CHINA'S EXCHANGE RATE REGIME AND ITS EFFECTS ON THE U.S. ECONOMY

HEARING

BEFORE THE

SUBCOMMITTEE ON
DOMESTIC AND INTERNATIONAL
MONETARY POLICY, TRADE AND TECHNOLOGY

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED EIGHTH CONGRESS

FIRST SESSION

OCTOBER 1, 2003

Printed for the use of the Committee on Financial Services

Serial No. 108–56

U.S. GOVERNMENT PRINTING OFFICE

92–336 PDF WASHINGTON : 2003

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
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CHINA'S EXCHANGE RATE REGIME AND ITS EFFECTS ON THE U.S. ECONOMY

Wednesday, October 1, 2003

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON DOMESTIC AND INTERNATIONAL MONETARY POLICY, TRADE AND TECHNOLOGY,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to call, at 2:02 p.m., in Room 2128, Rayburn House Office Building, Hon. Peter King [chairman of the subcommittee] presiding.

Present: Representatives King, Biggert, Paul, Manzullo, Ose, Kennedy, Feeney, Hensarling, Murphy, Barrett, Maloney, Sanders, Sherman, Hooley, Baca and Emanuel.

Chairman KING. [Presiding.] Good afternoon. This hearing will come to order.

The subcommittee today meets to examine the issue of foreign currency exchange rates and their relationship to the United States economy, in particular, the much-publicized relationship between the Chinese yuan and the U.S. dollar.

I want to thank my Ranking Member, Ms. Maloney, for her usual bipartisan cooperation in preparing for this hearing, as well as the cooperation the subcommittee has received from the administration.

We are particularly fortunate that both Under Secretary Taylor from Treasury and Under Secretary Aldonas from Commerce have made themselves available to share their expertise on currency exchange and trade-related matters. I am aware of the time constraints these gentlemen face today, and we will do our best to accommodate their schedules.

My understanding is that the next series of votes is at about 3:30 p.m., so we will try to move this along as much as we can.

As the subcommittee specifically charged with international monetary policy, we have been looking at this issue for the better part of the year. In fact, it was my colleague on the committee, Congressman Green, and also Congressman English, who initially approached me in the spring, underscoring their concerns as they relate to their manufacturing bases back home.

While currency pegs have been a reality for some time, it has really only been in the last month or so that considerable national attention has been paid to valuations of foreign currencies and the effects they may be having on U.S. export opportunities and the economic recovery overall.

I am very aware that many see this as a U.S.-jobs issue. Others view it as a function of global economic integration. Some also contend that currency intervention by China and others in Asia is tantamount to currency manipulation and thus actionable under appropriate trade remedies.

It is my hope that this hearing today will provide a thoughtful and appropriate forum for the various viewpoints we discuss as Congress works with the administration to ensure competitive free markets for U.S. manufacturing and its labor force.

When we look at the challenges to our manufacturing sector, the key, of course, is getting the fundamentals right at home, in other words, putting in place a strong domestic growth agenda. The China challenge is complex, and there are a number of dimensions to the problem. These include ensuring that China continues to open its markets, plays by the rules of free trade, removes restrictions on capital flows and moves toward a market-determined exchange rate.

While we need to address all these challenges, it is important that China is one of the few engines of growth in the world economy today, and that imports and foreign investment into China are expanding rapidly.

However, there is much more that China can and should do to implement its WTO commitments, and we look forward to hearing what the administration is doing to hold China to these commitments. To that end, I want to underscore my strong support for the efforts of Treasury Secretary Snow in his most recent visit to China, as well as the APEC meetings in Thailand and G-7 finance ministers meetings in Dubai. This administration continues to press for market-based exchange regimes and the need for flexibility.

Under Secretary Taylor will understandably be limited in his ability to speak to many of these issues pending the upcoming currency report. I am confident that he, along with Under Secretary Aldonas, will be able to discuss efforts currently taking place on multiple fronts to promote job growth, economic expansion, and level the global economic playing field.

One truth seems to be universal with regard to the topic of discussion today. There is unanimity that the yuan is undervalued. Where to go from there and the potential effects stemming from any corrective action raise a myriad of questions, such as a possible U.S. interest rate predicament, given massive Chinese holdings in U.S. treasuries.

Regardless of the resulting exchange regime in China, steps to bring about that change must be taken, mindful of the delicate economic interplay our own economy has with it and countries in that region. I would caution against a rush to judgment, particularly in light of the current political environment.

I look forward to the testimony, in which I thank all the witnesses in advance for their time today.

With that, I recognize the Ranking Member, the gentlelady from New York, my colleague, Ms. Maloney.

Mrs. MALONEY. I thank the Chairman for yielding and for calling this important hearing. And I congratulate my two colleagues for their hard work, and I appreciate their time and testimony today.

This afternoon, the subcommittee considers the issue of the Chinese exchange rate and its impact on the U.S. economy. Any discussion of the current state of our nation's economy must begin with employment. For many of our constituents, these are extremely difficult economic times.

More than 9 million Americans are without jobs. Since January 2001, the number of unemployed Americans has grown by 3.2 million, the most in our history since President Hoover was in office.

Worse yet, the number of Americans experiencing long-term unemployment has nearly doubled. In New York City, the national unemployment rate is a high rate. But in New York, it is even higher, so it is of tremendous concern, I believe, to everyone in New York and I would say to all of our colleagues in Congress.

In this environment, it is understandable that concern would focus on a country that utilizes an artificial peg to maintain a set exchange rate with the U.S. dollar. While many economists believe the Chinese currency peg maintains an undervalued remimbi that benefits Chinese exports, the full impact of this policy and the increasingly intertwined relationship between our two economies is even more complicated.

While making it difficult for domestic producers of textiles, furniture and other manufactured goods to compete, some economists point to lower-priced consumer goods in the U.S. and lower interest rates as a result of an undervalued Chinese currency.

Additionally, the growth of the U.S. bilateral trade deficit with China is not nearly the result of an exchange rate mismatch. In part, it reflects the fact that China is increasingly an assembly point and final destination for goods manufactured in other Southeast Asian countries before export to the United States.

In this way, China absorbs trade deficit numbers that would otherwise be dispersed throughout the region. Overall, China's markets are opening to foreign trade and the country must be pushed to fully comply with commitments it made for entry into the World Trade Organization.

In 2002, China was the U.S.'s seventh-largest export market, while the U.S. was China's second-largest export market. If this relationship is to continue to grow, China must make strides in enforcing U.S. intellectual property and market access, especially in the service sector.

China also has a major impact on the financing of the growing U.S. national debt. The fiscal year 2004 budget deficit will exceed $500 billion, forcing the U.S. to seek increased foreign investment. Currently, China is the third-largest foreign holder of U.S. treasuries, as of June 2003, with a total of $123 billion. I look forward to hearing our panels discuss the impact of the currency peg on this investment.

In the long run, China and the U.S. will benefit from a free-floating Chinese currency that is determined by market forces. As we push the Chinese to move in this direction, it must be part of an overall effort to comply with WTO rules and move toward freer, fairer trade between our two countries that can benefit both countries.

I yield back the balance of my time.

Chairman KING. Thank you, Ranking Member Maloney.

And now, does anyone in the subcommittee have an opening statement? Ms. Biggert?

Mrs. BIGGERT. No.

Chairman KING. Mr. Manzullo?

Mr. MANZULLO. Thank you, Mr. Chairman, for holding this important hearing this afternoon.

For the last several years, American manufacturers have lost about 50,000 manufacturing jobs per month for the last 38 months in a row. The unemployment rate in Rockford, Illinois, the biggest city in the district that I am honored to represent, is 11.3 percent. The erosion of manufacturing jobs continues to happen over and over again. Americans can compete with anybody in the world. We need fair competition.

You have four countries in Asia that are purposefully fixing the currency. In the Financial Times today, "Dollar lifted as Japan steps in to sell the yen." They are not even casual about it. That means that the rules of free trade no longer apply. What that amounts to is when Asian countries fix the currency, that is the equivalent of a 15 to 40 percent price advantage over U.S. manufacturers. This amounts to an additional 40 percent tax on our exports to China and a price break of 40 percent for Asian imports into the United States.

NAM believes that if this continues, two-thirds of the trade deficit with those Asian countries will be sustained. These four Asian nations have cost manufacturers $140 billion in lost exports. It cost at least a half-million workers their jobs.

And the bleeding continues. To make it even more bleak, the Chinese argue that were it not for their generosity in keeping their dollar pegged to ours, there wouldn't be anybody in the whole wide world that is available to buy our Treasury bills and notes.

So to manipulate the currency, they help destroy American jobs, and then they tell us that "we are buying your T-bills to support your debt. And by the way, if you change the rules on currency, we won't buy your bills and the rate of inflation will go up, and we will also control not only your inflation but your lending rate."

The United States should not be in a position for China to determine the monetary policy of this country. It has to come to an end. The massive unemployment in this country continues unabated until we get some fair rules with regard to the currency. There is only on thing to do. The Chinese understand one thing. They have to be pushed against the wall to make that yaun float, and the yen too.

[The prepared statement of Hon. Donald Manzullo can be found on page 58 in the appendix.]

Chairman KING. Thank you.

The gentleman from Vermont?

Mr. SANDERS. Thank you very much, Mr. Chairman. And thank you for calling attention today to an issue that many of us have been talking about for a number of years, essentially, as Mr. Manzullo just indicated, the collapse of manufacturing in the United States. In the last 3 years, we have lost some two million manufacturing jobs, jobs in Vermont, the Midwest, California. It is high time that the United States Congress started to pay attention to that issue.

While I share your concerns, Mr. Chairman, about the manipulation of currency, the truth of the matter is that it is not the most fundamental issue that must be addressed. The issue that must ultimately be addressed is our trade relationship with China, permanent, normalized trade relations.

Now when that agreement was first brought forth, we were told by all of corporate America what a great agreement it would be and how many new jobs would be created here in the United States. I think all of us understand that many of us, not me, but others, were sold a bill of goods. Trade policy with China has been an absolute failure. We have a trade deficit of over $100 billion with China as part of a $435 billion trade deficit.

Ultimately, what we must do is while all of us want a positive relationship with China, we want to work well with China, we have to recognize that our current trade policy has failed, and we have to eliminate and do away with permanent, normalized trade relations.

I am happy to mention to you, Mr. Chairman, that I have introduced tripartisan legislation with Congressmen Sensenbrenner, Pence, Burton, Gene Taylor, Goode, Pascrell, Wamp and Michaud to repeal permanent, normalized trade relations with China.

Now in case anybody doesn't know what is going on, let me just tell you. Over the last short period of time, we have lost 180,000 jobs in the textile industry. We have lost 46,000 steelworker jobs. Our apparel industry is virtually nonexistent anymore. One in five jobs among companies producing aircraft is gone; 360,000 jobs in industrial machinery; 290,000 jobs in electronic and electrical equipment, and on and on.

Some people have told us in the past, Mr. Chairman, "Don't worry. It is just those blue-collar factory jobs, and Americans don't want those anymore. They really want the high-tech jobs, the computer jobs. That is where the money is." Well, if anybody doesn't understand that we are losing those jobs in leaps and bounds, then you don't know what is going on.

What we are seeing now is a huge exodus of information technology jobs, computer jobs, high-tech jobs that are going out the window. Large companies from Microsoft to many, many others are now moving their high-tech efforts to Third World countries where well-educated people can do those jobs for a fraction of the wages earned in the United States of America.

So again, Mr. Chairman, while I think it is important to look at the currency issue, and I support your efforts there, we have got to ultimately get the bull by the horns and say, "Our current trade policy has failed."

Do we want to trade with China? Yes, we do, but it should be in a bilateral way which works well not just for China but for American workers as well.

I am not critical of the Chinese. They have done very well in this trade agreement. But it might be a good idea if the United States Congress started representing American workers for a change, and we can work on that in the months to come.

Mr. Chairman, thank you very much.

Chairman KING. Thank you.

Mr. Paul?

Dr. PAUL. Thank you, Mr. Chairman.

I, like the rest of you, am very concerned about the loss of jobs. I think everybody is. The whole country is concerned about the loss of jobs to other nations.

I think most people recognize that it is related to our currency problems. Of course, what we are dealing with today is whether or not we should put pressure on China to change the valuation of the yuan.

But I think at times we are going at this in an incorrect fashion, because we are arguing the case for fluctuating rates. We want the Chinese to do something that is inherently not normal. Because when we want to measure something, if you are building a building or measuring something in the economy, you want a sound and dependable unit of measurement.

China, as a matter of fact, has done well because they have had a fixed measurement of value. They have good growth rates, and now we say, "Well, we are not doing so well so we are going to put all the blame on China, and we want them to have a fluctuating rate." That is sort of like arguing that if there was one State in this country that wasn't doing as well as another one for other reasons that, "Well, maybe if we had 50 different currencies, and we could adjust currencies, we might be able to achieve something."

So instead of going in the direction of having a single currency with which we could measure production and goods and services, we are going in the opposite direction of blaming a currency, whether it is too weak or too strong.

I think the thing that we fail to see is when we say that we don't like what the Chinese are doing, we fail to see the other half of the coin, of the benefit of what the Chinese do when they buy our debt. I mean, what are the Chinese supposed to do with the money? We say, "Well, buy some goods and services." But what if we can't compete? There is still the balance of payments; so the dollars always come back here, and they do a great service because they finance our extravagance, our deficit financing.

Not too long ago, a financier, a financial journalist, actually, went over to China, and visited with businessmen. He asked, "Why are you over here? Why are you starting a business in China?" Their answer was very clear, and it should send a message to us: "It is so much easier to start a business in China than in the United States, especially in places like Massachusetts and California." That was the answer. Why? Because of the taxes and the regulation and labor costs, all kinds of things.

So maybe sometimes we have to look to ourselves on why we make ourselves less competitive through our tax system.

Mr. SANDERS. Will my friend yield for a second?

Dr. PAUL. Yes, I will be glad to yield.

Mr. SANDERS. Does my friend think that it might also be easier to do business in China because people are paid 30 cents an hour because there are no environmental regulations?

Dr. PAUL. I will take my time back. Yes, I think that is obviously the case, but that is not the only reason. There are a lot of different reasons why our companies have to leave, and that obviously is one of the major reasons. But the point that I want to make is that stability in currencies is not a negative. Stability is not a negative. It is a positive, especially if it could be ever internationalized in a voluntary commodity fashion, rather than having fluctuating fiat currencies dictated by central governments around the world where there is no standard of value. Someday we will have to determine that currencies should have a standard of value and be something real, or you are going to continue to have trade imbalances.

Chairman KING. The time of the gentleman has expired.

Mr. Emanuel?

Mr. EMANUEL. Thank you, Mr. Chairman.

The fact is in the 1980s, we had a severe trade problem with Japan. In the 1990s, we had a major problem related to Mexico, starting with NAFTA. And today, we are facing manufacturing job losses that may relate to China's trade practices and currency policies.

The currency issue is certainly important. It is relevant. Additionally, there are a host of other issues that are relevant. But in my view, what distinguishes the current situation from Japan and Mexico is that we are now without an economic strategy in the United States focused on retaining jobs and investing in our own future to maintain our competitive edge.

The currency issue is relevant, but solving it is not the solution to three million lost jobs and to a destruction of the industrial base. It does not answer the whole problem as it relates to China. I believe in free trade, having worked on NAFTA and GATT. The truth is, the premise behind trade and free trade and globalization has been that high-tech, high-skilled jobs would move north; low-skill, low-tech jobs would move south; and that would be kind of where things would settle out.

But what has happened is the high-tech, high-skilled jobs have moved to India, and the low-tech, low-skill jobs have moved to China. All of us who would believe in globalization as a good thing have got to acknowledge not only has it not worked out, but the principal underpinning of globalization has not worked out.

And we need to address it. Rather than having a win-win situation, right now we have a win-lose situation here at home. And American people will not support a policy if it is seen as one where 75 percent of the folks on one side of the ledger are losers.

Although we will deal appropriately here with the issue of currency and how that affects trade with China, it is a piece of the puzzle but not the whole puzzle.

Mr. SANDERS. Would my friend yield?

Mr. EMANUEL. Sure.

Mr. SANDERS. Is my friend suggesting that the trade policies developed by Ronald Reagan, George Bush the first, Bill Clinton and this President may have some fundamental flaws that need to be addressed?

Mr. EMANUEL. Yes and no.

[Laughter.]

Well, you asked me part of the Clinton question so I thought I would give you both answers. The fact is, I still believe free trade is the right thing to do. What has to go with that is an investment in education, job training, and health care. The fact is, health care costs that our companies are bearing here, running at 20 percent inflation in this country, make them competitively disadvantaged to countries that don't pay health care and don't have a health care policy, or do have a health care policy that doesn't actually fall to their bottom line. So I think the right strategy is to make investments in our competitive future. Is that my time?

Chairman KING. The time of the gentleman has expired. You can finish your thought.

Mr. EMANUEL. But it would be an interesting discussion. I don't think the trade policies were wrong. I think the trade policies were right. The question is whether we are going to have an investment strategy that emphasizes both trade and training.

Chairman KING. I thank the gentleman.

Mr. Ose?

Mr. OSE. Thank you, Mr. Chairman.

I am sitting here intrigued by this entire question. It seems to me that the subject of the hearing being the exchange rate between the Chinese currency and American currency and whether or not it has been unduly influenced from the Chinese side, there is the exact reciprocal argument that could potentially be made relative to the United States, or the value of the United States currency, as it relates to every other currency in the world except the Chinese currency.

I would just be very cautious about the arguments one might make in favor of the Chinese not being able to manipulate their currency in terms of our partners in the WTO and elsewhere coming to us and suggesting that by virtue of interest rate changes here domestically and the like, we might be manipulating our currency.

Now, while I don't subscribe to Mr. Paul's comments about the inadequacies of a fiat currency, I do find his observations illuminating in the context of value in exchange for something.

I do want to point out that Mr. Emanuel is correct from where I sit relative to the trade policies that we need. The stuff we have done here in the last few months, in the last couple of years, is now manifesting itself in terms of economic growth. We have had in the last couple of months significant growth in retail sales. We are having significant growth in after-tax discretionary income.

