

I commend the Subcommittee for holding this important oversight hearing and I am honored by the invitation to testify. It is a source of enormous personal satisfaction for me to have served in a bipartisan manner on the staff of this committee from 1983 to early 1998 when I left to take a position as Assistant Secretary in the Department of Commerce's International Trade Administration where I headed the Market Access and Compliance unit. During the period of 1987-1988, when the provisions of the 1988 Omnibus Trade Law dealing with "Exchange Rates and International Economic Policy Considerations" were being formulated by this Committee, I served as the Committee's General Counsel and was directly involved in the negotiations which led to their formulation. Chairman Dodd and

Ranking Member Shelby are the only members of the Committee today who were involved in crafting the Banking Committee's contribution to the Omnibus Trade and Competitiveness Act of 1988. Among other things the Banking Committee contributions required the Treasury Department to identify countries that manipulate their currency to gain trade advantages. I was invited today to give the Committee my understanding of the background and early implementation of those provisions of law and also to discuss how they relate to China' current exchange rate practices.

I should note that the views I will present today are my own and not necessarily those of any of my present employers nor the U.S. China Economic and Security Review Commission.

Banking Committee Formulation of the Exchange Rate Provisions of the 1998 Trade Bill

Under Article I, Section 8 of the United States Constitution it is the Congress, not the Executive Branch, which is charged with the regulation of both foreign commerce and the value of our currency. In 1987 the leadership of the Congress, troubled by our nation's rising trade deficit, decided to craft an Omnibus Trade Bill and charged each relevant Committee in the House and Senate to formulate portions of such a bill that fell under such Committee's jurisdiction. Senator Proxmire, then Chairman of the Banking Committee, asked the International Finance Subcommittee, then led by Senators Sarbanes and Heinz, to develop the Banking Committee's portions of such a bill. Chairman Proxmire asked me as his General Counsel to work closely with the Subcommittee and to keep him informed of developments. I thus worked closely with Senators Sarbanes and Heinz and was personally involved with all facets of the Banking Committee's contribution to the Omnibus Bill.

The Banking Committee on May 19, 1987 marked up and ordered to be reported S. 1409, the United States Trade Enhancement Act of 1987, which dealt with a number of trade issues within the Committee's jurisdiction including exchange rates and international economic negotiation. The Committee Report stated:

> "The cumulative trade deficits of over $500 billion, built up by the U.S. since 1982, have made this country the world's largest debtor nation and underscore the need of our economy to compete internationally."

The various portions of this Omnibus Trade Bill reported by each Senate Committee were merged into one bill, each Title of which was managed by its authoring Committee and considered sequentially on the Senate floor during the summer of 1987. The House followed a similar procedure and in fact passed its bill H.R. 3 first. This was because the trade bill was considered a revenue measure on which the House had to act first. The Senate, at the conclusion of its work on its trade bill in August 1987, took up H.R. 3, substituted the text of the Senate bill and called for a conference with the House. Small groups of Senators from each Committee were appointed to conference the different portions of the Senate bill within the jurisdiction of each Committee. Senators Sarbanes, Dixon and Heinz of the Senate Banking Committee conferenced the provisions dealing with exchange rates and international economic negotiations.

The Conference Report Provisions

On April 20, 1988 the Conference Report on the Omnibus Trade and Competitiveness Act of 1988 was agreed upon and ordered to be presented. Title III of the Conference Bill dealt with International Financial Policy. Subtitle A dealt with "Exchange Rates and

International Economic Policy Coordination". In Section 3002 of the bill, which became law, Congress found that:

> "...a pattern of exchange rates has at times developed, which contribute to substantial and persistent imbalances in the flow of goods and services between nations imposing serious strains on the world trading system... **policy initiatives of some major trading nations that manipulate the value of their currencies in relation to the United States dollar to gain competitive advantage continue to create serious competitive problems for United States industries."**

Section 3003 of the Bill stated the "goal of the United States in international negotiations" was to achieve macroeconomic policies consistent with more appropriate balances in trade.