I know that the unemployment rates in California, in particular, seem to have stabilized. There may be some minor fluctuations, but they seem to be stabilized. And if there is one State in the union that benefits from trade around the Pacific Rim, and consequently with China, it would be California, just by its geographic location.

The other aspect of this is that there is only one class I got an A in college, and that was currency valuations. I am most intrigued to hear what Secretary Taylor will offer in terms of the long-term implications of trying to argue only one side of this question relative to Chinese valuation as opposed to having to account for both sides of the equation if the United States is viewed as also manipulating its currency.

Mr. Chairman, I yield back.

Chairman KING. Perhaps at the next hearing we can bring in your currency professor.

Mr. OSE. And ask him about the grade.

Chairman KING. Maybe we will turn it over to Judiciary.

Mr. Kennedy?

Mr. KENNEDY. I would like to join my voice to those who are expressing concern with how big of a hit our manufacturers are taking and what that is meaning for our jobs. But I would like to reject the idea that some are suggesting that the solution to that is to close down relations with China or to close down, really, freedom or relations with anyone else.

I am a strong believer that the problems of freedom, which we are wrestling with right now, are best solved through more freedom. And if you look at it, it has been mentioned by Mr. Paul and others, that we have some limitations on freedom in this country as well, whether that be the steel tariffs where we are imposing a cost on our manufacturers that is not borne by anyone else, whether that be the high cost of health care where we are paying double in our country for health care as other industrialized countries, whether it be the very big burden from litigation that we have imposed on our businesses. We have a number of costs, and lack of freedom for our businesses that we bear here that is hurting us.

But also no other country of a similar scale in the trade environment has a fixed currency like China does. That lack of freedom is something we need to address. We need to have that be a free-floating currency like everyone else's. And that will help us be more competitive, help bring the trade deficit in line.

Other Asian countries, like Japan, are happy to prop up their currencies to keep them on a par from a regional perspective with China, which is also similarly hurting us.

Increasingly, it is unhealthy for America to be the sole engine of growth for this world economy where we are having a huge trade deficit and growing every year. That has to stop. The way it has to stop, as economists will tell you, is, and I also probably got that A, too, but we have to get these currencies to allow for that adjustment.

One of the concerns I have that may or may not be addressed here is, the banking system is said to be, by Glenn Hubbard and others in China, not stable enough to really absorb a floating currency. Are we going to be addressing that? And with the $360 billion in reserves that China has built up, can they recapitalize that banking system, and move us towards a stronger banking system to allow that?

They also need to open up their markets. We have to have a strong, stable world economy that has more engines than just the United States, and part of that is certainly opening up their markets, having a free-floating currency.

I thank you, Mr. Chairman.

Mr. SANDERS. Will my friend yield for a second?

Mr. KENNEDY. Certainly.

Mr. SANDERS. Thank you very much.

Just a question. You used the word "freedom" a whole lot in your introductory remarks. Is it your understanding that freedom is about a company throwing American workers out on the street, moving to China, paying people pennies an hour, having those people arrested when they try to form a union, and then bring that product back into this country tariff-free. Is that what you are talking about as freedom?

Mr. OSE. Would the gentleman from Minnesota yield, please?

Mr. KENNEDY. Certainly.

Mr. OSE. If I might just observe, if I were living in the early 1900s and was asked that question of an imperial America in terms of our ability to go into another country and impose an economic doctrine, I would answer in the affirmative to Mr. Sanders's question.

Mr. SANDERS. But we no longer live in imperial America. Presumably we have moved beyond that phase of our development. And I would hope that we don't go backwards to where we seek to impose such an economic regime.

Chairman KING. Fascinating discussion, but the gentleman's time has expired.

Mr. Murphy?

Mr. MURPHY. Thank you, Mr. Chairman.

I am looking forward to hearing the testimony especially from my colleague from Pennsylvania, Congressman English. But as part of this, in historical perspective, although the Cold War has long been over, we are still very much in a battle between communism, socialism and capitalism, that neither communism nor its cousin, socialism, has been able to survive in a capitalist world and create jobs and pay people decently without certain manipulation.

And those manipulations from government control and central control, which oftentimes run roughshod over environmental issues, run roughshod over paying people decent wages and safe workplaces are part of what allows the Chinese to have workplaces where they can have goods manufactured at much lower cost than in America.

Now as long as there are Americans, of course, who are looking for less expensive goods, they have a marketplace here. And I suspect they will continue to do that, and that is part of the thing that we want to protect in a capitalist marketplace, to allow people access to goods.

That being the case, we also have to recognize that it does no good over the long run for us to destroy our own manufacturing sector in the meantime. If one looks historically at anyone who has done this, where they will be in a competitive position, a tradition you have seen time and time again is, you move into a marketplace, you sell goods lower, you destroy your competitors, and then you can go ahead and raise the prices, or you control the marketplace. So in the long run, I don't think that is helpful for America.

We see some of these manipulations, for example, in steel. We have to remember that steel is a manufactured product. And we look at the kind of things taking place now with tariffs, and we have to remember that in America we are so good at producing steel at perhaps one or two persons per ton, but I believe in some Asian countries it is maybe 14 or 15 people per ton it takes, and you have to do that by manipulating jobs and manipulating currency.

I think this is a serious issue that we have to look at. What is the long-term impact not only upon our jobs and our manufacturing base, but long-term impact upon our own safety and security with jobs and so on?

I am looking forward to hearing the comments made by Congressman English and the solutions he is proposing.

Thank you, Mr. Chairman.

Chairman KING. I thank the gentleman.

I thank the members for their opening statements.

On the schedule, we are going to have votes at about 3:30 p.m. I also understand that the two Secretaries from Commerce and Treasury have to leave here by 3:30 p.m. So what I would like to do is ask Congressman Green and Congressman English to make their statements, and then ask if the members of the committee would defer questioning the two members so we can get right on to the administration officials.

With that, I would like to acknowledge Congressman Mark Green and Congressman Phil English, both of whom really are responsible for this hearing being brought in the first place. I want to thank them for their input, for their long-time interest in this issue.

I will ask a member of the full committee, Congressman Green.

STATEMENT OF HON. MARK GREEN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF WISCONSIN

Mr. GREEN. Thank you, Mr. Chairman, Ranking Member Maloney, distinguished members of the subcommittee, for not only holding this very important hearing, but also I was very interested to hear the discussion we had leading up to this.

Obviously, the questions of manufacturing job losses go well beyond currency issues. I think manipulation of currency, because it is the jurisdiction of this subcommittee, but also because it represents a concrete issue, a tangible issue, that we can act upon and take action on and have an immediate impact it makes it so very important.

We have all heard a lot about the loss of the American jobs in the last few years. Obviously, this news has been terrible. We have been losing jobs for 38 consecutive months. While few sectors seem to escape the downturn, manufacturing has been hit especially hard.

In Wisconsin, we have lost over 60,000 manufacturing jobs in these last 3 years. We have seen some of our oldest and most established companies, such as Mirro and even Evenflo buckle and finally break under the pressure. As a result, whole communities in my state have been thrown into turmoil. Many families in my district are facing, at best, an unsettled future.

As I have said, there are a lot of factors that contribute to the flight of our manufacturing jobs. I think all of these factors do have to be addressed. But I believe that an important concern is the unfair advantage by some East Asian countries, particularly as we have all said already, the People's Republic of China. The unfair advantage that they have been creating for their manufacturers through a policy of currency manipulation is one that we must take up. This policy is unfair. It is anti-competitive. It is anti-freedom. And it is costing us jobs.

It is not the only factor. Again, it may not even be the largest factor. But it is one that we should address, and if we can address it, I believe it would provide an immediate benefit to manufacturing and manufacturing jobs in this country.

As some have already mentioned, since 1994 China has pegged its currency at 8.3 yuan to the dollar. The goal behind this effort is simple and intentional: to drive exports and fuel economic development. The Chinese success in this policy has been remarkable and costly. Our trade deficit with China has grown from $20 billion in the early 1990s to an estimated $125 billion this year. Our ratio of imports to exports in China stands at about 6 to 1, while in the same period, U.S. manufacturers have struggled to compete with China's economic surge.

Fueled by an exchange rate policy that some economists and manufacturers estimate makes Chinese products 15 to 40 percent cheaper compared to U.S. goods, many manufacturers have found it nearly impossible to compete, no matter how efficient they become, no matter how much they are able to accomplish through cost cutting.

In the last several years, the world has stood by as China has promised that change is forthcoming. We even helped bring China into the world economic community and WTO with the commitment that they would live up to international rules of fair trade, including reforms of their currency policies. Unfortunately, this has not been the case, and I believe that we can no longer afford to wait to see if these promises will ever be kept.

Now, if Congress could pass a law requiring China to at least partially float its currency, I would introduce one tomorrow. Unfortunately, Congress does not have that luxury, and even more unfortunately, the Chinese know it. Earlier today, Congressman Manzullo and I had the opportunity to meet with senior Chinese officials to talk about the problems that we are seeing in our bilateral trade relationship, including the problems of currency manipulation.

Their response was to say that they heard what we had to say and they appreciated our point of view. That is all they said, they said no more. Why? Because they know that we cannot pass a law today that would force them to float their currency.

There are steps that we can take, however. One thing we can do is pass a law to try to offset the advantage that the Chinese are providing for themselves through currency manipulation. In fact, Congressman English, Congressman Ballenger, and I have already introduced such a bill. This legislation is H.R. 3058, the China Act.

Under this legislation, the Secretary of the Treasury is required to analyze whether China is, in fact, manipulating its currency to achieve an unfair advantage in trade. If in fact manipulation is found, the Secretary is directed to levy tariffs in a percent equal to the degree of manipulation. For example, if the Secretary finds what some have suggested, a 40 percent advantage, there would be a 40 percent tariff on Chinese goods coming into this country.

Such a high tariff would almost certainly help offset the unfair gains that Chinese producers have been receiving. Most importantly, this legislation sends a clear message to other countries that we are prepared to take bold action. I know this committee does not have jurisdiction over this legislation, but I am hopeful that members will work with me, Congressman English and others to pass this legislation through the House.

Make no mistake, we understand that this is tough medicine, that it is harsh medicine. But we think that tough medicine is important right now because we do need to send a signal of strength and impatience.

For those who oppose this legislation and our approach, I would ask them, quite frankly, for their alternatives. If we all agree that there is a problem of currency manipulation, and if people don't support the approach that Congressman English and I have taken, then what is the approach that we should take? What steps should this Congress take to try to level the playing field?

Getting China to reform its currency policies is going to require a full-court press, more than just Congress. I am pleased that the Bush administration has taken some actions and that they also support more flexible currency, a more floating currency for China. I think that is an important step. I look forward to continuing to work with the administration in ensuring that this body is doing everything it can to enhance their efforts.

Our legislation is a powerful and appropriate tool. I think, at the very least, it will help convince China that the time has come now for action, no more stalling, no more delaying, and no more waiting.

Mr. Chairman, thank you once again for allowing me to testify. I appreciate it.

[The prepared statement of Hon. Mark Green can be found on page 56 in the appendix.]

Chairman KING. I thank the gentleman for his testimony and for the interest he has shown in this throughout.

And now the gentleman from Pennsylvania, Mr. English.

STATEMENT OF HON. PHIL ENGLISH, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF PENNSYLVANIA

Mr. ENGLISH. Thank you, Mr. Chairman, Madam Ranking Member, distinguished members of the subcommittee. It is a real privilege to be able to appear here today to explore what I believe to be substantial negative effects to the U.S. economy as a result of Chinese monetary policy. I want to thank you all for the opportunity to testify before you today, and especially thank you, Mr. Chairman, for having the foresight to schedule this hearing on something so topical for our economic future.

When President Clinton approved China's entry into the WTO in 1999, many believed that a new era of vast opportunity for U.S. businesses and workers had been opened. Those in Congress, like myself, who were skeptical that this opportunity would not come without substantial risks, voted to grant permanent normal trade relations to China only after insisting that special safeguards relating to Chinese imports be included.

Looking back from China's accession to the WTO until this point, I would like to convey a clear message. Few of the benefits intended for America have been realized as a result of this Chinese accession to the WTO because China has not abided by the terms of their international commitments. And while the current administration has begun to develop a comprehensive strategy to ensure China plays by the rules, these steps need to be accelerated, strengthened and reinforced.

China has pegged its currency, the yuan, at a rate of approximately 8.3 to the dollar since 1994. As a result of this peg, other major currencies in East Asia have also been under tremendous pressure to intervene by infusing massive amounts of foreign currency into their reserve accounts or manipulate their currency to maintain stability.

If China were to freely float its currency, it would deny other Asian countries a convenient excuse for manipulating their currencies. This would bring about a revaluation of Asian currencies against the dollar, and for that matter, against the euro, which is needed to restore a balance among global currencies and reduce the threat of a hard landing for the dollar.

Misalignments in currency, particularly in the case of China, adversely affect the benefits gained from trade concessions. In fact, misalignments in currency caused by government policies intended to maintain an unfair trade advantage can impair and even nullify trade concessions.

Many economists estimate that the Chinese yuan is undervalued against the dollar by as much as 40 percent. Essentially this amounts to a 40 percent subsidy on all Chinese exports to the U.S. and a 40 percent barrier on all U.S. exports to China. U.S. exports to China currently face an average bound tariff of 15 percent.

If recent estimates of China's currency undervaluation are correct, the effect of a free and open currency market would be more than twice as large as the effect of eliminating every tariff that China imposes on U.S. imports. Therefore it is imperative that countries allow their currencies to reflect their true value, or else all of the benefits of bilateral trade will be compromised.

Because China's currency is pegged to the dollar and other currencies have readjusted against the dollar, the economic effect of China's currency policy to the United States is more pronounced. To illustrate the point, since February the dollar has fallen by approximately 25 percent against the euro, but by 10 percent or less against the yen and most other Asian currencies. The dollar has, of course, remained unchanged against the yuan. At the same time, China's net exports to the U.S. have grown rapidly, but China's trade surplus with the world as a whole has actually been falling. It is down sharply this year.

This strongly suggests that China's currency regime is contributing strongly to the rapidly ballooning trade imbalance between the U.S. and China. The U.S.-China trade deficit is projected to reach more than $120 billion in 2003, $17 billion over the previous year, and the largest bilateral trade deficit in the world. This is precisely why the practice of maintaining currency to obtain an unfair advantage in trade is illegal within the frameworks of two international bodies, the World Trade Organization and the International Monetary Fund, as well as U.S. law.

While each provision contained within international or domestic law defines this highly destructive practice slightly differently, the end goal of each provision of law is the same: to provide a mechanism to countries which play by the rules, to address the egregious practice of currency manipulation and thereby restore the benefits of free trade.

As I have studied this issue further, Mr. Chairman, I found that the international mechanisms to make this adjustment are flatly inadequate. For this reason, I have recently introduced along with my colleague, Mr. Green, and Representative Cass Ballenger, H.R. 3058, the Currency Harmonization Initiative Through Neutralizing Action Act of 2003.

While there have been multiple bills and resolutions introduced in Congress on this topic, the CHINA Act enjoys the most robust co-sponsorship, currently supported by over 60 members of the House of Representatives. The premise of the CHINA Act is straightforward. It requires the Secretary of the Treasury to determine if China is manipulating its currency to gain an advantage in trade.

If the Secretary finds manipulation is occurring, then he is directed to impose a tariff equal to the degree of manipulation on all imports from China. This is in addition to any existing tariff, or any other existing findings, like antidumping provisions, on Chinese products. This is a measure that actually levels the playing field. It strips China of its ability to give itself an arbitrary advantage. It is a flexible tariff, and it can be adjusted to meet the actual extent of the distortions from the artificial undervaluation of the yuan.

While I understand that participation in an open and fair global economic system is essential to U.S. economic prospects, when China breaks the rules the U.S. suffers the consequences.

Through observing the direct effect China's state-sponsored mercantilism has had on my district in northwestern Pennsylvania, it is very clear to me that China's currency regime is neutralizing gains made through trade liberalization, heavily contributing to our bilateral trade deficit with China, subsidizing Chinese exports to the U.S. and taxing U.S. exports to China.

Of potential greater consequence, however, is that this type of blatant disregard for international trade law will erode support within the U.S. for the WTO and the multilateral trading system.

Very simply, Mr. Chairman, Congress must ensure that the U.S. maintains the ability to police our own markets and force others to play by the rules.

Thank you for the opportunity to present this testimony.

[The prepared statement of Hon. Phil English can be found on page 53 in the appendix.]

Chairman KING. Thank you, Mr. English.

As I stated before, Mrs. Maloney and I have agreed, because of the time constraints, to forego questioning of Congressman English and Congressman Green so we can get to the administration officials.

But I do want to thank both of you for the tremendous input you have had on this. I want to thank you after the fact for all the buttonholing you did of me on the floor earlier this year as you were convincing me of the necessity of having this hearing, and thank you for the job you are doing for your constituents on this very vital issue.

Mr. ENGLISH. Mr. Chairman, thank you for you farsighted leadership.

Chairman KING. Now, if the second panel will step forward please?

I want to thank Under Secretary Taylor and Under Secretary Aldonas for being here today. I realize the time constraints you are under. Rather than go through introductions or anything else, I just want to welcome you to the committee and thank you for being here.

I will give it to Secretary Taylor.

STATEMENT OF HON. JOHN B. TAYLOR, UNDER SECRETARY FOR INTERNATIONAL AFFAIRS, DEPARTMENT OF THE TREASURY

Mr. TAYLOR. Thank you very much, Mr. Chairman, for inviting me to this important hearing.

This is the fifth time I have appeared before this subcommittee to address various international economic issues. Previous testimonies were on emerging markets, developing countries, removing barriers to the free flow of capital. In each of these cases, I have stressed that the goal of our policies is to raise economic growth and increase economic stability around the world and, in doing so, benefit the American people with more jobs, more security and a better life. My testimony today will be no different in this respect.

The administration's major economic endeavor now is to strengthen the economic recovery in the United States. The jobs and growth package enacted into the law this summer was essential, but there are barriers to economic growth in other countries. This is where our international economic strategy comes in.

Our policy towards China is part of this strategy. The strategy is to urge the removal of rigidities and barriers wherever they exist and to encourage pro-growth, pro-stability policies that benefit the United States and the whole world. It is a two-track approach of domestic and international. The international part is applied both bilaterally and multilaterally.