Multilateral Negotiation Provisions

Section 3004 (a) of the bill charged the President to engage in "multilateral negotiations" to achieve among other things:

> "more appropriate and sustainable levels of trade and current account balances, and exchange rates of the dollar and other currencies consistent with such balances."

Bilateral Negotiation Provisions

Section 3004 (b) of the bill entitled "Bilateral Negotiations" stated:

> 'The Secretary of the Treasury **shall** analyze on an annual basis the exchange rate policies of foreign countries, in consultation with the International Monetary Fund, and consider whether countries manipulate the rate of exchange between their currency and the United States dollar for purposes of preventing effective balance of payment adjustments or gaining unfair competitive advantages in international trade.'

That section went on to state that if the Secretary "considers that such manipulation is occurring with respect to countries that (1) have material global current account surpluses and (2) have significant bilateral trade surpluses with the United States, the Secretary of the Treasury **shall** take action to initiate negotiations with such foreign countries on an expedited basis, in the International Monetary Fund or bilaterally, for the purpose of ensuring that such countries **regularly and promptly** adjust the rate of exchange between their currencies and the United States dollar to permit effective balance of payment adjustments and to eliminate the unfair advantage...

Treasury's Need to Be Honest Is Cited

In the Conference Report the conferees also stated:

> **"It is the intent of the Conferees through the reporting requirement to increase the accountability of the Executive Branch regarding the impact of the exchange rate on foreign borrowing and the competitive position of U.S. industries as reflected in the nation's trade and current account balances...**

The Conferees then went on to state: "The success of the legislation hinges on the process of reporting and consultation by the Secretary of the Treasury with Congress". The Conferees knew the legislation could not achieve its purposes if the Treasury Department failed to accurately report on whether foreign governments were manipulating their currencies. That was a crucial first step to have the Congress and Executive Branch work together to develop strategies to counter the unfair practice.

Reports on Foreign Treatment of United States Financial Institutions

Two other sections of Title III of the Omnibus Trade Act of 1988 that have not received as much attention as the Exchange Rate sections are also relevant to the subject matter of the this hearing. They are Sections 3602 and 3603. Section 3602 requires the

Secretary of the Treasury to submit to Congress every four years beginning in December 1, 1990 a report which identifies countries which are denying U.S. financial firms national treatment, that is, equitable market access. Section 3603 requires the President or his designee (read Secretary of the Treasury) to conduct market access discussions with the governments of such identified countries that are major financial centers.

The first such report issued in December 1990 identified a number of counties whose financial firms had good access to the U.S. market but denied U.S. firms access to their own market. The Committee used that report as a basis for crafting a piece of legislation entitled "Fair Trade in Financial Services". This legislation would have required U.S. financial regulators and the Treasury to deny market access in the United States to financial firms from countries that denied market access to U.S. financial firms. That bill passed the Senate and the House and although it was never enacted into law it did play a major role in opening up the Japanese financial market to U.S. financial firms and demonstrated how the Congress and the Executive Branch could work together to achieve policy goals set by the Congress.

My understanding is that even though the provision of law requiring such national treatment reports regarding financial services is still on the books, the Treasury Department on its own decided to stop preparing them and submitting them to the Congress. I believe it would be very useful if the Banking Committee were to write to the Treasury asking it to carry out that legislative requirement. It would permit the Congress to better carry out its oversight of the important goal of achieving market access for U.S. financial firms in major foreign markets.

The Treasury at First Actively Identifies Currency Manipulators

The exchange rate provisions of the Omnibus Trade Law were enacted into law in the final months of the Reagan Administration in 1988. The new Administration of President George Herbert Walker Bush made good use of the new tools given to it by Congress to go after countries that manipulated their currencies. That Administration had no difficulty identifying and reporting to Congress that at various times Korea, Taiwan and China were currency manipulators. It negotiated with each to put an end to the cited practices it then found objectionable. The then Under Secretary of the Treasury for International Affairs David Mulford, who is now Ambassador to India, told the Committee he found the law most helpful and commended the Committee for formulating it.

The Committee should understand that such identifications of currency manipulators and successful negotiations to curb the cited practices took place during the period before the United States joined the World Trade Organization in 1994. Prior to joining in 1994 we still maintained unimpaired Section 301 of the Trade Act of 1974 as amended by the 1988 Omnibus Trade Act. Under Section 301 the USTR maintained the ability to identify unfair trade practices of foreign governments that damaged U.S. commerce and to impose duties or other import restrictions in retaliation. We had the ability under Section 301 to use access to our market as a lever to open foreign markets or to negotiate to end unfair trade practices utilized by foreign governments.

Use of Section 301 Curbed by Our Entry into the WTO

The United States gave up the ability to use Section 301 unilaterally to target unfair trade practices when it joined the World Trade Organization. Although Section 301 is still on the books it now only provides a vehicle whereby private industry or certain Committees of Congress can petition USTR to negotiate with foreign governments about unfair trade practices or to take cases to the WTO. It also provides the Executive Branch with the statutory authority to implement WTO authorized retaliatory action that would be permitted only after winning a case in the WTO's dispute settlement process.

Because Section 301 remained on the books after we entered the WTO there were concerns voiced by some countries that it might be used contrary to our WTO obligations. The European Union thus brought a case in the WTO claiming that the U.S. by **simply** maintaining the statute on its books was violating its WTO obligations. The WTO Panel which handled the dispute did not find that having Section 301 on our books was itself a WTO violation because it noted the U.S. Government agreed it would use the provision of law only to implement actions permitted after a WTO dispute settlement process was completed. (See International Economic Relations: Cases and Materials by Jackson, Davey and Sykes at page 331).

Once China joined the WTO in 2001 the U.S. Government lost its ability to take unilateral action under Section 301 against China for unfair trade practices such as currency manipulation. This does not mean we can not use other provisions of our law to target specific unfair trade practices utilized by the Chinese to increase their exports to our market such as dumping or export subsidies. The Chinese under priced currency is clearly acting as an export subsidy to Chinese exporters and should be countered by countervailing duty tariffs.

The Treasury Failed To Utilize the Exchange Rate Provision of the 1988 Trade Bill from 1994 to the Present

The Treasury Department has failed to utilize the exchange rate provisions of the 1988 Trade Bill since 1994. Despite very evident practices of exchange rate manipulation by a number of Asian nations, including China, the Treasury has read the relevant provisions of the 1988 Trade Bill in a tortured manner in order to avoid carrying out the important task given it by Congress regarding the policing of currency manipulation. For some reason which is difficult to fathom the Treasury has been reluctant to use the tool this Committee crafted to have the Congress and Executive Branch work together to head off currency manipulation that harms our industries and workers. Perhaps its officials are closer to certain interests which would consider naming currency manipulators a "protectionist" practice. The Treasury's failure to be honest with Congress has consequences even to its own efforts to curb China's illegal currency practices. Last September when Tim Adams, the Treasury Under Secretary for International Affairs criticized the IMF for failing to police blatant violations of the IMF provisions forbidding currency manipulation, which will be discussed below, Mr. Rodrigo de Rato, the IMF Managing Director defended the IMF by retorting that the Treasury had not named China a currency manipulator in its own reports to the Congress.

In recent years under Chairmen Sarbanes, Shelby and Dodd this Committee has taken a very active role in calling the Treasury to account for its failure to carry out its statutory duties on exchange rates. It has pressed that agency to acknowledge the reality of how China and other Asian nations are using under priced currencies to undermine our domestic manufacturers and encourage them to outsource their operations to Asia to survive. Because of the Treasury's reluctance to carry out its statutory duties the Committee might consider changes to the current law that would give the Congress a greater role in policing currency manipulation as an illegal and unfair trade practice. It is the Congress, after all, that has the authority under the Constitution to take the lead in foreign commerce matters.

Reports of the Bipartisan China Commission Cite China

The bipartisan U.S.-China Economic and Security Review Commission, on which I served three two year terms, has had no problem identifying China as a currency manipulator. In its very first Report to the Congress in July 2002 the Commission stated:

> "The exchange rate of the Chinese yuan to the dollar is also an important factor contributing to the U.S. deficit ... China accomplishes this by large official purchases of dollars in order to maintain an exchange rate lower than would otherwise occur by market forces alone. By holding down the exchange rate China gains an unfair trade advantage that increases the U.S. trade deficit beyond what the market would dictate."