I am pleased to report that this endeavor is working. Economic growth in the United States is picking up significantly now after the severe shocks of the terrorist attacks, the corporate accounting scandals, and the stock market drop of 2000. Global economic growth is also improving.

There are also notable improvements in economic stability around the world. The number and the severity of financial market crises are down. Capital flows are up, and interest rate spreads are down compared to the late 1990s. This improvement is very important for the United States. Greater economic stability is essential to creating a long-lasting recovery, which is needed for sustainable job growth in the United States.

Despite this progress, we need to do more. During the summer months, Secretary of Treasury Snow embarked on an international pro-growth tour to Europe, to Asia, including China, as I will discuss in a minute, culminating in the annual meetings of the IMF and World Bank in Dubai, where he forged a new agreement on a new G-7 agenda for growth.

But now let me address China's economy and its exchange rate policy and how it fits into this overall strategy. Free market reforms in China have made China one of the largest economies in the world. But for nearly 10 years now, the Chinese have maintained a fixed exchange rate for their currency, the yuan relative to the dollar. In doing so, they have accumulated a large amount of foreign exchange. At the same time, China has significantly restricted capital flows into and out of China.

With this rapid growth and accumulation of foreign exchange reserve, China is now in a position, in our view, to show leadership on the important issue of exchange rate flexibility. A flexible exchange rate regime would be good policy for China. It would allow China to open the nation to capital flows and at the same time reduce macroeconomic imbalances.

We have been urging China to reduce barriers in other areas, such as trade and capital flows. As you know, tariffs on manufactured goods are scheduled to come down from the average of 17 percent now to an average about 9 percent as a result of the WTO commitments. I think this should be accelerated. Even at 9 percent, China will be well above the United States's average and the average of other large economies, which now stands around 4 percent. It is important for China to go further in reducing these trade barriers as well.

Secretary Snow has encouraged these changes during his very successful trip to Beijing last month. He met with Premier Wen, Vice Premier Huang, Central Bank Governor Zhou and Finance Minister Jin. During Secretary Snow's visit to China, a number of important announcements were made by the China Central Bank, including steps to remove restrictions on money and capital. They have indicated the intention to move forward towards more exchange rate flexibility.

In addition, following Secretary Snow's trip, a number of new economic engagements between China and the United States have been discussed, in particular a whole new engagement between China and the entire G-7. The first meeting between senior officials from the G-7 and the finance ministry in Central Bank of China took place in Dubai last week and represented a significant degree of exchange on economic issues.

So I am pleased to report, Mr. Chairman and other members of the committee, that our efforts to engage in financial diplomacy are bearing fruit. Active engagement with China and other countries is paving the way towards freer markets. The administration's effort to raise growth in the United States and abroad, and thereby create jobs at home, is already showing signs of success.

Thank you very much, Mr. Chairman. I will be happy to answer your questions.

[The prepared statement of Hon. John B. Taylor can be found on page 85 in the appendix.]

Chairman KING. Thank you, Secretary Taylor.

I understand Mr. Manzullo wanted to make a motion to have his full statement made a part of the record. Without objection, so ordered.

Secretary Aldonas?

STATEMENT OF HON. GRANT ALDONAS, UNDER SECRETARY FOR INTERNATIONAL TRADE, DEPARTMENT OF COMMERCE

Mr. ALDONAS. Thank you, Mr. Chairman.

If I might, I would like to submit my full statement for the record and summarize my comments.

Chairman KING. Without objection, so ordered.

Mr. ALDONAS. Mr. Chairman, Ranking Member Maloney and members of the committee, thank you for the opportunity to appear. This is obviously an important topic, and I very much appreciate the opportunity to appear to discuss it. I want to focus on two aspects of the topic of the hearing, on our trade relationship with China and the impact on our manufacturing sector.

I do want to provide a little bit of context at the outset, because I think they are facts that are often lost in the discussion about our trade with China.

The first thing is that the United States starts from a position of real strength in manufacturing, which is often lost in the discussion. The United States remains the largest producer and exporter of manufactured goods in the world. Standing alone, our manufacturing sector would be the fourth-or fifth-largest economy in the world. Our manufacturing sector alone is larger than the entire economy of China.

Productivity and manufacturing, which is the best indicator of our future strength, is way up, higher than it was in the late 1990s. In fact, in the last 2 years we have seen stronger productivity growth than we have at any time since 1960.

What is more, manufacturing after many months of slow growth, as Congressman Manzullo pointed out, is beginning to participate in the broader economic recovery. Orders for durable goods and the purchasing and managers index, which is an indicator of future demand for manufacturers, are up significantly.

Now having said that, there are three statistics which generate real cause for concern. The first is the employment numbers, which have been discussed; second is the trade deficit; and the third is the sharp drop in the share of world trade made up by our exports, which is another good indicator of our relative competitiveness, our manufacturing sector.

What drives all three, as you pointed out in your opening statement, Mr. Chairman, is the lack of stronger economic growth abroad. Now that is not to say that government-imposed constraints, like the Chinese currency peg, as John was referring to, help the matter. They certainly create a sense of unfairness in terms of the trade, which we heard loud and clear from manufacturers as we went across the country over the last 6 months, visiting 23 cities, meeting with manufacturers large and small in every industry, basically. And there was no topic other than China that was a higher concern from their point of view.

Now having said that, they, too, recognize that growth at home and stronger growth abroad were the keys to a broader manufacturing recovery. In terms of growth abroad, I do want to pick up on the comments of Congressman Kennedy. The problem there is, frankly, slow growth in Europe and Japan and certain other Asian trading partners that have not yet fully recovered from the 1997 financial crisis.

It doesn't happen to be China. China, together with the United States, has accounted for most of the world's economic growth this year. China's imports and our exports to China have risen significantly despite the currency peg. China's trade with the world is roughly in balance as has been noted. Our own exports are up 15 percent per year and are growing faster than exports to any other destination.

Now could we do better? Absolutely. And this is where I think the peg comes into play.

I hope no one operates under the illusion that China represents a market economy. Many of the drivers of the economy and the production of manufactured goods remain in state hands. What that means in practical terms is that Chinese companies will not face the same capital market pressures that ours do to turn a profit, which may be the ultimate subsidy in the system.

In other words, the common concern identified by U.S. manufacturers about the lack of a level playing field went right to the heart of both the issue of the exchange rate peg, but more fundamentally about the underlying operation of the financial markets, which I think is the key that John really is turning to. I know that the Treasury has been working on that with the Chinese.

The effect on trade is that a heavy investment in China funded by state-owned banks has led to a great deal of capacity on the market that continues to pump out manufactured goods that are looking for an outlet.

The question is, how do we respond. John addressed the currency side of the equation. I want to say that there are two things underway on the trade side. First, we are using every opportunity to press the Chinese for full compliance with their WTO commitments. The first year following China's accession to the WTO, I personally think that both the administration and Congress showed an extraordinary amount of patience as China worked to pass the literally thousands of new laws that were needed to bring the country into compliance with WTO rules.

But now, as we move deeper into the second year of China's participation in the WTO, we need to see the actual enforcement of those laws and compliance with WTO rules in other areas. Toward that end, the President, Secretary Evans, Ambassador Zoellick, Secretary Snow, certainly John, have all made that point vigorously to their counterparts in China, as have I.

Secretary Snow's recent visit represented the start of a 3-month process in which the administration will be regularly engaged in discussions with our Chinese counterparts on these issues, including meetings between the President and President Hu, at the time of the APEC meetings, Ambassador Zoellick's trip to China.

The Secretary and I will be going to China at the end of the month. We will then be followed up with a visit of the Chinese premier here in December, as well as a meeting of the Joint Committee on Commerce and Trade, at which point WTO compliance will be front and center in our discussions.

Second, we also have been extraordinarily vigilant with respect to the injurious effects of other forms of government support for Chinese industry. Over 50 percent of the antidumping actions initiated by this administration focused on imports from China. Nonetheless, I do think we can do a better job.

That is why one of the principal recommendations that we will be moving forward with is the creation of an unfair trade investigation scheme, which is to adopt a proactive approach with respect to trade with China, as well as our other trading partners, since this isn't a problem with China alone.

The point is that we do not have to wait for a petition to know that there are unfair trade practices going on, that those ought to be investigated when we know of allegations, that we ought to certainly be going after the issues that we face with our trading partners. And there certainly are industries, like tool and die, that we have talked about, Mr. Manzullo, where you can see the net effect of a lot of government involvement in the Chinese economy, not just the currency peg in terms of creating an unlevel playing field.

Let me stop there, and I will be happy to answer any questions you have.

Thank you.

[The prepared statement of Hon. Grant Aldonas can be found on page 60 in the appendix.]

Chairman KING. Thank you very much.

In view of the time constraints, I am going to limit myself just to one question, actually the same question to each of you.

If China did float its currency, how do you respond to the argument that traders would dump dollars on the world market and lower the value of American investments, corporate bonds? And also, what impact would it have on manufacturing service sectors in this country? Would it necessarily increase the demand for U.S. exports? So I guess I am asking you to give the downside of the free-floating currency.

Mr. TAYLOR. Mr. Chairman, the United States treasury markets are resilient. They are deep. They are liquid. The amount of treasury securities that are held in China is under 4 percent, by our best estimates, of our total amount of securities. And the total amount of reserves that the Bank of China holds are much more than our treasury securities. So we emphasize the great attractiveness of our treasury securities and will continue to do so. We don't see that as an issue.

With respect to the impacts on the United States economy, a change in price affects buyers and sellers in different ways. It is difficult to estimate exactly how much a change in the yuan would have on the United States. In fact, there is large debate about how much overvaluation there is of the currency amongst economists. Both Congressman Green and Congressman English indicated a significant range of uncertainty there, and I would think it is even wider——

Chairman KING. Actually, the number they mentioned was 40 percent, I believe.

Mr. TAYLOR. They talk about a range. I believe it was 15 to 40—a large range. I think it is even wider than that.

Chairman KING. Secretary Aldonas?

Mr. ALDONAS. Thank you.

First of all, just to pick up on John's comment, obviously what drives investment in the United States, including investment in manufacturing, actually has a lot more to do with the relative rates of growth between our economy and other economies. To the extent the United States is growing at a pretty fast clip right now means it is a more attractive investment at the end of the day. I think that is part of the attraction of investors, whether it is in T-bills or whether it is in foreign direct investment.

The second thing is, would a change in the currency increase exports? I think it is very much about what you would see as the knock-on effect in the Chinese economy if in fact by de-linking the peg or revaluing they slow their economic growth. Odds are it would have a negative impact on our exports, frankly. And that is, I think, the risk that many point to.

We have an interest in a stable and growing Chinese economy as long as the terms of trade are fair. That is why I have a tendency to look more to the tools that we have and grapple with the problems that are facing individual industries than look to a change in the currency peg necessarily to improve our exports.

Chairman KING. Ms. Maloney?

Mrs. MALONEY. Thank you, Mr. Chairman.

Secretary Taylor, I am trying to understand what you intended and what was accomplished by the U.S.-led statement on exchange rate flexibility at Dubai. In some ways it seems to have created more confusion than anything with little agreement even within the G-7 countries about what the statement means.

If it was indeed an effort to achieve more exchange rate flexibility globally, then why do you say in your testimony today, "There are benefits from a hard exchange rate," and "The choice of an exchange rate regime is one where country ownership is particularly important"?

After the meeting, the dollar declined after the release of the Dubai statement. Was this a desirable outcome, for the dollar to decline?

Mr. TAYLOR. Well, let me answer your question in four different ways.

First, I think it is important to understand exactly what the statement was. If I could do so, Congressman Maloney, I would like to read the statement.

The ministers and Central Bank governors of the G-7 stated, "We reaffirm that exchange rates should reflect economic fundamentals. We continue to monitor exchange markets closely and cooperate as appropriate. In this context, we emphasize that more flexibility in exchange rates is desirable for major countries, for economic areas to promote smooth and widespread adjustments in the international financial system based on market mechanisms."

The second point I would make is, there was strong agreement among the ministers and Central Bank governors who made this statement in Dubai. I was at the meeting and I can attest to their support for this statement.

The third point I would mention is that Secretary Snow indicated at the time this statement was released that he reiterated the strong-dollar policy for the United States.

And the fourth thing I would like to emphasize very strongly here is this statement was part of a larger document, still pretty short, just a little over one page, but a larger one nonetheless, that emphasized a whole new agreement on raising economic growth in the G-7.

For the first time, the ministers and the Central Bank governors agreed on what they called the G-7 agenda for growth. Under this agenda for growth, each of the countries are endeavoring to take policies that raise growth in their own countries It is very important to the United States that growth rise in Japan and in Europe and in Canada, the other members of the G-7, and I think this part of the statement is very significant, this so-called G-7 agenda for growth.

I would be happy to talk to you more about that.

Mrs. MALONEY. But what happened after the Dubai statement was that the dollar declined, so when all the G-7 countries voted together, were they voting together to bring down the dollar, because that was the outcome?

Mr. TAYLOR. As I say, the second part of what my answer to your previous question was that Secretary Snow reiterated a strong-dollar policy in Dubai.

Mrs. MALONEY. Well, also, both of you testified about the recent trip of Secretary Snow that he made to China where he met with many important Chinese leaders, and he prodded the Chinese to float their currency.

Besides being courteous and having many important meetings, did the Chinese give the administration or our country, any timetable for when we can expect real progress in this direction?

Mr. TAYLOR. There is not a timetable.

Mrs. MALONEY. Did we win any concessions during the trip, where you can point to an action the Chinese will take at a given point in the future?

Mr. TAYLOR. I think there are a number of significant actions that the Central Bank announced, mainly related to what I would call preparatory actions related to the exchange rate, such as beginning to remove some of their restrictions on capital flows, the restrictions that Chinese citizens have to hold foreign currencies, which affects currency values. A long list of things was put out in terms of announcements along these lines.

In discussing the issue with China, Secretary Snow has noted, I have noted, that there is clearly an intention to move towards a flexible exchange rate at some time. There is not a deadline. There is not a time line, so I can't give you that. I do feel that this intention has been there for a while. My sense is that perhaps it could have even come earlier were it not for the 9-11 attack, the other uncertainty that occurred in the world economy.

So, you can't put time lines on things like this because events occur which affect time lines. But again, I think it is promising about the intentions.

Mrs. MALONEY. So the intentions are there, but there is no concession, no time line and really no decision when they will take action.

Mr. TAYLOR. As I just said, there are a number of announcements and changes in policy that are related to flexibility in the Chinese economy, related to the financial mark of flexibility. And those had to do with the gradual removal of capital controls. I think that is very significant.

Chairman KING. The gentleman from Illinois, Mr. Manzullo.

Mr. MANZULLO. Thank you.

First of all, I want to thank both of you gentlemen for the tremendous work that you have been doing. John Snow is just a remarkable individual.

And Grant, you had one of those hearings in my congressional district and you got an earful there. But we told you that was going to happen and you knew that prior to coming, and we appreciate your sensitivity.

I just have one remark and a question. There are a lot of things that we can do to bring about and narrow the trade imbalance. We have a horrible system of issuing visas to Chinese who want to come to this country to buy stuff. This is scandalous. And, Grant, how many times do we call you with a list of people? We are not talking about export-controlled items, things that are not subject to a validated export license.

Every Chinese purchaser is presumed to be a bad person by our government. I am the chairman of the American-Chinese Inter-Parliamentary Exchange. We are hosting them. They are in town this week, and they said, "There is a lot of stuff we want to buy from you," and it is not even high-tech stuff, "but we can't even come to your country to shop." Now, whose fault is that? The Chinese? That is the fault of our own U.S. government.

The task force that we have put together, and I know, Grant, you have helped us out on it and Treasury is engaged and everything. We have got to loosen up dramatically. We need a yearly multi-visit businessperson's visa to allow people to go back and forth freely for the purpose of looking at stuff to buy.

How stupid our own government is that we close the doors to people who want to buy stuff from us, and then we end up complaining that we are not selling enough stuff to the Chinese. It is just absurd, and I know both of you agree with us.

In an article in today's Financial Times Japan intervened again, they are not even subtle. The New York Federal Reserve had to come in and conduct the sale for the Bank of Japan because by law it was obliged to do so. The question is, what plan does the administration have to stop this type of overt currency manipulation by Japan?

Mr. TAYLOR. We have a very good set of engagements with Japan on their policies, with the finance ministry, with the Central Bank.

What we have stressed in the last year-and-a-half or so is the importance of Japan to grow more rapidly. The way we have emphasized that is to do two things related to the financial markets. One is to for the Bank of Japan to raise the growth rate of the money supply, to put the monetary policy, if you like, which is more conducive to growth in Japan, and the benefits that higher growth in Japan will have for the United States's job creation, as well as the rest of the world, and Asia in particular.

The second part of it is to deal with the problems in the banks, the nonperforming loan problems. These are very much related to your question, and in fact a significant part of this is that they are actually making some changes here which are very, very good.

The new Central Bank governor, Governor Fukui, has had increase in money growth which is substantial. The person in charge of the financial market regulations, Minister Tanaka, has put on a very good reform plan under Prime Minister Koizumi's guidance and leadership. That is beginning to show up, and for the first time in a long time we see some signs of the harmful deflation in Japan starting to be eliminated, starting to come back, starting to diminish.

On top of all this, we see some strong growth in Japan, as I indicated in my written testimony. So that has been our focus.

The issues with respect to the currency are the kind of things that are being done there, the kind of things that are reflected in the G-7 statement that I read for Congressman Maloney, which was established in Dubai.

So that is the strategy. We think it will work, and there are already signs of it working. As always in changes in economic policy, it doesn't occur overnight, but we think there is really good progress being made here.

Mr. ALDONAS. Congressman, if I could add just a couple of comments to that. One is really to compliment John and Secretary Snow, and I have worked in this area for over 25 years at this point. This Treasury, more than any other I have seen, worked with, whether I was in the private sector or in public service. If there was a point at which we could divorce finance from trade back in the 1940s and live in what we thought was a fixed exchange rate regime, that ended a long time ago, and obviously the dialogue that has gone on and the efforts that John has undertaken to bring these issues back to the forefront and really allow us to grapple with the underlying problems.