That statement by the Commission was made almost five years ago. Instead of taking action in a timely manner to stop the practice the Treasury has permitted this problem to metastasize creating a much more difficult issue with China, giving China increasing leverage over our economy, and doing great harm to the U.S. manufacturing base, including our defense manufacturing base.

The bipartisan China Commission in three subsequent reports to the Congress issued in June 2004, November 2005 and November 2006 has described how China's exchange rate policies violate both its WTO and IMF obligations and is doing great damage to America's manufacturing and industrial base.

China's Exchange Rate Policies Violate Both its WTO and IMF Obligations

The Chinese Vice Premier Madam Wu Yi, who is leading the Chinese delegation at this week's Strategic Economic Dialogue with Treasury Secretary Paulson, said last week that "the U.S. should not politicize trade issues." Secretary Paulson in turn is quoted in the May 22nd Washington Post as telling his Chinese counterparts "that Congress legislates on trade and there is a protectionist sentiment in this country." These statements imply that we are politicizing trade issues or acting protectionist if we ask China to live up to its legal obligations. I have often heard other Chinese officials claim that they have a "sovereign" right to control their own exchange rates policies. This would be true if they had not joined the International Monetary Fund and the World Trade Organization. By joining these organizations, from which they derive enormous benefits, China has agreed to follow the rules set forth in the treaties that establish and govern these organizations. If China were not a member of the WTO the United States would not have to give China most-favored-nation (MFN) trade treatment. Without MFN treatment Chinese goods would face over a 40 percent average tariff entering the United States. Because we give China MFN trade treatment as a member of the WTO their average tariff for goods exported to the United States is less than three percent. Every day as China violates its WTO and IMF obligations to us, we continue to permit it virtually unimpeded access to our markets. Demanding that China live up to its legal obligations is not acting in a protectionist manner. In fact those who countenance illegal foreign trade practices that inflict massive damage on our domestic corporations and their workers will bring about the very protectionist reaction they claim to fear. Let me explain what treaty obligations governing exchange rates China is violating.

a) China's IMF Obligations

The International Monetary Fund (IMF) was established in 1945 to help nations cooperate to avoid some of the economic and trade problems that marked the 1920's and 1930's. Article I of the IMF Charter, which is a treaty, states that one of its purposes is to

> "promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciations."

Article IV of the IMF Charter, entitled "Obligations Regarding Exchange Arrangements", obligates each member nation:

> **"to avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustments or to gain an unfair competitive advantage over other members"**

The IMF has adopted surveillance provisions to guide member nations on how various IMF Articles will be interpreted. With regard to surveillance of Article IV it defined currency manipulation as:

> **"protracted large scale intervention in one direction in the exchange market."**

China is blatantly violating this IMF obligation by having its Central Bank on a regular basis intervene in currency markets to purchase hundreds of billions of dollars in order to prop up the dollar's value against the yuan, the Chinese currency. The more U.S dollars China earns in trade, the more purchases of U.S. dollars China's Central Bank makes. In the first quarter of 2007 it bought about $45 billion dollars monthly which exceeds last years purchases significantly. This is because China's bilateral trade surplus with us and its global surplus are both increasing dramatically. Its surplus with us this year will be above $250 billion and its global surplus will be near $300 billion. In the last decade the United States has run trade deficits with China totaling nearly $1.2 trillion. China has also accumulated foreign currency reserves of over $1.2 trillion dollars, many of which are in U.S. dollar reserves. They invest these dollars in U.S. Treasury bills and other dollar obligations such as those issued by Fannie Mae and Freddie Mac. These re-cycled dollars help keep U.S. interest rates lower than they would otherwise be, but also give the Chinese Government increasing leverage over the health of the American economy. We also must pay the interest on these bonds to the Chinese Government so we send China additional dollars to what they earn on their ever increasing trade surpluses with us. This adds to our current account deficit. It is a situation that poses a real danger to our national interests if left to worsen. China's exchange rate practices also violate China's WTO/GATT Commitments.

b) China's WTO/GATT Commitments

The WTO rules governing exchange rates derive from the pre-existing Article XV of the General Agreement on Tariffs and Trade which was incorporated as part of the legal commitments assumed by WTO members when the latter organization was created in 1994. Article XV of the GATT entitled "Exchange Arrangements" states in part:

> "Contracting parties shall not by exchange actions frustrate the intent of the provisions of this Agreement, nor by trade actions, the intent of the provisions of the Articles of Agreement of the International Monetary Fund"

The intent of the GATT Agreement as stated in the organization's preamble states the desire of its parties to enter into:

> "reciprocal and mutually advantageous arrangements related to the substantial reduction of tariffs and other barriers to trade and to the elimination of discriminatory treatment to international commerce."

Moreover there is a direct linkage between GATT Article XV and IMF Article IV since the GATT Article XV states that the GATT when dealing with problems regarding foreign exchange arrangements shall consult fully with the IMF. It is thus very important to ensure that, if the United States should decide to bring a WTO case against China for its currency manipulation, it should also be working within the IMF to convince its members that China's exchange rate actions violate that institution's Article IV obligations and are creating very serious imbalances in today's global economy that threaten its stability. The G-7 Finance Ministers at their meeting on February 10, 2007 called for a rise in the Yuan's trade weighted exchange value.

<u>China's Exchange Rate Practices Are Part of Its Larger Economic Strategy</u>

In my additional views filed under the U.S.-China's Economic and Security Review Commission's 2006 Report I stated that:

> "China has instituted economic incentives, including subsidies and an under priced exchange rate to induce foreign companies including U.S. multinational corporations to increase their "shareholder value" by transferring production facilities and technology to China. There they can achieve higher profits by producing goods for sale back to the United States and to other markets. Such incentives are part of China's "export led growth strategy".

This Chinese export led growth strategy contributes to the enormous imbalances in our economic and trade relationship with China, and to the erosion of America's manufacturing and technology base. America's corporations may achieve short-term increases in shareholder value by cooperating with such a strategy but overall the situation poses a long term threat to America's economic primacy and even our national security as we lose skills and capacities essential to our defense industrial base.

<u>Our Corporate and National Interests Have Diverged</u>

The above discussion should not imply that the single minded focus on shareholder value demonstrated by U.S. based multinational corporations is somehow an indication of malevolent behavior. Rather it demonstrates recognition of the fact that there can be fundamental conflicts between the goals of U.S. companies (which are operating in a system that requires and rewards them to make profits for the corporation's shareholders) and our broader national interests. Sixty per cent of China's exports are made by foreign invested companies in China. That nation's current economic strategy is based on its understanding of how to motivate the behavior of the world's multinational corporations to help it build its economy. China has been following such a strategy since 1978 with ever increasing success. In recognition of this fact, America's elected officials must reclaim control of the policy agenda of our economic relationship with China from the corporate sector. Our public officials, who are accountable to all our citizens and not just corporate shareholders, must develop policies to give U.S. companies incentives to serve America's national interest by keeping and creating in this country good paying high tech jobs that sustain high living standards and our defense industrial base.

Conclusion

We as a nation need a coordinated comprehensive national policy and strategy to compete in the global economy. Such a strategy must be multifaceted, including among other things, developing measures to incentivize corporations to keep higher value added jobs in this country, increased emphasis on science education, modernizing our nation's infrastructure, vigorously enforcing our trade laws and agreements, increasing funding incentives for breakthrough technologies, getting our fiscal affairs in order, reforming health care to reduce its costs to our businesses, and ensuring we do not countenance exchange rate practices that undermine our domestic manufacturers.

Thank you again for giving me the opportunity to present my views on these important matters. I hope they are of some assistance to this great Committee on whose staff I happily served for many years. I will be pleased to answer any questions you have on these issues.