In fact, I think John's point about working with both the Japanese and the Chinese on their financial markets is in the end the answer in terms of trying to open up the market further, and that has real value for our economic growth and the growth of exports.

The other point I wanted to raise was in direct response to what you said, Congressman Manzullo, about the other things that our exporters worry about and that our manufacturers worry about. What would probably surprise everybody is the degree to which we heard more comments during the roundtables about keeping our own side of the street clean, in effect, than we actually heard about the level playing field. The arguments about the level playing field were intense in a way that some of the others were not.

But by and large, most of the comments recognized we have things like a visa policy which gets in the way of our exporting, that we have things in terms of costs that our manufacturers bear that we need to be observant about otherwise we are not going to be creating the most favorable place to invest in manufacturing. And those are things that are the real levers we have in our own hands and know how to use.

Chairman KING. The gentleman from Vermont?

Mr. SANDERS. Thank you very much, Mr. Chairman.

And thank you very much, guests, for being with us today.

Mr. Aldonas mentioned phrases like the fact that the United States today still has the most powerful manufacturing sector in the world. But I think he also understands that in the last 3 years we have lost 2.7 million manufacturing jobs in that powerful sector. According to The Washington Post, we have lost 16 percent of the jobs in our manufacturing sector.

I hope that instead of just talking about how wonderful we are doing, he would look at some of the real crises that exist in that sector.

According to the U.S. Business and Industry Council, this is a business organization, Beijing has a trade surplus with the U.S. of about $120 billion this year. The rule of thumb is that every $1 billion in the trade balance represents the gain or loss of 10,000 jobs. Using that standard, the trade deficit with China could explain the loss of more than one million American jobs. Now here is another point. According to Forrester Research, we will lose 3.3 million high-tech jobs in the next 12 years in the areas of life sciences, legal work, art design, management and so forth and so on.

I see us as being in a very serious crisis. I see the situation, according to these forecasters, is actually getting worse.

Now my questions for the gentlemen are as follows. What does the Bush administration say to General Electric, IBM, Motorola, Kodak, Intel and dozens of other corporations who are throwing American workers out on the street and moving to China, where they are hiring people at 30 or 40 cents an hour? What do we say to those guys? Is that good public policy? Thank you very much, General Electric.

Furthermore, it is not just the loss of jobs. It is the loss of wages in the private sector in the last 30 years. Today, a worker in the private sector is earning 6 percent less in real wages than was the case 30 years ago. What is your attitude toward large corporations who are throwing American workers out on the street and moving to China?

You talk about a level playing field. Maybe I am living in a different world, but in China, workers make 30 or 40 cents an hour. How is that a level playing field with workers in the United States who in the middle class are trying to make $15 or $20 an hour? What does a level playing field mean when a worker in China goes to jail when he or she tries to join a union? What does it mean when there are virtually no environmental regulations in China, causing havoc environmentally in that country and perhaps for the rest of the world? So those are my questions.

What do you guys say to those corporations who throw American workers out on the street and go to China? Tell the workers of Pennsylvania or Vermont about the level playing field that exists when workers make 30 cents an hour.

That is my question.

Mr. ALDONAS. If I could, Congressman, the first thing is, to be very clear with China, is that where there are issues like the sorts of things they adopt with respect to labor rights, that the policy of the administration is they have to reform. We have a conversation with these guys regularly about the human rights aspects of these policies.

Mr. SANDERS. And that conversation has been going on for 20 years, and Chinese workers are going to jail when they form a union. But I don't want to let you off the hook that easy, Grant, if I might. I want you to get back to the basic issue.

Mr. ALDONAS. Sure.

Mr. SANDERS. Tell me about the level playing field when workers go to jail for forming unions and when they make 30 cents an hour. If you were a corporate executive, would you move to China?

Mr. ALDONAS. Congressman Sanders, two points. One, I do know that we are living in a global economy.

Mr. SANDERS. Yes.

Mr. ALDONAS. And to do that, to succeed locally, you are going to have to succeed globally.

Mr. SANDERS. Not necessarily.

Mr. ALDONAS. Yes, and that means what we are going to have to do is get the fundamentals right and we are going to have to allow our companies to get their costs down. And indeed what has happened in that global economy is real economic geography has reasserted itself, which means a lot more is going to be done closer to where consumers are.

So to give you an example on some figures that go with it, when U.S. companies invest in China, there are $60 billion worth of sales by the U.S. companies that invest in China in China, to Chinese consumers. There are $20 billion of sales by U.S. companies that invest in China that export back to the United States. Net, in terms of their activities in China, there is real value, which means jobs back in the United States.

Mr. SANDERS. But how do you talk about jobs in the United States, when according to the trade deficit we have probably lost a million? Of course, some jobs are being created, but you are losing a lot more than you are creating.

Mr. ALDONAS. Well, then we ought to talk about what goes on in the context of the labor statistics. I mean, what you have is, you have two surveys.

Mr. SANDERS. You have two what?

Mr. ALDONAS. Two surveys that the Bureau of Labor Statistics does. One is the establishment survey, which is the figure that is commonly cited about the 2.7 million job losses. The other is a household survey. And there is always a lag between the two surveys.

What you have right now, and I don't know if you saw the column by Allan Meltzer, a professor at Carnegie Mellon, in the Wall Street Journal, but he identified the difference right now. If you look at the establishment survey, which surveys existing businesses, it does not capture start-ups that have happened in the last couple of years, they will show $2.7 million job losses. If you look at the household survey, when they survey households and ask are you employed, what it will show is there are 220,000 job losses. Not good, but not bad in the context of this recovery.

I see your staff aid seems to be expressing some shock behind you. But what I would ask him to do, then, is actually go to the Bureau of Labor Statistics and talk to them seriously about the two surveys and what the differences are.

Mr. SANDERS. We have $100 billion trade deficit with China. Do you agree with that?

Mr. ALDONAS. Absolutely.

Mr. SANDERS. And you see that as the loss of how many jobs?

Chairman KING. I am sorry, the gentleman's time expired, so I would allow Mr. Aldonas to answer the question and then move on.

Mr. SANDERS. Thank you, Mr. Chairman.

Mr. ALDONAS. What I see is a trade deficit that is expanding generally, of which China represents about one-sixth.

And just to make it a little more poignant, I had to order a cell phone recently. I said, "Look, I am the Under Secretary of Commerce for International Trade, get me a Motorola," because I want one that operates all over the world, right, rather than a Samsung or something else. I picked it up and turned it over. Guess where it was made?

Mr. SANDERS. Let me guess.

Mr. ALDONAS. Ireland.

[Laughter.]

My point is that this is a global phenomenon. And my point in saying that is that we have a trade deficit——

Mr. SANDERS. I am glad that you found something in Ireland. When I go to a department store, most of the products that I find are made in China. I am glad you found Ireland.

Mr. ALDONAS. I am sorry, Mr. Sanders, but my point in saying that is that we have a trade deficit which is growing because of the relative growth rates in our economy compared to others. That is not a China phenomenon alone. My point in saying that is not to diminish what we need to do with respect to China. It is to make sure that we don't let others off the hook as a part of that process. A lot of what John was talking about with respect to some other countries in terms of growth is the real key to driving a recovery in manufacturing at the end of the day.

Mr. SANDERS. Thank you very much.

Chairman KING. Mr. Ose?

Mr. OSE. Thank you, Mr. Chairman.

This is perhaps the most interesting hearing I have sat through in my 4 1/2 years.

Chairman KING. See, what you are going to be missing, Doug?

Mr. OSE. Let's go on to my questions.

[Laughter.]

Mr. Taylor, do interest rates, relative interest rates, affect currency valuations?

Mr. TAYLOR. Yes, among many other factors, they do.

Mr. OSE. There is also productivity.

Mr. TAYLOR. Productivity, prices.

Mr. OSE. Inflation? Inflation affects it?

Mr. TAYLOR. Yes, very much so, many factors.

Mr. OSE. You said something a little bit ago about how Treasury had advocated to the Bank of Japan that they increase the domestic money supply in Japan. Does domestic money supply affect interest rates?

Mr. TAYLOR. In Japan, the interest rate is now effectively zero because of the deflation. So they are trying to get to a situation where inflation is above zero, equal to or greater than zero, as they say. And they want to keep the rate of money growth up until that happens. Until that happens, the interest rates are going to be zero. And so effectively in Japan, it is not a direct impact.

Mr. OSE. It does come around, though.

Mr. TAYLOR. Ultimately when you get a situation where the deflation is over, which I hope is soon, then it will be more back to the natural situation where you have a nominal interest rate which fluctuates as in most countries.

Mr. OSE. So there is a connection between money supply activities taken to reflate an economy, a relative inflation rate, and ultimately around the circle to interest rates.

Mr. TAYLOR. Yes.

Mr. OSE. The question I have is, in advocating for an increase in money supply, is that currency manipulation? Because if you affect interest rates, you affect relative currency valuations.

Mr. TAYLOR. I would answer your question as no. There are many, many factors that affect exchange rates. The importance of growth of the money supply ultimately is that it will increase money growth, it will get translated into higher inflation, and higher inflation makes the currency less valuable. So in an extreme, extreme situation of very high money growth, there isn't going to be an effect on the exchange rate.

What we have noted, after years and years of looking at exchange markets, is there are many manufacturers and it is always hard to trace the impact of any one. But certainly in extreme situations you can see countries, for example, which have very high money growth and very high inflation, they have depreciating currencies.

Mr. OSE. Correct.

Mr. TAYLOR. We saw that in the past and will in the future.

Mr. OSE. I would argue that there is a connection. It may well be round-about, but there is a connection. And there are multiple factors.

Mr. Aldonas, I find your testimony fascinating, because you are out there on the front line, so to speak. Both of you have mentioned not only the current account, but also the capital flows out of China in terms of the overall net effect. Can you expand, if you will, on your estimation of the relative importance of capital outflow and the inability of the Chinese to freely flow capital out?

Mr. ALDONAS. I really should defer to John on that. I am happy to give you my personal view, but I think we should let the Treasury speak for the administration with respect to that.

Mr. OSE. All right. Mr. Taylor?

Mr. TAYLOR. The extent to which capital outflows are restricted in any country, it effects the currency because it restricts the amount that people can buy of other currencies. That certainly is not a factor that would affect the pressure on the yuan if the changes in the capital restrictions went through.

That is one of the reasons why when we engage with the Chinese, when you just talk about the exchange rate, you automatically start talking about capital controls.

Mr. OSE. Let us talk basics here. A restriction on capital outflow supports the value of the currency is what you are saying.

Mr. TAYLOR. Yes.

Mr. OSE. All right. Now I just asked that question because I just want to be very clear on that, because I have heard a lot of argument about what is supporting the value of the currency right now is demand for Chinese goods. But as you have pointed out, the restriction on capital outflow is part and parcel of this argument too.

Mr. TAYLOR. It most certainly is. I go back to the beginning. There are a multitude of factors that affect exchange rates, as you know from your course.

Mr. OSE. Thank you, Mr. Chairman.

Chairman KING. Thank you, Mr. Ose.

Ms. Hooley?

Ms. HOOLEY OF OREGON. Yes, thank you, Mr. Chair.

Mr. Taylor and Mr. Aldonas, thank you very much for being here today.

This is an important issue facing American workers. I would venture to say, however, that the reason this issue has received so much attention is not the Chinese manipulation of its currency, but what is happening to the loss of American jobs. People are very concerned what is happening to manufacturing in this country and what is happening to jobs.

So I have a three-part question and a little story to tell in between. Aside from the policy of tax cuts and maybe dealing with the Chinese currency issue, what else is the administration doing to help create jobs?

And then, I was talking to a gentleman the other day who happens to manufacture furniture. He was talking about most of the manufacturing in furniture-making having left this country. He said at first they went to Mexico, and then they have now really left Mexico and gone to China.

So I want to know what part does this currency issue play in the loss of manufacturing jobs? And what other factors are contributing to the loss of jobs and manufacturers leaving this country that Congress should be aware of or that we can do something about?

Thank you.

Mr. TAYLOR. Well, let me start.

First of all, I think dismissing the tax cuts at the beginning is a mistake. I think the tax cuts are an important part of what we can do to raise——

Ms. HOOLEY OF OREGON. I didn't dismiss the tax cuts. I said aside from that.

Mr. TAYLOR. I just wanted to mention that. Anyway, sorry.

In addition to that, the health care reform proposals to reduce the very high and rising cost of health care will create more opportunities for workers. President Bush has emphasized the importance of tort reform to reduce the costs on small businesses, in particular start-up firms. Of course, it is a concern right now; and the medical field as well. Those are things that are very important.

I think from speaking with the international portfolio at the Treasury, that getting growth to be high in other countries is very, very important. And that is what I have spent most of my time on, is getting higher growth not only in China, but higher growth in Japan and especially Europe right now.

Because a number of people have mentioned how the United States really cannot and should not be the sole engine of growth, because the U.S. economy is doing quite well now as it is starting to move ahead. And that is going to create more jobs in the manufacturing sector, as in other sectors. But growth in other countries, growth around the world, is a very important part of this, in my view.

Mr. ALDONAS. If I could add, the first question was what else is the administration doing and what has the President proposed. One thing I always like to make clear is, the President has never said it is only about tax cuts. What he has identified are a lot of other drivers in the economy.

What was interesting about it, Congresswoman Hooley, was that it is exactly what we heard from manufacturers themselves. When they talked about keeping our side of the street clean, what they were talking about were things like health care costs and energy costs, tort reform, cost of tax compliance, just to give you an example.

We have an alternative minimum tax that applies to corporations in this country. We collect almost no revenue from the alternative minimum tax as applied to those. And yet, for a manufacturer, what it means is, it used to be illegal to keep two sets of books. Now, by virtue of the alternative minimum tax, you keep four.

So you have a dead-weight economic loss that flows simply from the cost of compliance. And the depreciation schedules, under the alternative minimum tax, deeply erode some of the competitiveness and the productivity gains that our manufacturers are trying so hard to achieve.

So what they talked about, and really a number of the comments went right to the heart of the agenda that the President has put forward about trying to match what the private sector has done in manufacturing to cut costs so that the government is lowering the burden on our guys as well.

Ms. HOOLEY OF OREGON. Do you believe that manipulation of the Chinese currency is adding to the loss of manufacturing jobs?

Mr. ALDONAS. I think we need to be careful about the word "manipulation." They are maintaining a peg.

Ms. HOOLEY OF OREGON. Okay, maintaining a peg. Do you think that is contributing?

Mr. ALDONAS. I think to the extent that it contributes, to the extent that it is currently undervalued, it would mean both higher import competition and less of an export market. And that has the potential to affect both the competition we feel, even if it is simply on the basis of price and there was no greater volume in the goods, or in terms of our export potential.

But I always like to think past the exchange rates, because it is the fundamentals that drive it that are probably more important to be working on. In some respects what Secretary Snow and Secretary Taylor have been doing is really to go to the heart of the problem. The problem is not so much the exchange rate. It is what you have to do with the underlying financial markets so that you can have that freedom.

The thing that I really want to get to is that, and this is what I think the hearing is really about, just as you were saying, Congresswoman Hooley, is that when there is something like a peg, and when another government has intervened in the market, it creates a perception of unfairness. And in fact, what we see is the friction that comes in the trade accounts.

One of the reasons we are having trouble with this, and we are grappling with some of the pressures on trade, and you see folks who have lost their jobs point to this as a problem, is simply by virtue of the fact they can see the government visibly intervening. I think that is a lot of the issue and a lot of what we have to grapple with in terms of trying to make sure that we are having this constant agenda with the Chinese on trade, on finance, that keeps the spotlight on the problem and tries to remove these things, because it is that perception of unfairness which drives a lot of the demand for protection.

Chairman KING. The time of the gentlelady has expired.

Votes have been called. What I would like to do is I will be recognizing Mr. Paul to ask one question, then I understand that the two witnesses have to leave.

I would ask if our third panel, Dr. Goldstein and Mr. Vargo, can stay around, and we will recess until approximately 4:15 p.m.

Ms. HOOLEY OF OREGON. Mr. Chairman, a point of clarification, if I could. Mr. Chairman, I just want to add something to the record in answer to Mr. Aldonas's comment on the household and the establishment surveys of unemployment.

He said we should ask the Bureau of Labor Statistics about the two surveys. I just wanted permission to place into the record comments from the Bureau of Labor Statistics Commissioner at a recent joint economic hearing endorsing the use of the establishment survey as a more accurate measure of unemployment in an exchange that he had with Senator Bennett. I would like to get the relevant comments and place them in the record establishing that as the one that they believe is the most accurate on unemployment.

Thank you.

Chairman KING. I would also like to say to members that they can submit questions to the witnesses up to 30 days.

And with that, Mr. Paul.

Dr. PAUL. Thank you, Mr. Chairman.

This is directed to Secretary Taylor. Has the administration taken a position on this legislation that was briefly described earlier, H.R. 3058? Does the administration have a position on that?

Mr. TAYLOR. No. I have not fully digested it myself.

Dr. PAUL. But it essentially threatens the Chinese if they don't do what we want. We put on a possibly a 40 percent tariff. In general, would you support something like that?

Mr. TAYLOR. With what I have looked at so far, it seems to me the approach that we are taking now to this issue is more productive than an approach which raises tariffs. As far as I know, there is not a formal position, but it seems to me that we have a good strategy in place with respect to this issue and we would like to pursue that.

Dr. PAUL. Okay. Also, very briefly, we are talking about flexibility, we are talking about really devaluation of the dollar in comparison to the yuan. Is it not true that throughout history when countries have used competitive devaluations that they don't work that well? That generally they do not achieve what is sought and that frequently prices go up rather quickly and most of those who promote devaluations are somewhat disappointed?

Mr. TAYLOR. I agree with that very much.

Chairman KING. That will have to be the last question unless Secretary Aldonas wants to add to that.

I want to thank both of you for your testimony today. It has been very illuminating. I appreciate your time and your patience.

If the third panel can wait, we will reconvene at approximately 4:15 p.m.

Thank you very much.

[Recess.]

Chairman KING. It is very seldom we have a panel of witnesses with such exceptional credentials. It is even more unusual to have experts who are so patient and tolerant and understanding of the foibles of the House of Representatives. So I do thank you for enduring all this and for waiting around for this length of time.