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IMF Chief Opposes United States on China;
Response Defies Efforts to Crack Down on Possible Currency Manipulation

BYLINE: Paul Blustein, Washington Post Staff Writer

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An unusual public rift between the International Monetary Fund and the Bush administration deepened yesterday as the IMF's top official made it clear that he will not cooperate with any U.S. plan to label China as a currency manipulator.

Rodrigo de Rato, the IMF's managing director, said in an interview that "we don't see evidence" that China is violating the fund's rules against maintaining an artificially cheap currency. He also suggested that the U.S. Treasury is staking out a position on the issue that contradicts its previous stance.

Rato's comments were a defiant response to a demand by a senior administration official for the IMF to crack down on currency manipulation, and they appeared likely to inflame members of Congress and labor and industry groups that are pressing for tough action against China over the currency issue.

Beijing's critics complain that the exchange rate of the Chinese yuan, which has been held at slightly more than 8 yuan per dollar for years, is far out of line with market forces and gives Chinese manufacturers a major advantage in competing with foreign firms. Some lawmakers are threatening to enact legislation that would slap across-the-board tariffs on Chinese goods if Beijing fails to significantly raise the yuan's value.

Rato's remarks came in answer to questions about a speech Friday by Timothy D. Adams, the Treasury undersecretary for international affairs, who attacked the IMF for being "asleep at the wheel" in policing currency systems. Although Adams's speech did not mention China explicitly, its thrust was clearly aimed at prodding the IMF to take a much more aggressive approach in tackling the currency issue. He criticized the fund for seldom invoking its power to cite countries that are "manipulating exchange rates" to gain "unfair competitive advantage."

In the interview, Rato, a former Spanish finance minister, showed no sign of backing down in the confrontation between his institution and a top official of the U.S. government, which is the fund's largest shareholder and is sometimes described as the puppet master behind its policies.

On the contrary, the IMF chief went beyond comments he made Friday at the same conference addressed by Adams. Yesterday, Rato flatly disputed claims that China was violating IMF rules against currency manipulation for competitive gain. "My information here is strictly what the [IMF] staff has given me -- that there is no evidence," he said. "There is a strong argument by the Chinese authorities that their main objective" in keeping the yuan steady against the dollar "is the stability of the economy."

Rato asserted that the IMF has been, if anything, well ahead of the curve compared with other governments and economists in urging China to allow its currency to move upward. In a pointed barb, he noted that the Treasury itself has refrained from tagging China for manipulation in its own semiannual reports on foreign exchange policies. "Up to now, we have had the same position as the U.S. Treasury," he said.

That comment suggested that Rato thinks the Treasury is changing its position for political reasons. The IMF chief declined to elaborate, but the view is widespread among the fund staff that Adams's broadside was designed to appease lawmakers such as Sens. Charles E. Schumer (D-N.Y.) and Lindsey O. Graham (R-S.C.), co-sponsors of the leading bill that would penalize China for failing to raise the yuan.

Rato's statements would appear to undercut any hope by the Treasury of using the IMF to batter the Chinese. Some economists argue that strong pressure from an international body like the IMF is much more likely to be effective with the Chinese than bilateral threats and would reduce the risks of a tit-for-tat trade war between the United States and China.

A senior Treasury official, asked for a comment on Rato's comments, said, "This is the beginning of the conversation, not the end" on what the IMF's priorities should be.

"At the end of the day, the shareholders, the board [of the IMF] set the priorities, and the agenda," added the official, who spoke on condition of anonymity because he did not want to intensify the dispute. The reaction to Adams's speech by officials of other countries, he said, has been "pretty positive."

The speech, he said, "was not about the managing director . . . it was more focused at the institution. . . . We hope to take more of a leadership role in setting the agenda and direction for the institution."

Testimony of John W. Nolan, Vice President and General Manager, Steel Dynamics, Inc. before the Senate Banking Committee Hearing on China Currency Manipulation - May 23, 2007

Good Afternoon Chairman Bayh and Members of the Committee. Steel Dynamics began its journey in 1994 as a "greenfield" flat-rolled steel producer in Butler, Indiana. Today, we are arguably the fifth largest steel producer in the United States, and we are an American company, with American values and interests. We have eight (8) production facilities in Indiana employing nearly 2,000 Hoosiers. We have bought or built twelve (12) more facilities in the United States that when combined with our Indiana operations, produce over five (5) million tons of steel products annually, and support more than 3,500 American families.

It is a fact that the government of China manipulates its currency to the detriment of U.S. manufacturers, and it is a fact that the Chinese government has actively intervened in the currency market to gain export advantage for its manufacturers since 1994. China's $470 billion global trading surplus in 2006 and its $225 billion bi-lateral trading surplus with the United States affirm this. The brilliant Chairman of the Federal Reserve, Ben Bernanke, also understands this economic reality because he has recognized and emphasized this significant point to which most economists agree -- that manipulation of the value of the Chinese Yuan by the Chinese government clearly constitutes an export subsidy for Chinese manufacturers. Given that the Bush Administration has failed during the past six (6) years to directly confront this unfair trade practice via the WTO, I would like to focus in my testimony today on the Administration's additional failures to enforce trade laws passed by Congress -- trade laws intended specifically to address surging imports from China that might materially injure U.S. manufacturers. I will then ask Congress to act expeditiously to amend these laws to ensure that they are used as Congress originally intended they be used.

In 2001 Congress passed the China Permanent Normal Trade Relations Act. The centerpiece of this Act, which granted China permanent normal trade relations with the United States and membership in the WTO, was the inclusion of a China specific safeguard that was only allowed in U.S. law for a period of twelve (12) years. This was supposed to be a panacea to give relief to U.S. industries that suffered import surges as a result of China's complete and unfettered access to the U.S. market and its WTO membership. To everyone's grave disappointment, the President of the United States has all but nullified this congressionally mandated statutory provision.

Since 2002, there have been four affirmative decisions by the International Trade Commission in Section 421 cases. In each the President has denied relief claiming that the rebuttable presumption of full relief had been met, and concluding that there would be more harm to the U.S. economy from relief than benefit to the U.S. industry producing the subject products. Since the negative 2002 determination by the President on steel wire hangers, wire hanger imports from China surged by 800%, from 300 million hangers to 2.4 billion hangers a year. Thirteen of the fifteen U.S. plants producing these products have already shutdown. In a March 5, 2007 article, *Fortune Magazine* reports that the last two steel wire hanger plants, one in Wisconsin and one in Alabama will also be shutting down soon. The Chinese will have gone from 15% of the U.S. market to 90% of the U.S. market with the rest supplied by other imports. Soon whenever a man or woman in this country picks up a shirt or blouse on a wire hanger from the dry cleaners it will be carried by a Chinese wire hanger. About 2,500 workers lost their jobs in this industry and the U.S. steel wire rod industry has permanently lost several hundred thousand tons of annual consumption due to the loss of this important downstream market.

In a 2004 case on ductile waterworks fittings, the President again denied relief for exactly the same reason cited in the steel wire hanger case. In the three years since that case concluded, imports from China have more than tripled their market share, from 20% to approximately two-thirds of the U.S. market and major foundries have been shut down in Chattanooga, Tennessee and Aniston, Alabama, as well as partial foundry shut downs in Birmingham, Alabama. Another major production site, Tyler, Texas will see its operations dwindle as its parent company ramps up a new foundry -- in China!!!. In the very near future our entire municipal waterworks infrastructure carrying water from every U.S. local water authority to every U.S. home or business will be entirely dependent upon imports from China.

The last Section 421 case -- and I emphasize -- it will be the last ever 421 case unless Congress changes the law, was near and dear to Steel Dynamics. That case involved circular welded non-alloy steel pipe. This 421's petitioners were many of the U.S. steel industry's largest customers. At the time the case was brought, imports from China had increased from 10,000 tons in 2002 to 290,000 tons in 2004. After the President said no to relief in late 2005, these imports soared to 680,000 tons in 2006 and are on pace for nearly a million tons in 2007. In fact, as evidenced by the chart attached to my testimony, after the President waved the green flag to the heavily subsidized and state controlled Chinese steel pipe and tube industry, imports of pipe and tube have surged uncontrollably to a total of 3.5 million tons this year, approximately 30% of the entire U.S. market. Every ton of pipe from China that replaces a ton of pipe produced in the United States also takes a ton of steel sales from SDI and other U.S. mills. There have already been three major plant shutdowns by U.S. pipe producers and it is our understanding that many more will occur in the near future.