So I would like to introduce to the subcommittee Dr. Morris Goldstein, Senior Fellow of the Institute for International Economics, and Mr. Frank Vargo, Vice President of International Economic Affairs at the National Association Of Manufacturers.

I would certainly welcome any statements you wish to make. We will begin with Mr. Vargo.

STATEMENT OF FRANKLIN J. VARGO, VICE PRESIDENT, INTERNATIONAL ECONOMIC AFFAIRS, NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. VARGO. Thank you, Mr. Chairman. I have a prepared statement for the record and some very brief remarks to make at this time.

Exchange rates are one of the main things that have been affecting our trade, and that is why the NAM has been making such a big fuss over them for a while now.

China poses an enormous opportunity for American exporters, workers and investors, but also a huge, huge challenge through its exports to the United States, a huge challenge to a growing range of U.S. manufacturing industries such as plastics, tool and die, furniture and many others that are feeling particularly impacted right now.

China has an increasingly modern infrastructure, low wages, productive work force and a significantly undervalued currency. So it is simultaneously the largest threat that many NAM member companies see and also the largest prospective market for exports and investment that other members see.

Our trade deficit with China is the largest in the world now. The growth of that deficit and the rapid spread into more and more products and industries is leading to significant increase in calls for protection. I have never seen anything like it in my years at NAM or my many years at the Commerce Department.

I want to stress the NAM wants a productive trade relationship with China, and we are very concerned about the present trends. We need to see our trade move in a more sustainable direction and we do not have much time. We have to reject protectionism. That road will not work.

We believe that the best direction for the future with China is for China to move as quickly as possible to market forces. Most importantly, that means the Chinese currency has to stop being held at a very undervalued level. There is no question, as you have heard repeatedly already, that the Chinese yuan is very undervalued. Last year, the U.S. trade deficit with China was $100 billion. So far this year it is running close to $130 billion.

It is important not to overstate China's importance in the current U.S. manufacturing slowdown, for China is not the principal cause of that difficulty, but it is a factor. Other factors including the drop in our global exports, which is a larger factor, and cost pressures are also very important. But the greater importance of China lies not with the present, but in the future. Because if the 20-year trends continue, our deficit with China will triple in five years.

I have a lengthy prepared statement, but I do encourage you to look at some point at the table in the very back of my statement which gives a matrix showing alternative trade balances under varying assumptions of export and import growth rates for the next five years. What that shows is that even the most robust export growth rate of, say, 30 percent a year or so is still going to leave us with a trade deficit that will be more than two-and-a-half times as large.

So it is clear, if we are going to have a more balanced relationship, the rate of import growth is going to have to slow. We don't want to do that through protection or through legislation. So the best way to do it is through the currency valuation that is either market-determined or that emulates that.

We want to be very careful to note that China cannot be the scapegoat for our economic difficulties. It is a mistake to say that if we just fix the China currency we have done everything. That is not so. We have to work on the cost of regulation, the cost of litigation, so many things in the United States as well. But still, if we do not deal with the China currency now, we are going to have a problem that is just going to get away from us and we will not be able to deal with it.

We are very pleased at the administration's very active program in seeking to bring about a more market-determined currency and we support that, and we want to see the administration have the maximum leverage.

Finally, just let me note that there are already is some legislation being introduced that would put on tariffs across the board, and the NAM has not taken a formal position, but it is extremely unlikely that we would be able to support that legislation.

One piece we do support is Manzullo-Stenholm, Congressional Resolution 285. We hope that it will get a lot more cosponsors. We see it as very WTO-consistent and a very reasonable way to go. We hope that that will pass before the President goes to Asia later this month.

Thank you, Mr. Chairman.

[The prepared statement of Franklin J. Vargo can be found on page 91 in the appendix.]

Chairman KING. Thank you, Mr. Vargo. Your full statement will be made a part of the record.

Dr. Goldstein?

STATEMENT OF MORRIS GOLDSTEIN, DENNIS WEATHERSTONE SENIOR FELLOW, INSTITUTE FOR INTERNATIONAL ECONOMICS

Mr. GOLDSTEIN. Mr. Chairman and Ranking Member Maloney, thank you for the opportunity to testify before this committee on the important issue of China's exchange rate regime and its effects on the U.S. economy.

I have a written statement for the record, and then I am going to give just a brief summary of it now.

Chairman KING. Without objection, your full statement will be made a part of the record.

Mr. GOLDSTEIN. My colleague, Nicholas Lardy, and I have recently been analyzing China's currency regime, and I would like to share with the committee five of our main conclusions.

First, so long as China maintains controls on capital outflows, runs surpluses on both the overall current and capital accounts and its balance of payments, and accumulates international reserves in large amounts, there is a compelling case that the Chinese currency, the remimbi, is significantly undervalued. Our preliminary estimates suggest that the undervaluation of the remimbi is on the order of 15 to 25 percent.

Second, a revaluation of the remimbi is in China's own interest as well as in the interest of the global economy. If China does not revalue the remimbi, net capital inflows and the large accumulation of reserves will continue. With its mountain of bad loans, China should not permit capital inflows and reserve accumulation to exacerbate the already excessive expansion in bank lending, money supply growth and investment.

And appreciation of the remimbi is, likewise, in the interest of the United States and the wider community. Unless China permits the value of its currency to rise, it will be much more difficult to obtain the broader realignment of key exchange rates in Asia and elsewhere needed to produce a marked correction in global payments imbalances, including a reduction in the U.S. current account deficit.

Third, urging China to adopt a flexible exchange rate regime and to open its capital markets, as U.S. Treasury Secretary Snow and others have suggested, is sensible advice for the longer term. But that advice is not appropriate for China's current circumstances, especially its weak banking system. Therefore, it is not likely to be heeded anytime soon, providing little relief for current exchange rate and payments problems.

A more practical approach is to urge China to reform its currency regime in two steps. In the first step, China would immediately revalue the remimbi by 15 to 25 percent, it would widen the currency band to between 5 and 7 percent from less than 1 percent, and it would switch from a unitary peg to the dollar to a three-currency basket with roughly equal weights for the dollar, the euro and the yen.

Step two should be adoption of a managed float after China takes further reforms to put the domestic financial sector on a sound enough footing to permit significant liberalization of capital outflows.

The advantage of a two-step approach is that it neither asks the rest of the world, including the United States, to live too long with an undervalued remimbi, nor does it ask China to ignore a key lesson of the Asian financial crisis by prematurely opening its capital account.

Fourth, the United States should take a multilateral tack in persuading China to alter its exchange rate policy and should reject proposals for unilateral trade measures directed against China's exports. Other countries also have a strong interest in seeing the remimbi rise closer to the level implied by fundamentalists. If China resists a rise in the remimbi, too much of the global exchange rate adjustment will fall, for example, on the euro, worsening Europe's anemic growth performance.

The U.S. Treasury should therefore continue to enlist the support of other countries in convincing the Chinese authorities that a more appreciated exchange rate for the remimbi is in the common interest.

As the institution charged with exercising firm surveyance over the exchange rate policies of its members, the IMF should take a more active stance in monitoring exchange rate misalignments and in applying a mix of persuasion and pressure, both private and public, to reduce the duration of such misalignments. Endorsing a vague G-7 call for more exchange rate flexibility is not exercising firm surveyance.

"Multilateral" does not mean everybody but the United States. The United States also needs to do its part to contribute to global adjustment by improving our savings and investment balance, and in particular by adopting a workable plan to reverse the now projected long stream of U.S. budget deficits.

What the United States should not do is impose a unilateral import surcharge on China's exports. China is not the only country to have used or is now using prolonged large-scale unidirectional exchange market intervention to maintain an undervalued exchange rate. China's import ratio relative to GDP now stands at a level three times higher than Japan and twice as high as in the United States.

An import surcharge directed exclusively at China's exports might well invite retaliation against U.S. exports to China and could risk a wider upsurge in protectionism when the opposite is needed to support global growth. An improvement in U.S. competitiveness calls for a broad-based decline in the value of the dollar, not for a tax on one side of one developing country's trade.

Fifth and finally, the impact of a medium-sized revaluation of the remimbi on the external accounts of the United States should not be exaggerated. Even if China did revalue the remimbi by, say, 20 percent, and even if other emerging economies in Japan followed that by half, that is appreciated by 10 percent, the trade-weighted value of the dollar would decline by about 5 percent.

By my numbers, that might produce an improvement in the U.S. current account on the order of $50 billion. The current account deficit in the United States this year is expected to be $550 billion. If we wanted to reduce the U.S. current account deficit by half, it would require a much larger and more broadly based further depreciation of the dollar in the neighborhood of 25 percent on a trade-weighted basis.

The long-running decline in U.S. manufacturing employment started well before the Chinese currency became undervalued and has a much wider set of origins than exchange rate factors.

Thank you, Mr. Chairman.

[The prepared statement of Morris Goldstein can be found on page 71 in the appendix.]

Chairman KING. Thank you, Mr. Goldstein.

You are talking about the practical approach of urging China to immediately devalue by 15 to 25 percent. What leverage do you think we have to bring that about? And what is the possibility or probability of that happening?

Mr. GOLDSTEIN. I think we have some leverage, first of all, because such revaluation is actually in China's interest. China is having a problem with an excessive increase in bank lending, money supply growth and investment.

Investment share is 42 percent of GDP, the highest it has ever been. Bank lending is going up at double-digit rates, near 20 percent, and they are starting to worry about financial stability. So part of the leverage is convincing them what is in their own interest.

Second of all, I mean, this is a large export market for China. China participates in the International Monetary Fund and other fora, so I think there are levers that we can use. The problem with asking them to float now and open their capital markets is they are not going to do it. So you are not going to get anything now. The reason why they are not going to do it is a very good reason: Their banking system is very weak. If they get bad news, and the capital market is completely open, capital is going to flow out in very large amounts, and the exchange rate is going to depreciate by a large amount, not appreciate.

Household savings deposits in China are 100 percent of GDP. If 5 percent of that flows out, that is bigger than the current account adjustments or other things that we are asking for. So until China gets its banking system in better shape, they are not going to do a float, and they are not going to have free capital movements.

So it seems to me a better strategy is let's ask them for something they really can do. They have a preference for a fixed rate. Let's revalue the rate by 15 to 25 percent now. Let's try and get them to agree to that. Let's get them to agree to a basket peg where the dollar is one of three currencies so that if the dollar has to depreciate more in the future, we won't have to have the remimbi-dollar changes parity every time.

That would bring some relief right now if they could do it. Later on, we can get the float. But a doctrinaire insistence on a float and an open capital markets now is going to get us neither. I don't see why the world should live with a seriously undervalued remimbi now.

Chairman KING. Assuming there is this revaluation of 15 to 25 percent, what impact would that have on other Asian economies? And would they follow, for instance, Korea, Singapore?

Mr. GOLDSTEIN. I think it would make it much easier for them to appreciate. As I say, even if they follow halfway, well, it starts to add up.

The main message I want to leave with the committee is, if you want to get a real correction in the U.S. current account deficit, I mean a large one, you have to get a broad-based decline in the dollar, not just against one currency. As I said, even if China goes 20 and the others in Asia go 10, that is $50 billion. And if you want to get $200 billion off, you need a 25 percent trade-weighted depreciation; 5 percent would be helpful. We should push for it, but I think people are exaggerating.

If you just pick one country and you just pick one side of the trade accounts, it is small. That is why these import surcharges, even if they were legal, which I think they are not, is not going to do much.

Chairman KING. Mr. Vargo, how would you react to that, the 15 to 25 percent adjustment? And also, what impact would it have on other currencies in Asia? And also, how would it impact our economy and our jobs?

Mr. VARGO. It would make a very significant impact on our trade with China. We would start to see the import growth rate moderate very significantly by market forces, not by any protection action. Second, we would start to see our export growth rate pick up with China.

I agree with Dr. Goldstein's analysis that we would also see the other Asian currencies come up. Because while they are looking at our market, I can tell you they are terrified of China. I was down in Cancun representing the NAM at the Cancun WTO ministerial and can't tell you how many other countries told us, "We are happy to do a free trade agreement with the United States, or a regional, but we are not going to cut our tariffs. It is because of China." So the Chinese currency in a sense could be affecting the entire WTO negotiation. So getting it up would have a very broad effect.

Could I just add the point that we have to have an overall realignment of our currency. The dollar is still too strong globally. People are too used to seeing in the press all of the euros at a new 2-year high, and other currencies are high. The dollar is still stronger today measured by the Federal Reserve Board currency index. It is stronger today than it was the day Secretary Rubin left office. It was too strong then, it is too strong now. The basic reason is the Asian currencies have not come down.

Chairman KING. In the earlier testimony today we heard a possible impact would be if China stopped buying our paper, stopped buying treasury notes. Do you see this 15 to 25 percent impact having any impact, any effect that way?

Mr. VARGO. No, Mr. Chairman, I don't, because the impact will be a moderation of the increase of the deficit with China. They will still have a lot of funds to put in, and there is nothing else they can do with it but put it in the United States, or in some other country's market, but then they have the dollar. The dollar has got to come back to the United States to earn interest.

Chairman KING. Well, I would be interested in Dr. Goldstein's view of that.

Mr. GOLDSTEIN. I agree with Frank. I don't think that is the primary worry right now. In any case, even if we were worried about foreign holdings of U.S. Treasury securities, the way to get that problem down is to shrink the current account deficit, which of course we need to finance. That is why we need a broad-based decline.

China is very important because without getting the Chinese to move, it is going to be harder to get others to move. That is why it is a very key part of the puzzle, even though by itself it is not that big.

Let me also say, I think the focus that we have heard a lot about at this hearing, about the $100 billion U.S.-China bilateral deficit, is misplaced. China has a deficit with the rest of the world of $75 billion. It is the overall current account deficit we want to look at. In China, this year, that is about 1.5 percent of GDP. It is going to be about $20 billion. We have a bilateral trade surplus with Australia. It doesn't mean we are manipulating the Australian-U.S. dollar.

I understand why people focus on it, but really, we want to look at the overall position of the Chinese balance of payments.

Chairman KING. Ms. Maloney?

Mrs. MALONEY. Thank you for your testimony.

Dr. Goldstein, you stated that the U.S. was working in a multilateral way on the currency in China and this issue and that unilateral measures, such as the tariff, would not succeed. How effectively are we working on a multilateral basis on this issue? And do you have ideas of how our government could be more effective in working in a more multilateral broad-based way as you advocated?

Mr. GOLDSTEIN. I think we are going in the right direction, but I think we have got to press harder. I think we ought to particularly press harder in the International Monetary Fund. There are provisions in the Fund where you can have a special consultation with a country to talk about exchange rate problems. I think we ought to use every venue we can to push on this issue.

Under the IMF rules, countries can pick any currency regime they want, fixed, floating, something in between. But what you are not allowed to do, or supposed to do, is have the wrong exchange rate. You can have the wrong exchange rate when you are fixed, you can have the wrong exchange rate when you are floating. And I think they have the wrong exchange rate. We ought to press on it.

The Fund, I think, has not been strong enough, active enough. That is the institution we have that was created to deal with this problem in a multilateral way. I think we have to get more serious about monitoring the rules that we have and enforcing them.

Mrs. MALONEY. Many of my colleagues, during their testimony and their questioning, talked about the large and growing unemployment challenge in our country. Some of them believe that it is tied to this, China's currency peg. What is your belief as to the aggregate impact of China's currency peg on U.S. unemployment across all sectors, not just manufacturing? Is it having a huge influence or is it a minor influence?

Many people believe that our unemployment is tied to this currency exchange, but possibly it is not. What is your opinion?

Mr. VARGO. Could I begin by answering that?

The currency with China is certainly not the main reason that we have lost 2.7 million American factory jobs you talk about, but it is a significant factor.

Mrs. MALONEY. How much of a factor?

Mr. VARGO. Well, let me just get back to the first part of your question saying the whole economy. This is a manufacturing recession. Manufacturing is about 14 percent of the American workforce, but about 90 percent of the increase in unemployment. So we really have to look at manufacturing here.

If we look strictly at the role of China, one way of looking at it would be to say how much has China's import penetration, its share of the U.S. market increase since unemployment started to increase back in 2000? Viewed that way, about 15 percent, not 50, percent of the decrease in U.S. manufacturing production, the increased import penetration by China is equivalent to 15 percent of the drop in our manufacturing production. I will say that the larger factor in trade has been the drop in our exports worldwide, and China has relatively little to do with that. That is about 30 percent of the drop.

So you take the increased import penetration, which is all from China, the import penetration from the rest of the world has been flat, and you take our export drop, that is about half of the drop in U.S. production and the other half can be attributed to domestic factors.

Mrs. MALONEY. Dr. Goldstein?

Mr. GOLDSTEIN. I would agree with the general conclusion. I think there are many factors going on that are important in the decline of manufacturing employment.

First is a slow growth in this country. Second, you have slow growth in our trading partners, particularly Europe. We have rapid productivity growth in manufacturing. We have a high dollar more generally. China's weight in the broad trade-weighted index for the dollar is a little less than 10 percent, so that tells you something right there. We are talking about 9, 10 percent of a high dollar.

I would also note that the manufacturing share of employment has been falling for 40 or 50 years. It has fallen in most industrial countries. So it can't be mainly the Chinese rimimbi. That is just not plausible. It contributes some. We ought to try and get rid of the undervaluation, but it is not the main thing.

Mrs. MALONEY. So blaming China for our unemployment is not the proper policy? It is wrong?

Mr. GOLDSTEIN. I think the fact that China has the wrong exchange rate is an important part of policy, and we ought to push as hard as we can to get that misalignment taken care of. But to blame it as the key factor behind the manufacturing employment situation is I think inaccurate.

Mr. VARGO. Could I add to that for just a moment, because I agree with that. My testimony states that and the NAM has never claimed that. It would be a mistake for us to be able to resolve the China currency problem and dust off our hands and say the job is done, because we have huge cost increases in the United States to deal with. We have a lot of problems.

But with China, it is not just where it is today. The problem, even though for some industries this is very, very painful right now, today, the problem is going to be so much worse in the future. As I noted in my testimony, if the trends continue for just 5 more years, we will have a tripling of the trade deficit. We have to head that off. The best way to do that is by moving towards market-oriented mechanisms.

If China is unable to go to a floating exchange rate very quickly, then certainly emulating that by removing some of the undervaluation is a very important thing to do for China as well as for the United States.

Mr. GOLDSTEIN. If I could, let me just mention one other quick point. Some people assume that if the Chinese currency goes up and they lose competitiveness, we will be the main beneficiary. Not so. Who will be the main beneficiaries? Other low-cost producers. Most of the substitution that occurs between China's exports to the United States occurs with other low-cost producers.

So some of the people that are getting complaints from their constituencies about China displacing jobs are going to find out they are being displaced by the Taiwanese or by the South Koreans or others. So that is a large part of the picture.

Again, one doesn't want to exaggerate and assume whatever they get will be our gain. We will get some of it, but a lot of it will go to others. That is why you need the broad-based decline in the dollar. One piece won't do it.

Mrs. MALONEY. Secretary Taylor, though, in his comments testified that he was for a strong dollar, that after the decision of the G-7 countries in Dubai and the dollar declined, he more or less said that was not a desirable outcome, that is not what they wanted. They wanted a strong dollar. But you are saying that is not going to help us economically?

Mr. VARGO. I can tell you from our position, and again I will go back to the Federal Reserve data, the dollar, using their broad measure of all currencies, today is still 15 percent higher than in early 1997, which is the last time when the NAM believes that our trade was in deficit, but a sustainable deficit. We are still 15 percent higher than that, largely because of the Asian currencies, and we are still higher than when Secretary Rubin, the architect of the strong dollar policy, left office.

So the dollar still has to come down if our trade accounts are to move more into equilibrium. There is no question of that. I don't want to speak for the administration on what they mean by a strong dollar policy. I will note that the administration has also been saying that markets should set the value of the dollar, and they have been saying that for over a year. And the currencies that are free to move have been moving in beneficial directions. The currencies that are not free to move, they have not.

Mr. GOLDSTEIN. I think Secretary Snow and Under Secretary Taylor are in a difficult position. The strong-dollar mantra has been around a long time.

If you are the one to say, "Well, we no longer believe in a strong dollar," you risk the dollar falling very rapidly, too rapidly, which could have an effect on our financial market. So once it has been out there, it is difficult to pull back from it.

I think a better expression would have been a sound dollar, because a sound dollar can move down and still be sound. When a strong dollar moves down, people start to say, “Well, if you are for a strong dollar and it is weakening, the policy must not be working.” But I think if you worry about the U.S. current account deficit, as I do, as a medium-term problem, then a lower value of the dollar, broad-based, would be helpful. The dollar would still be strong and sound.

Mrs. MALONEY. My time has expired. Thank you both for your insights.

Chairman KING. Going from a sound dollar to a very sound congressman. Mr. Kennedy?

Mr. KENNEDY. Thank you very much, Mr. Chairman and Ms. Ranking Member, as well as both of you for your excellent testimony.

I would like to, first, Mr. Goldstein, explore the banking issue, the concern that we cannot really float the Chinese currency right now because the banking system is not able to sustain it. What changes do we need in the banking system for them to be able to sustain it, that we need to encourage them to move towards? And is part of this a function of them restricting U.S. financial firms, from participating in their financial industry?

Mr. GOLDSTEIN. I think we want to distinguish between floating and open capital markets. The administration has called for both of those things.

It really is the open capital market that is the problem for them, because if people could take their money out freely and send it out of the country, well, whenever there is bad news about the banking system, they could move it out in very large amounts, and that would leave strong downward pressure on the currency.

They have made some progress in the last couple of years trying to bring down the nonperforming loan ratio. You need to get to a system where loans are made more on a commercial basis and less on a government-directed basis. I think it would be good if they had a larger role for foreign-owned institutions.

But they have to change the way they allocate credit. They are trying to do that. Instead of just doing it for various objectives that we wouldn’t think of as kind of good loan policy, they have to move away from that. They have to recapitalize some of those weak banks, and that is going to take some time. The problem is, if you say, “We want you to do that instantaneously,” go to free capital markets, they are very unlikely to do it. And then you want the rate to be freely floating also. It is too risky for them.

So I think in a 3-year, 5-year time horizon, they can make quite a lot of progress on banking reform. Once they have done that, then they might seriously consider moving to a float. But asking for too much risk, getting very little right now that, and what we could get now I think if we press is something helpful.

Mr. KENNEDY. Now, you also mentioned that the change in the Chinese currency might only bring down the trade-weighted value of the dollar by 5 percent or so. We have already seen a fairly significant decrease versus European currencies. How much has that really been? I am also trying to understand why the other Asians want to try to just stay in lock step with China, why China would let them really appreciate vis-a-vis them.

And what do we really need to do, and is it even realistic to try to get to this 25 percent adjustment in the trade-weighted basis without competitive reaction by other countries? What is really the best we could hope for in this type of scenario?

Mr. GOLDSTEIN. China's weight, again, in the broad index is about 10 percent. So when I was saying the 5 percent kind of weighted average, that was China did 20 percent appreciation with its 10 percent weight, Japan did 10 percent, the other emerging economies did 10 percent. All together, they have a weight of almost 40 percent. But if you assume those kinds of exchange rate configurations, you get about 5 percent. Since it has peaked, the dollar has come down 10, 12 percent, on weighted average, depending on which index you look at.

The rule of thumb that I use is, for every 1 percent you get in the trade-weighted dollar, that gives you about $10 billion on the current account. So you get 10 percent, you have 50. If the current account deficit this year is $550 billion, and we were to say, well, what would be safe would be, let's say, half, 275 or so. Well, we still need about 20, 25 percent, in that ballpark.

To get that, it is very hard to get it out of a few currencies. You have to get a lot of people participating in that by nontrivial amounts. I think that could happen. I think that could happen, and it would be a good thing for us and the world economy if it did happen. The tricky part is trying to manage it so that it doesn't happen too fast and in too sharp a manner. But if it stops now, we are still a long way away from what I think is a safe external position.

Mr. KENNEDY. You are saying if we have already had a 10 to 12 percent reduction in the trade-weighted value of the dollar, and this may give us another 5 percent, so we are really talking an impact of $50 billion to $170 billion, maybe up to $170 billion, combining the Chinese impact with the current impact.

Mr. Vargo, how would we think about that in terms of jobs? I mean, how much does adjusting the trade-weighted balance, or the export, current account balance by $50 to $170 billion, how many jobs is that really going to help us create here in America?

Mr. VARGO. It will have a very significant impact because of changes in trade, not because of trade agreements or WTO or permanent normal trade relations, but basically because of the dollar and because of slower economic growth abroad have accounted for perhaps half of the decrease in U.S. production. Getting our production back robustly cannot happen until we are able to get our net exports to start moving back up, and that means that the currencies have to become much more realistic.

I would be a little bit more optimistic than Dr. Goldstein in that I believe that the Asian currency reaction to China is even more robust and that everybody is looking over their shoulders at China. As China comes up, I think there would be even more of an upward movement on the part of other currencies. So this is a very necessary thing.

Is it the only thing that needs to be done and we can all go home and say we have put everybody back to work? No, but it is perhaps the single most definable thing. We still have to address the cost of litigation in the U.S., the rising cost of health care, so many things, but it is a very important thing to do.

Mr. KENNEDY. Mr. Goldstein, did you have a rule of thumb of 1 percent reduction trade-weighted equals $10 billion change in the current account, how many jobs, you know, would $10 billion in the current account equal?

Mr. GOLDSTEIN. No, I don't.

Mr. KENNEDY. We have talked about Europe and about the impact on Europe. Clearly, when we would have our currency weaker versus Europe, but the same versus China, China has got to just be killing Europe right now. If they are hurting us, the pain is double over there. Presumably, there would be a secondary effect by making the European economy stronger by having China devalue vis-a-vis the U.S. dollar as well, I would presume.

Mr. GOLDSTEIN. Yes. That is why I said other countries have a big interest. This should not be about, "Oh, we are taking it by ourselves." Because many countries have a very strong interest in the same outcome.

We need a decline in the dollar, but the euro has already taken a fair amount of that adjustment. If the Chinese rimimbi doesn't move, then the euro is going to get too great a share. We want that shared out in a more equitable way. The Asian emerging economies as a group have to take a larger share of the total adjustment. Europe will have to take some more euro appreciation, but we need to put relatively a bigger slice of that pie in Asia, and that starts with China.

Mr. KENNEDY. Thank you both for your comments.

Chairman KING. Thank you, Mr. Kennedy.

The gentleman from California, Mr. Sherman.

Mr. SHERMAN. Thank you.

I think this is, when we look back at it, in which we fiddled while Rome burned, we have the largest trade current account deficit in the history of mammalian life. I assume you gentlemen don't think that we can continue it for half a decade or a full decade without the whole thing exploding. We hope the dollar slides instead of crashes.

I am not so sure because, as you have pointed out, although you haven't used these phrases, we suffer from testosterone poisoning. It just feels so good politically and nationalistically to say we want a strong dollar, when more mature societies are all trying to have a "weak currency." Put another way, they want a strong manufacturing capacity. Every time we say we want a strong dollar, what we are really saying is we want a weak manufacturing capacity. Only we don't phrase it that way and so the politics work against us. Now, it is not just currency values. There are a host of other things.

There is a horror story where a man is tied up in a crypt while someone builds a brick wall, brick-by-brick, until he is completely enclosed. And you can turn to the man who is tied up in that crypt and say, "You should not object to any one of these bricks. After all, it is less than 1,000 of anything that would wall you in or deprive you of oxygen or any other sustenance."

And so, to give you an example, we export to China almost nothing compared to what we should, compared to what Europe does.

That is I think in significant part because the Chinese government instructs its entities to do it that way. And if you do it wrong, well, it is implied that you might go to a re-education camp. And since this is all oral, it is not a violation of WTO because oral intimidation is not a violation of anything. You can't prove it. And of course, you have to be aware of it because you see the examples.

Of course, we are not going to do anything about it, because the way you make money and power in our society today is figure out a way to make something for a nickel over there and sell it for $10 bucks over here, and that is where the fortunes have been made. Now they are being made in the service sector as people figure out a way to import services as well as importing goods.

My colleague asked how many jobs for each $10 billion. I have heard rules of thumb that each billion is 40,000 jobs. Do you gentlemen have any reason to think that that is in gross error?

Mr. VARGO. Yes, Congressman. The figures that have been worked up by the Commerce Department, and we have looked at them, are much more like somewhere in the range of 10,000 to 13,000 for jobs, 40,000 once upon a time, but that is overall in the economy, with all of the multipliers.

Mr. SHERMAN. Is that with a multiplier?

Mr. VARGO. It is indeed, sir, yes.

Mr. SHERMAN. So still, for each 1 percent, you are talking about 130,000 jobs. If they would all be in Los Angeles, so much the better.

That is a lot and shows the expense that we are paying for the testosterone high over at the White House and the Treasury. Because when they say they are for a sound dollar, every 1 percent of that is 130,000 unemployed Americans, a painful, painful discussion.

But I don't think it is enough to just reduce the trade deficit a little bit. In theory, we have to pay off the accumulated trade debt. We have to pay for the Mercedes we brought in last decade. It is not enough just to stop bringing them in sometime in the middle of this decade.

What currency slide would the dollar have to have for us to reach a balance of payment equality, let alone start repaying for the deficits we have accumulated when we in effect bought all of those Mercedes on time and haven't made any payments on them?

If we had a euro at 220 to the euro, maybe 60 yen to the dollar, would that be enough, assuming we reach there over a period of 2 or 3 or 4 years, to bring us into the trade balance? Gentlemen?

Mr. VARGO. Congressman, I don't see anything that extreme.

Mr. SHERMAN. Would something that extreme bring us into trade balance, or actually give us a trade surplus?

Mr. VARGO. Oh, I think it would throw the world into such turmoil that we would all be in the soup, that we wouldn't care.

Mr. SHERMAN. Even over 2 or 3 or 4 years?

Mr. VARGO. Yes.

Mr. SHERMAN. So what would bring us into trade equilibrium? Or do you really think that we can continue to run some sort of trade deficit for the rest of this decade and well into next decade?

Mr. VARGO. Let me start by noting that the NAM chairs a coalition for a sound dollar, not a strong dollar. We believe that the dollar has got to return at least to the relative level of 1997, which means it has got to come down.

Mr. SHERMAN. But would that give us a balance of trade?

Mr. VARGO. It would bring us to a deficit that probably would be about 1 percent or so of our GDP. It would not balance our trade.

Mr. SHERMAN. One percent of GDP meaning?

Mr. VARGO. It would be about $100 billion.

Mr. SHERMAN. $100 billion.

Mr. VARGO. Yes.

Mr. SHERMAN. That is still huge for our society which has already run up this huge debt. I mean, our credit card is already in double arrearages, and now you are just going to add another $100 billion.

Mr. VARGO. To get it above that would take a further downward movement of the dollar.

Mr. SHERMAN. Twenty, 25 percent and we are in balance?

Mr. VARGO. Oh, over a couple of years, I think that would certainly do it, but our goal has been to get us back to a sustainable level.

Mr. SHERMAN. Sustainable deficit is an interesting——

Mr. VARGO. Well, something in the range of 15 to 20 percent further I think would suit manufacturing quite well.

Mr. GOLDSTEIN. Representative Sherman, just a few points.

I think one has to be careful about saying we want just a weak dollar as if that is always a good thing. I think the strong dollar in the second half of the 1990s had a lot of advantages and was appropriate, given the way the U.S. economy was performing at that point.

Mr. SHERMAN. If I can interrupt, I have been following these things, perhaps not as long as you, but I have heard every conceivable excuse from the business-as-usual folks as to why we are running a trade deficit. We are running a trade deficit because we had a federal budget deficit. Well, then we had a federal budget surplus. Oh, well then it is because we have a strong economy. Well, then we have a weak economy. Well, we have a bigger trade deficit because we are running at a, all that happens is every possible combination of fiscal, monetary and economic circumstances between us and our trading partners has existed over the last 20 years, and there is only one constant: a U.S. trade deficit.

Mr. GOLDSTEIN. If you want me to continue, I will try and give you an answer.

I think you have to look at the dollar, given the circumstances and what the economy is doing and what other economies are doing. The strong dollar in the second half of the 1990s was appropriate, given the way the U.S. economy was expanding. If the dollar was weaker, we would have been even more overheated at that point. But over the past 2 or 3 years, that has not been the case. The economy has been much slower, and therefore a lower dollar is appropriate, and the current account position has gotten worse.

Mr. SHERMAN. So you are saying the trade deficit of 1999 was a good thing?

Mr. GOLDSTEIN. I am saying that a stronger dollar had an advantage, given the cyclical position of the economy. Similarly, in Europe the weaker exchange rate had an advantage, given that they were having very, very slow growth.

Mr. SHERMAN. If I can interrupt for a second, I think cyclical trade deficits make sense in a world in which they are genuinely cyclical. But if, because we ignore how many different ways we are taken to the cleaner brick by brick, we never run a trade surplus, then I would argue that a trade deficit is never cyclical and is therefore never appropriate because it is part of the brick wall.

Under your circumstance, where you say in 1999 it was appropriate for us to have a trade deficit and to have a high dollar, you would also have to——

Mr. GOLDSTEIN. No, that is not what I said.

Mr. SHERMAN. Well, you said a high dollar, which led inevitably, inextricably——

Mr. GOLDSTEIN. No, we were talking about a high dollar versus a low dollar. Then we can talk about what is the sustainable, with all due respect, what is the sustainable U.S. current account deficit.

Mr. SHERMAN. Sustainable, so over a century we would accumulate $20 trillion, $30 trillion worth of accumulated debt?

Mr. GOLDSTEIN. Well, no, not without limit. I would say a sustainable U.S. current account deficit is about 2 percent of GDP, not 5 percent.

Mr. SHERMAN. But if you do that for a century, then at the end of the century how large is your accumulated debt?

Mr. GOLDSTEIN. It depends on what the return is on U.S. investments. One of the things you find is that investments in this country have yielded a much higher return than, I mean, a much lower return than investments abroad. So actually net interest payments that we have are quite low.

Where the sustainability issue comes in, I think, is that over time foreigners who are holding U.S. assets, dollar-denominated assets, those dollar assets become a larger and larger share of the foreign portfolio that they want to hold. When that gets too high, then they are very uncomfortable with it. But the economy grows, the rate of return on those is important. I think it is not the case that we necessarily have to have a U.S. current account surplus. We can have a deficit, but it has to be one that is coincident with our ability to service it. It has to be coincident——

Chairman KING. If the gentleman would yield for a moment, I hate to inject myself into this testosterone-charged dialogue, but the gentleman has far exceeded his time. If you could begin to wrap it up, it would be much appreciated.

Mr. SHERMAN. Yes. I would simply say that talking about a sustainable deficit is like talking about a sustainable carry-forwarded-forever credit card balance that expands every year as the bank decides to grant you a little bit more credit, and that what you should have is a credit card that you actually pay off from time to time, and that we ought to be talking about a much lower dollar versus the yen and versus other currencies.

My time has expired.

Chairman KING. I thank the gentleman for his illuminating questions.

I would hope that now that the word has gotten out that we deal with such testosterone-rich issues, that in a subsequent hearing there will be standing room only with people out into the hallways.

I want to thank the witnesses for their time and their patience. Again, I can't thank you enough. It was very interesting testimony, very illuminating testimony. I also thank you for your patience.

Without objection, the record of today's hearing will remain open for 30 days to receive additional material for members and supplementary written responses from witnesses to any question posed by a member of the panel.

I would also ask unanimous consent to members of the full committee that were unable to be present today be allowed to insert their statements into the hearing record.

The subcommittee is adjourned.

[Whereupon, at 5:15 p.m., the subcommittee was adjourned.]

APPENDIX

October 1, 2003

Opening Statement

Chairman Michael G. Oxley
Committee on Financial Services

Subcommittee on Domestic and International Monetary Policy, Trade, and Technology

"China's Exchange Rate Regime and Its Effects on the U.S. Economy"
October, 1, 2003

Good afternoon. I would like to thank Chairman Peter King for convening today's hearing on an important issue which is assuming a growing importance in our national economic policy. This is an excellent use of the Subcommittee's jurisdiction not just over international monetary policy matters but also economic growth and stabilization.