What amazes and frustrates me is that when I bring these issues up to USTR and ask them why they do not use their power to self-initiate 421 cases when they see the devastating impact on certain industries of massive surges of Chinese imports all I get back is a blank stare and then the general political pablum about how the Administration is always committed to enforcing laws. How can they be committed to enforcing the law by denying relief and then in the face of import surges of 300%, 400%, 800% and the total and complete devastation of an industry and fail to initiate their own 421 case to try to save the industry. It is either that they do not care or that they have another agenda and that agenda is not in the best interest of the United States and its workers.

As a company trying to create and maintain good jobs in the state of Indiana, I am also overwhelmed by the loss of manufacturing jobs in Indiana caused by increased imports from China. Most of these lost jobs are in the steel using sectors with the hardest hit being the auto parts industry. According to the 2007 Indiana Manufacturer's Directory which was reported on May 9, 2007, in just the last 12 months Indiana lost 2.4% of our manufacturing jobs, 17,000 lost jobs. Of these 17,000 lost jobs over 11,000 were in auto parts. Our state lost 12% of our auto parts jobs in one year. We are representative of the United States job losses in auto parts. The Chicago Fed reported that there have been nearly 200,000 job losses in the auto parts industry in just the last four years. The cause of this is the increase in auto parts imports from China from a billion dollars in 2001 to over 7 billion dollars in 2006. The Economic Policy Institute reported that Indiana was the hardest hit state in the mid-West in terms of job losses by reason of surging imports from China.

In industries like auto parts, the Chinese government targets the creation of an entire industry through subsidized loans, special economic zones, the provision of input materials at subsidized rates, and of course massive currency manipulation. The Commerce Department has refused to even investigate whether currency manipulation is an export subsidy. Members of the Committee, this is beyond the pale!! Mind you, unlike the Schumer-Graham Bill imposing a 27.5% tariff on all goods from China, countervailing currency manipulation vis-à-vis the Department of Commerce means that only U.S. industries that can demonstrate injury by reason of increased imports from China will obtain relief. At the present time, approximately 1% or 3 billion dollars of Chinese exports are currently covered by unfair trade case duties. Application of the countervailing duty law to China and mandating that the DoC defines currency manipulation as a countervailable subsidy will not result in massive trade disruptions with China. It will merely allow U.S. industries to fight for and obtain the elusive "level playing field" we have for so long sought.

At SDI, we feel fortunate that nearly 60% of what we produce finds its way into the nonresidential construction market. At the present time, the Chinese aren't shipping many buildings to the United States. However, 40% of our sales are made to the flat-rolled steel market. Our flat-rolled products often wind up as pipe and tube products, auto parts, automobiles, or appliances. Virtually, all of these market segments are under assault today by the Chinese, severely reducing demand from this important customer base, lessening our sales opportunities, and contributing to market oversupply. I note a recent announcement by the one-hundred (100) year old American company "Citizen's Coke" of Indianapolis. The announcement stated that Citizen's Coke was shutting down its coke ovens because its foundry coke customers, like a former Chrysler auto parts foundry in Indianapolis, had shutdown and moved to China. We do not want the same thing to happen to ultra-modern, environmentally, and super efficient steel producers like Steel Dynamics. Therefore, I ask this Committee to make every effort possible to combat Chinese currency manipulation, and to urge the Finance committee to fast track to the floor of the Senate provisions that are currently in Senator Rockefeller's trade bill, S.364. These provisions would remove Presidential discretion from Section 421 enforcement and require the Department of Commerce to apply the countervailing duty law to Chinese currency manipulation. Thank you very much for today's opportunity to appear before you.