I particularly commend Mr. King for his foresight since he has been looking at this issue throughout the year, long before it became fashionable to focus on the relationship between the valuation of China's currency and the U.S. economy.

The strength and flexibility of our country's economy derived in no small measure from our commitment and leadership to free and open capital markets. We encourage countries, both through negotiation and example, to leave the seeming security of capital controls and other market restrictions.

Embracing free markets means providing freedom for capital to find its most productive home and for markets in goods and services to grow beyond national borders.

A commitment to free markets also implies a corollary commitment to accept that perhaps old ways of doing business are more productive if they are done elsewhere. This is what economists refer to as "creative destruction."

Permitting capital to leave a country should create a significant incentive for people and industries to innovate so that they can become more competitive in the marketplace. I also believe that free movement of capital necessarily also creates the environment for free movement of ideas that can provide the foundation for creating or enhancing democratic processes.

This mutually beneficial arrangement can only work, however, if both goods and capital can flow freely through economies. Liberalizing one sector (e.g., goods) while keeping a tight rein on another sector (e.g., capital) may feel good and may provide security against messy volatility in the short-run. However, this policy can create serious imbalances in the economy choosing this policy and it can inhibit fair competition.

That is why today's hearing is so important. China is the world's most populous country. It is becoming one of the United States' most important trading partners. It has recently served as a source of strength in Asia, as well as an engine of economic growth globally.

Many people, including me, welcome its efforts to become more integrated in the global economy and seek to encourage further economic liberalization. U.S. companies and consumers benefit from a strong and growing China, but only if that growth is based on a fair system.

At the same time, China's vibrant economic growth and potential for 21st Century success should lead it to adopt 21st Century exchange rate policies as well. If China is going to be serious about its WTO commitments, it must also recognize that fair competition requires market-determined exchange rates in addition to opening its markets to foreign companies.

It is true that such large changes cannot occur overnight, especially in a command economy. It is also true that a financial system must be strong and resilient in order to absorb the kind of capital market volatility that accompanies floating exchange rates. Finally, it is true that China's fragile banking system needs to be strengthened if a floating rate system is to be launched successfully.

These facts should underscore the importance of China moving clearly and unambiguously towards banking sector reform. They cannot serve as an excuse for delaying these necessary reforms.

I commend Secretary Snow for his efforts in Asia and the G-7 concerning this issue. Secretary Snow's leadership demonstrates the U.S. commitment to free markets and fairly determined exchange rates. I look forward to Undersecretary Taylor's update on the progress of these initiatives.

Of course, exchange rates are only part of the story. Our dynamic economy for some time now has been undergoing a dramatic shift towards service sector jobs and away from manufacturing jobs.

It is unclear how the Chinese exchange rate regime contributes to, or accelerates, this trend. However, the trend should not be confused with the notion that the U.S. economy will someday outsource all production of physical goods. We should not accept that possibly unfair competition will require hard-working Americans doing a good job to be unemployed.

I therefore commend the Administration's recognition that it will take more than just international economic diplomacy to foster free and fair markets. The manufacturing sector in this country is a significant source of innovation, patent development and, therefore, economic growth. We cannot permit potentially unfair competition to undercut this important activity.

The Commerce Department recognizes this and I look forward to Undersecretary Aldonas' testimony describing how American manufacturing interests and concerns are being addressed.

Written Testimony of

The Honorable Phil English
United States Representative
3rd District, Pennsylvania

Before

Subcommittee on Domestic and International Monetary Policy,
Trade and Technology

Committee on Financial Services

"China's Exchange Rate Regime and Its Effects on the U.S. Economy"

October 1, 2003

Chairman King, Ranking Member Maloney and Members of the Committee, it is my pleasure to appear here today to relay what I believe to be substantial negative effects to the U.S. economy as a result of Chinese monetary policy. Thank you for the opportunity to testify before you today.

When President Clinton approved China's entry into the WTO in 1999, many believed a new era of vast opportunity for U.S. businesses and workers had opened. Those in Congress, like myself, who were skeptical this opportunity would not come without substantial risks, voted to grant Permanent Normal Trade Relations to China only after insisting that special safeguards relating to Chinese imports be included.

Looking back from China's accession to the WTO until now, I would like to convey a clear message: few of the benefits intended for America have been realized because China has not abided by the terms of their international commitments. And while the current Administration has begun to develop a comprehensive strategy to ensure China plays by the rules, these steps must be accelerated, strengthened and enforced.

China has pegged its currency, the yuan, at a rate of approximately 8.3 to the dollar since 1994. As a result of this peg, other major currencies in East Asia have also been under tremendous pressure to intervene by infusing massive amounts of foreign currency into their reserve accounts or manipulate their currency to maintain stability. If China were to freely float its currency, it would deny other Asian countries a convenient excuse for manipulating their currencies. This would bring about a revaluation of Asian currencies against the dollar (and the Euro) which is needed to restore a balance among global currencies and reduce the threat of a hard landing for the dollar.

Misalignments in currency, particularly in the case of China, adversely affect the benefits gained from trade concessions. In fact, misalignments in currency caused by government policies intended to maintain an unfair trade advantage can impair and even nullify trade concessions. Many economists estimate that the Chinese yuan is undervalued against the dollar by as much as 40 percent. Essentially, this amounts to a 40 percent subsidy on all Chinese exports to the U.S. and a 40 percent tariff on all U.S. exports to China. U.S. exports to China currently face an average bound tariff of 15 percent. If recent estimates of China's currency undervaluation are correct, the effect of a free and open currency market would be more than twice as large as the effect of eliminating every tariff that China imposes on U.S. exports. Therefore, it is imperative countries allow their currencies to reflect their true value or else all of the benefits of bilateral trade are eliminated.

Because China's currency is pegged to the dollar, and other currencies have readjusted against the dollar, the economic effect of China's currency policy to the United States is more pronounced. To illustrate the point: since February, the dollar has fallen by approximately 25 percent against the Euro, but by 10 percent or less against the yen and most other Asian currencies. The dollar has, of course, remained unchanged against the yuan. At the same time, China's net exports to the U.S. have grown rapidly, but China's trade surplus with the world as a whole has actually been falling, and is down sharply this year. This strongly suggests that China's currency regime is contributing strongly to the rapidly ballooning trade imbalance between the U.S. and China. The U.S. – China trade deficit is projected to reach more than $120 billion in 2003, $17 billion over the previous year and the largest bilateral trade deficit in the world.

This is precisely why the practice of manipulating currency to obtain an unfair advantage in trade is illegal within the frameworks of two international bodies – the World Trade Organization and the International Monetary Fund – as well as U.S. law.

While each provision contained within international or domestic law defines this highly destructive practice slightly differently, the end goal of each provision of law is the same: to provide a mechanism to countries which play by the rules to address the egregious practice of currency manipulation and thereby restore the benefits of trade. As I have studied this issue further Mr. Chairman, I have found the international mechanisms to be inadequate.

For this reason, I have recently introduced – along with Representatives Cass Ballenger and Mark Green – H.R. 3058, *The Currency Harmonization Initiative through Neutralizing Action (CHINA) Act of 2003*. While there have been multiple bills and resolutions introduced in Congress on this topic, the CHINA Act enjoys the most robust co-sponsorship, currently supported by over 60 members of the House of Representatives.

The premise of the CHINA Act is straightforward: It requires the Secretary of the Treasury to determine if China is manipulating its currency to gain an advantage in trade. If the Secretary finds manipulation is occurring, then he is directed to impose a tariff equal to the degree of manipulation on all imports from China. This is in addition to any existing tariffs on Chinese products.

This is a measure that actually levels the playing field. It strips China of their ability to give themselves an arbitrary advantage. It is a flexible tariff and it can be adjusted to meet the actual extent of the distortions from the artificial undervaluation of the Yuan.

While I understand that participation in an open and fair global economic system is essential to U.S. economic growth and job opportunities, when China breaks the rules, the U.S. suffers the consequences. Through observing the direct effect China's state-sponsored mercantilism has had on my district in northwest Pennsylvania, it is very clear to me that China's currency regime is: neutralizing gains made through trade liberalization, heavily contributing to our bilateral trade deficit with China, subsidizing Chinese exports to the U.S., and taxing U.S. exports to China. Of potential greater consequence, however, is that this type of blatant disregard for international trade law will erode support within the U.S. for the WTO and the multi-lateral trading system. Very simply Mr. Chairman, Congress must ensure that the U.S. maintains the ability to police its own markets and force others to play by the rules.

Thank you again for the opportunity to appear before you today.

Statement of the Honorable Mark Green, M.C.
Before the Subcommittee on Domestic and International Monetary Policy, Trade, and Technology
House Committee on Financial Services
October 1, 2003

Chairman King, Ranking Member Maloney, distinguished members of the subcommittee, thank you for holding this important hearing on China's exchange rate regime and its effects on the U.S. economy. I very much appreciate the opportunity to provide this testimony on what I view as a critical first step in fighting unfair trade practices and protecting American jobs. I am hopeful this hearing will give us an opportunity to explore China's currency practices, their impact on American producers, and the steps needed to level the playing field.

We have all certainly heard a lot about American jobs in the past few years. Unfortunately, most of this news has not been good. While few sectors seem to have escaped the recent economic downturn, manufacturing has been particularly devastated. In Wisconsin, we have lost over 60,000 manufacturing jobs. We have seen some of our oldest and most established companies, such as Mirro and Evenflo, buckle and finally break under the pressure. As a result, whole communities in Wisconsin have been thrown into turmoil, and many families in my district are now facing an unsettled and troubling future.

There are several factors contributing to the flight of our manufacturing jobs. While all of these factors must be addressed, one of my top concerns is the unfair advantage some east Asian countries, particularly the People's Republic of China, have been creating for their manufacturers through currency manipulation. We simply cannot allow countries like China, to continue their illegal, anti-free market trade practices. Their actions are costing us jobs.

Since 1994, China has pegged its currency at 8.3 yuan to the dollar. The goal behind this effort is simple and intentional – to drive exports and fuel economic development. Their success in this policy has been staggering. Our trade deficit with China has grown from $20 billion in the early 1990s to an estimated $125 billion this year. Our ratio of imports vs. exports to China today stands at about 6 to 1.

Throughout this same time period, U.S. manufacturers have struggled to compete with China's economic surge. Fueled by an exchange rate policy that some economists and manufacturers estimate makes Chinese products 15 to 40 percent cheaper compared to U.S. goods, many U.S. manufacturers have found it nearly impossible to compete – no matter how efficient they become.

For the past several years, the world has stood by as China has proclaimed change is forthcoming. We have even brought China into the world community and WTO with the commitment that they would live up to international rules of fair trade, including reforms of their currency policies. Unfortunately, this has not been the case. With 37 straight months of manufacturing losses in this country, we cannot afford to wait any longer. The time for action is now.

If Congress could pass a law requiring China to, at least partially, float its currency, I would introduce one tomorrow. Unfortunately, Congress does not have that luxury. However, Congress can pass a law to offset the advantage the Chinese are providing for themselves through currency manipulation. In fact, Congressman English, Congressman Ballenger and I have already introduced such a bill. The legislation is called the CHINA Act and it is H.R. 3058.

Under the CHINA Act, the Secretary of the Treasury is required to analyze whether China is manipulating its currency to achieve an unfair advantage in trade. If manipulation is found, the Secretary is directed to levy tariffs in a percent equal to the degree of manipulation. For example, if the secretary finds a 40% advantage, a tariff of 40% would be placed on Chinese goods. Such a high tariff would most certainly help offset the unfair gains Chinese producers have been receiving. Most importantly, this legislation sends a message to other countries that we are prepared to take bold steps to enforce fair trade practices. While I know this committee does not have jurisdiction over this legislation, I am hopeful the members will work with me and my colleagues to pass the CHINA Act through the House.

Getting China to reform its currency policies is going to require a full-court press that includes more than just Congress. That is why I am pleased the Bush administration also supports a free-floating currency for China. Treasury Secretary Snow recently returned from a trip to China in which he continued to press the Chinese to make the necessary reforms and come into compliance with their international obligations. I was also pleased to see the recent success the administration had at the G7 summit, where the organization expressed as "desirable" a more flexible exchange rate regime.

I look forward to continuing to work with the administration and ensuring this body is doing everything it can to enhance their efforts. The CHINA Act is a powerful and appropriate tool that I hope will advance the administration's efforts and convince China the time has now come for action. No more stalling, no more delaying, no more waiting.

In conclusion, it's time to get tough with the Chinese and send them a message that we will not stand for their unfair currency polices. American businesses can compete with anyone when the playing field is level, but not when the deck is stacked against us. Good people are losing their jobs and our economy is suffering because the Chinese are not playing by the rules. Our economic future is at stake. It is time for action.

I want to again thank the chairman and the committee for holding this important hearing. I look forward to working with you and seeking solutions to end China's unscrupulous manipulation of currency.

DONALD A. MANZULLO
COMMITTEE ON SMALL BUSINESS
CHAIRMAN

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REMARKS OF THE HONORABLE DONALD A. MANZULLO (IL-16TH)

"China's exchange rate regime and its effects on the U.S. economy"

Subcommittee on Domestic and International Monetary Policy, Trade, and Technology
Committee on Financial Services
U.S. House of Representatives
October 1, 2003 2:00PM in Room 2128 RHOB

Thank you, Mr. Chairman for holding this very important hearing today.

For the last several years, American manufacturers have been pummeled by extreme competition from foreign competitors. Since July 2000, more than 2.7 million Americans who have worked in the manufacturing sector have lost their jobs. According to a recent study issued by the Federal Reserve Bank of New York, the vast majority of these jobs will never return. Manufacturing now forms only about 14.1 percent of our Gross Domestic Product (GDP).

Americans stand ready to compete with anyone in the world. But the competition must be fair. And many of our lost jobs the last several years were due to unfair international monetary trade practices by various East Asian countries, primarily China, Japan, South Korea and Taiwan, who are not playing by the rules. Those East Asian countries continually take actions to artificially lower the values of their currencies to the detriment of American manufacturers and workers. Such actions make U.S. exports more expensive to sell to those countries while inviting more cheap imports into the United States.

Economists estimate these manipulations give the Asian products a 15 to 40 percent price advantage over U.S. manufacturers. This amounts to an additional 40 percent tax on our exports to Asia and a price break of 40 percent for Asian imports into the United States. The National Association of Manufacturers (NAM) believes these manipulations account for two-thirds of the United States' trade deficit with those Asian countries. They have cost U.S. manufacturers over $140 billion in lost exports and they have cost at least 500,000 American workers their jobs. These practices must stop.

In addition, NAM estimates that China alone has over $300 billion in foreign currency reserves that it can use to its advantage. Right now, foreigners purchased almost the entire $257 billion in Treasury notes and bonds issued in the past year to finance our budget deficit. Japanese and Chinese investors - primarily their central banks - accounted for half of that amount. Some argue that we shouldn't do anything to offend the Japanese and the Chinese because it could upend how we are funding our government right now. They also argue that an Asian sell-off of

U.S. dollars could drive up U.S. bond yields, weaken the housing market, and depress American domestic consumption. Is this the kind of leverage we want to hand to them? We need to begin an orderly process now by which nations like China begin to move towards a more flexible exchange rate and other nations like Japan stop intervening in currency markets to weaken their currency to bolster their economy at home.

Last week, I, along with a bipartisan coalition of Members of Congress including Representatives Charlie Stenholm, Mike Rogers of Michigan, and Baron Hill, introduced a resolution to express the sense of Congress that the U.S. government strongly condemns foreign currency manipulation. We expect our trading partners to treat the people, producers, workers, farmers and manufacturers of the United States fairly.

I commend Treasury Secretary Snow, Commerce Secretary Evans and President Bush for their strong statements against currency manipulation and their actions thus far in their stated expectations that these governments will allow their currencies to float freely based on market forces. I want to particularly commend Secretary Snow for his skill in convincing the G-7 Finance Ministers two weeks ago in Dubai to agree to flexible exchange rates.

H.Con.Res. 285 encourages the Administration to continue with these actions while pursuing other options, too.

First, the U.S. must vigorously enforce laws that provide remedies to counteract foreign currency manipulation.

Second, the U.S. must continue to encourage the harmonization of an international exchange rate policy of freely floating exchange rates based on market forces.

Third, the U.S. must enable the dollar and other currencies to move toward their equilibrium rates by correcting market imperfections, countering foreign currency manipulation and seeking cooperation among the major countries in seeking coordinated actions.

And finally, the U.S. must instruct the United States Trade Representative to take action under section 301 of the Trade Act of 1974 should negotiations with the foreign currency manipulators fail to produce meaningful results.

But I want to reinforce that currency manipulation is not exclusively a problem between the U.S. and China. Despite the agreement in Dubai, Japan appears to return to more aggressive intervention in the currency markets to weaken their strengthening yen. We were making gradual progress during this past month and unfortunately it stopped on Monday. It appears that the Bank of Japan is trying to draw a line in the sand at 110 yen to $1 dollar. Japan will not tolerate the yen dropping below that level. We need our Treasury Department to vigorously oppose Japan's attempt to prop up its economy at the expense of our workers. Japan needs to make some fundamental adjustments to encourage consumption at home -- not export their problems abroad.

These are some of the steps that the U.S. government has available today and must use to level the playing field for American workers who are competing at a disadvantage. The future of U.S. manufacturing is on the line.

"China's Exchange Rate Regime and Its Effects on the U.S. Economy"

Grant D. Aldonas
Under Secretary of Commerce for International Trade Administration

Testimony before the House Committee on Financial Services
Subcommittee on Domestic and International Monetary Policy, Trade and Technology

October 1, 2003

Mr. Chairman, Members of the Committee, thank you very much for inviting me to participate in this hearing to discuss our trade relationship with China and the Department's role in implementing the President's Manufacturing Initiative. Both issues are timely and I appreciate your willingness to focus the Committee's attention on these two inter-related topics. While I will leave comments related to China's currency to Under Secretary Taylor, I will focus on the broader market rigidities that have impact for U.S. manufacturing.

The Economic Context

Let me start by setting the economic context for discussing both the health of our manufacturing sector and our trade relationship with China. I want, first, to underscore the continuing strengths of our manufacturing sector. We tend to forget that the United States remains far and away the largest producer and exporter of manufactured goods in the world. Standing alone, our manufacturing sector would rank as either the 4^{th} or 5^{th} largest economy in the world. Far from being hollowed out, our manufacturing sector is, in fact, larger than the entire economy of China.

In addition, I think it's important to stress that productivity in manufacturing today is higher than it was even during the late 1990s when everyone was speaking about a "new economy." Those increases in productivity, and the policies that we have adopted to reinforce them, have allowed the United States to reclaim the top spot in the World Economic Forum's rankings as the most competitive economy in the world.

The productivity numbers are important for another reason that reaches beyond the current economic prospects of our manufacturers. What they reinforce is the importance of a healthy manufacturing sector at the core of our economy. According to Paul Krugman, the noted economist and, I should add, at times a critic of this Administration, "Productivity isn't everything, but in the long run it is almost everything. A country's ability to raise its standard of living over time depends almost entirely on its ability to raise output per worker." What both the latest statistics and Krugman's comment point out is the contribution that manufacturing makes to innovation – innovation that is key to raising our productivity and the standard of living enjoyed by all Americans.

Having said that, there is no doubt that our manufacturers face some very significant economic challenges in today's business environment. Most importantly, they face continuing pressure on pricing power and profit margins due to the excess capacity on the market even as the recovery from the recent recession takes hold. The most recent figures suggest that the economy grew at a 3.3% rate in the second quarter of this year and the pace of economic activity appears to have accelerated since then. Timely fiscal stimulus and management of the money supply appear to have set the foundations for a solid recovery.

It now appears that manufacturing, after many months of very slow growth, is beginning to participate in that broader economic recovery. Durable goods orders have been up generally, although down in August. And, the Purchasing Manager's Index, a key indicator of future economic growth, is now consistently above the level that means stronger growth ahead.

Even on the unemployment front, there are signs of job growth consistent with a stronger economy. It's probably worth recalling that unemployment has remained above 6 percent for four months. Not that long ago, that would have been perceived as relatively low in terms of unemployment.

Having said that, I want to reiterate, as the President has, that the Administration is committed to working towards an economic climate where everyone that wants a job has one. And there is an important story to tell about the unemployment figures in manufacturing. The job losses began in 2000 when the manufacturing sector entered into a recession about 10 months earlier than the economy as a whole.

The recession in manufacturing began in 2000, ten months in advance of the general recession in the economy. The economy was just beginning to cope with the effect of a sharp drop in business investment as industry pulled back from a period of heavy investment in technology. Not surprisingly, most of the job losses in manufacturing came in precisely those industries – telecommunications equipment and computing – that benefited most from the boom in investment related to the "dot.com bubble" of the late 1990s.

What has surprised most economists has been the fact that manufacturing continued to shed jobs deep into the recovery of the economy. As recently as this past month, manufacturers dropped another 93,000 from the employment rolls. Employment in manufacturing has been declining for decades as productivity gains have significantly reduced the number of man-hours needed to produce a given product. Those gains have averaged 3% or more for the last 15 years. And, employment in manufacturing has fallen commensurately.

Some share of the recent reduction in manufacturing employment during the initial stages of the recovery and expansion is directly attributable to the efforts of manufacturers to cut costs and raise productivity. Under considerable competitive pressure, American manufacturers are finding ways to do more with less. And, the labor market is responding by shifting jobs to other industries.

That said, the more important thing to focus on for purposes of our discussion today is the link between the competitive pressure that has driven American manufacturing to pursue those productivity gains and what is going on in the international environment, particularly with respect to our trade with China and its emergence from a fully state-controlled economy to become a major force in manufacturing.

On the international front, one of the most frequently cited statistics is our trade deficit, which has been growing overall and particularly with China. Although the trade deficit is often thought of as an indicator of our competitiveness, and over long periods of time it is such an indicator, today it is better understood as a measure of the relative growth in our economy compared to our trading partners. In past recessions, continuing growth abroad mitigated the effect of the U.S. recession on our manufacturers. In the most recent recession, that did not happen. Japan led and Europe followed us into the recession and neither has yet to climb out to any significant degree.

The data behind the trade deficit bear out the effects of differences in economic growth rates between economies. While the common perspective is that the entire deficit is due to an increase in imports, the truth is that our exports have fallen off far more sharply. That points to the fact that the economies of both Europe and Japan are stagnant. As former Treasury Secretary Lawrence Summers put it, "The world economy is flying on only one engine." That engine happens to be the United States. In eleven of the last twelve years, US economic growth has outpaced that in Japan, Germany, and the European Union.

What's more, slow growth among our leading trading partners is not new. Japan's economy, which still represents close to 2/3 of the gross domestic product of Asia, has barely grown for a decade. Germany's economy has not grown appreciably in three years. On top of that, the rest of Asia, with the notable exception of China, has presented a very mixed picture in terms of economic growth since the onset of the Asian financial crisis in 1997. While some economies have recovered, others have not. And, these are markets that were once among the fastest growing in the world – markets that had become significant consumers of the sorts of advanced technology capital goods that our manufacturers sell.

What that should tell us, both in terms of the economy as a whole, and the manufacturing sector in particular, is that perhaps the most significant single action we could take is to step up encouragement of our trading partners, particularly Japan and Germany which together make up 20 percent of the world economy, to jettison their anti-growth policies and to adopt policies that are designed to boost economic growth. We need to preach what we practice because the alternative to growth is always a zero-sum game of dividing up the existing pie and that leads directly to the sort of strains we are seeing now in our trade relationships.

Our Trade Relationship with China

Which leads me to China. In the more than 20 roundtables the Department held with manufacturers across the country over the past six months, there was no single country that garnered more attention than our trade with China and its emergence from state-imposed economic isolation to become a major center of manufacturing. The Chinese have made considerable progress over the last two decades in lifting more than 200 million people out of poverty by relying ever more heavily on the market to direct resources within its economy.

The stakes involved are high. China is our fourth largest trading partner. Bilateral merchandise trade reached $147.2 billion in 2002. Last year, China overtook Japan to become our third largest source of imports. In July of this year, China surpassed Mexico to become our second largest source of imports. Our imports from China are more than five times greater than our exports. The bilateral trade deficit hit $103 billion in 2002 and reached $65 billion in the first seven months of this year. In addition, China has provided help on a number of fronts – from the arms talks with North Korea to the War on Terrorism. China has helped on the economic front as well. Along with the United States, China accounts for most of the current growth in the world economy.

The upside is that China's economic policies have brought about a rising standard of living in China and considerably higher disposable income. All of that makes China an attractive market for much of what we produce in the United States.

It is worth noting that since 2001, China has been our fastest growing export market by far among our top ten trading partners. Our exports to China surged 19% in 2001, 15% last year, and more than 22% in January-July even though our exports to the world declined 7%, 5%, and rose less than 3% during the same respective time periods.

One of the basic reasons for negotiating for 13 years with the Chinese over their accession to the World Trade Organization was to ensure that we would knock down the many barriers to entering China's market. On paper, the accession agreement represents a considerable success. Today, the tariff rates that China imposes are lower on average than much of the rest of the developing, and in some instances, the developed world. In addition, the WTO agreement obliges China to protect the intellectual property of U.S. manufacturers and service suppliers. The agreement also eliminated many of the barriers to the free distribution of American goods throughout the Chinese economy, instead of being beholden to trading through a Chinese state enterprise as in the past.

The situation facing our manufacturers from a competitive perspective was far worse prior to China's entry into the WTO. Our manufacturers lacked access to the Chinese market, but their manufacturers had relatively free access to ours. In the first year following China's accession to the WTO, I think both Congress and the President showed an extraordinary amount of patience as China worked to pass the literally thousands of new laws needed to bring the country into compliance with WTO rules.

Now, as we move deeper into the second year of China's participation in the WTO, we need to see actual enforcement of those laws and basic compliance with WTO rules in other areas. I know that the President, Secretary Evans, Ambassador Zoellick, and most recently Secretary Snow have all made that point vigorously with their counterparts in China. And, I can attest that, at a working level, the rest of us have taken up the cause just as vigorously.

But, there is still a very, very long way to go. We have considerable challenges in terms of WTO compliance, particularly in areas like the protection of intellectual property that represents the key U.S. competitive edge in many manufacturing industries. In fact, no country raised more attention as a source of concern than China during the roundtable discussions. Our manufacturers complained about rampant piracy of intellectual property; forced transfer of technology from firms launching joint ventures in China; a broad range of trade barriers; and capital markets that are largely insulated from free-market pressures. We also heard rising concerns about the timeliness and direction of China's implementation of its WTO commitments in areas such as transparency, IPR protection, trading rights and distribution services, agriculture, and financial services.

Fundamentally, China's change from a non-market economy to one that operates fully on market principles is incomplete. Although the Chinese often make the case that they are a market economy because they want the benefits that designation would yield under our antidumping laws, the simple fact is that many of the main drivers of the Chinese economy remain in state hands. Whereas U.S. companies face continuing pressure from our capital markets to turn a profit, that pressure simply does not exist in many cases in China.

In one sense, this problem is not new. American firms have seen the same pattern in other Asian markets for years. Even the 1997 financial crisis has not weaned industries or governments from those unhealthy practices – witness Korea's continuing support for the Hynix semiconductor operations, a company that was otherwise headed for liquidation.

I recognize that many commentators see a demand for a "level playing field" as a demand for protection, but that is not always, or even usually the case. Most manufacturers I have spoken with over the last six months didn't want protection; they wanted the unfair trade practices that rigged the game against them eliminated. A good example is the forest products industry, which has an enormous fight with Canada over subsidies. In the context of our roundtable on forest products manufacturing their principal request was for the President to negotiate the elimination of the barriers they faced abroad and the subsidies they faced in terms of competition from imports.

The same held true for most manufacturers with whom we discussed China. There was a strong recognition that we were better off in a world in which the rules were observed and the competition was fair, than a world segmented by trade barriers which would mean less trade and slower economic growth for all.

At the same time, I also must stress that there are significant parts of our manufacturing sector that are under extraordinary pressure to adjust to new levels of competition from imports, particularly from China. Industries like textiles and apparel in the south and tool and die in the Northeast and Midwest offer examples of the sorts of pressures our manufacturers face. Both the challenges and the pain felt in many communities are very real.

In the case of textiles and apparel, the challenges are particularly intense because the industry is emerging from a 40-year period when it was protected by quotas on imports of competing material and clothing. As a consequence, the industry remains highly fragmented and is being forced to go through, all at one time, the adjustment and consolidation that most U.S. industries went through in the 1970s and 1980s.

In the last round of world trade negotiations, President Clinton agreed to phase out the quota system that had protected the textile industry. Most of the truly sensitive items from the perspective of U.S. industry were given the longest phase-outs. But, the quotas will come to an end on January 1, 2005, and that will mean still stronger competition from imports.

What is not generally understood is that most of the sharp increase in Chinese imports has come at the expense of our other trading partners. As new products have come free of quota arrangements, retailers no longer face the need to source products from multiple countries. Instead, much of what was previously shipped to the United States from other Asian countries now comes to us from China. But, that has not meant less pressure on U.S. manufacturers in terms of price competition.

While the argument most frequently raised about China by commentators seems to be the difference in wage rates, most of my conversations with manufacturers, particularly in textiles, suggested other reasons for increased Chinese competition. What is not often understood is that, today, the textile industry is actually very high tech. There is very little labor involved in many products that come out of the industry and wages are a relatively small portion of the total cost of production except in the case of products that require considerable hand stitching.

The truth of that statement was brought home to me in a conversation with a North Carolina manufacturer of textile products used in the luggage industry. Most bags today are made with some form of rip-stop material, none of which is hand sewn. Nor is the frame of most roll-on bags manufactured by hand. Yet, the North Carolina manufacturer showed me 5 suitcases, one nesting inside the other, that sold for a total price – delivered from China – of under $30. In other words, the total cost of the five bags was below the North Carolina manufacturer's cost of materials alone.

The point to that story is simply that it is not wages alone that allowed the Chinese manufacturer to sell the 5 pieces of luggage for a delivered price of less that $30. The cost of most of the materials is determined in world markets, so if the Chinese economy were open to international trade and competition, then the Chinese manufacturer's materials costs would be comparable to that of the U.S. costs. This means that to get the delivered price down to below $30 there must be a very large amount of government subsidy, express or implied, to the manufacturer – a subsidy that can take the form of an outright cash grant to the exporter, but more often will take the indirect form of tariff protection against competition, the forgiveness or rebate of taxes, or the continuing extension of credit to uncreditworthy enterprises.

In my view, although the textile industry is commonly criticized for seeking protection based on the past 40 years of quotas, the complaint that has led the industry to seek safeguards against Chinese imports stems from a different motive. There is no real argument that the Chinese market operates fully on a market basis, and the reasons for the industry's request for help stems from that simple difference between the pressures they face in our market on a day-to-day basis and the pressures that their Chinese competition doesn't.

What that also points out is the fact that, in addition to pressing the Chinese at every opportunity on their compliance with their WTO commitments, we also have to be extraordinarily vigilant regarding the injurious effects of other forms of government support for Chinese industry that are not covered by current WTO rules. Those sorts of practices require a different type of tool – one that requires digging out the facts regarding the underlying competitive differences that our industry faces in terms of import competition from China.

As I noted above, the textile industry is not alone in facing Chinese subsidies and protection. Other industries like tool and die face similar competitive conditions. That is why one of the most forward-leaning recommendations we intend to make regarding our trade is the establishment of an office in the Commerce Department the sole function of which will be to investigate these sorts of practices. When we find these anti-competitive practices, we will vigorously seek their elimination by the Chinese and by other trading partners.

The one thing I can assure you, Mr. Chairman, and Members of the Committee, is that the Department of Commerce is dedicated to making sure China does play by the rules. We will vigorously pursue China's compliance with its WTO commitments and we will enforce our domestic unfair trade laws rigorously and fairly, as both President Bush and Secretary Evans have made clear.

The Department of Commerce's Role in Trade With China

The Department of Commerce, in close coordination with USTR and other agencies, has adopted.an aggressive and multi-pronged approach to ensure that China honors its WTO commitments and that U.S. companies benefit from these opportunities. We will target unfair trade practices wherever they occur. We are exploring the use of new tools to expand our trade promotion activities in China. We are expanding efforts to engage Chinese officials to make sure they "get the rules right" as they continue their enormous task of restructuring their economic system.

The Commerce Department has actively provided WTO-related technical assistance to China since September 2000, well before China's accession to the WTO. Initial programs focused on increasing the awareness of general WTO principles among Chinese government officials. As China developed an increasingly sophisticated understanding of the WTO system, our programs have been tailored to more specific areas, such as standards development and intellectual property right (IPR) protection. For example, in 2003 Commerce sponsored or coordinated programs on fertilizer standards, antitrust, government procurement, medical device regulatory training, and information and communication technologies standards and conformity assessment.

Despite China's commitments to crack down on rampant piracy, counterfeit CDs, DVDs, and pharmaceuticals continue to flood the U.S. market. In addition, piracy and counterfeiting in China has a significant impact on U.S. intellectual property rights holders in China itself. In fact, the International Intellectual Property Alliance estimates that business software, music, movie and entertainment software piracy rates in China exceed 90%, with damages of $1.85 billion in 2002. We have raised specific IPR concerns during our meetings with senior Chinese government officials and have repeatedly demanded that the Chinese government uphold its bilateral and multilateral IPR commitments.

Through the annual Special 301 process, we scrutinize China's IPR conditions in close coordination with our colleagues in other agencies. To make sure that China has the tools to implement its commitments, we have organized a series of seminars with Chinese officials. Programs in development for later this year include a WTO pharmaceutical regulatory seminar and anti-counterfeit training, and IPR criminal & border enforcement seminars. We have worked on these programs on an intra and inter agency basis, using the resources of US Patent and Trademark Office, Department of Justice and other agencies. We think China can and should do better in these areas. We continue to press for progress.

However, keeping our focus on China's WTO implementation and the country's other trade practices is only part of the solution. We must continue to enhance the ability of U.S. businesses to compete in China. We are increasing our efforts to ensure that U.S.-developed technical standards are accepted in China just as they are throughout the world. We are launching "Doing Business in China" seminars in cities across the country to address concerns about the Chinese market from small and medium-sized businesses. We are exploring ways to develop more trade leads in China and to provide even more targeted information on opportunities in China for companies in the U.S.

Combined with these domestic efforts, we regularly engage Chinese government officials to ensure trade agreement compliance and market access for our products and services. Secretary Evans will visit China in October to advance U.S. interests and advocate for a level playing field in our economic relations with China. We will have another opportunity to raise outstanding issues during the 15th U.S.-China Joint

Commission on Commerce and Trade (JCCT) to be held in Washington in early December.

The President's Manufacturing Initiative

With that, I would like to turn to the topic of the President's Manufacturing Initiative. In March of this year, during Manufacturing Week, Secretary Evans had the opportunity to speak before the National Association of Manufacturers in Chicago. At that time, he announced the President's Manufacturing Initiative.

As a part of that initiative, Secretary Evans directed me to lead a comprehensive review of the issues influencing long-term competitiveness of U.S. manufacturing. The central goal of the review is to develop a strategy to ensure that government is fostering an environment that promotes a dynamic manufacturing industry. The review will conclude with the release of a report later this fall.

The Commerce Department's senior management, including Secretary Evans and Deputy Secretary Bodman, all pitched in. We held roundtable discussions with manufacturers in the aerospace, auto, semiconductor, and pharmaceutical sectors, among others, in more than 20 cities across the United States – from Manchester, New Hampshire to Columbus, Ohio, to Detroit to Los Angeles – to develop the report and recommendations.

What we heard from manufacturers in terms of the challenges they face was significant. While the international competition is what has garnered most of the attention in the press, by far the greater weight of the manufacturers' comments focused on domestic issues – what I call "keeping our side of the street clean." What I mean by that is simply paying attention to the needs of our manufacturers as we develop legislation or implement regulations. It is the steady accumulation of multiple burdens, rather than a single cause, that has had the most severe impact on the competitive environment in which our manufacturers operate.

The list of issues our manufacturers identified should not surprise anyone who has taken a serious interest in manufacturing. While our manufacturers have tightened their belts and raised their productivity in an effort to remain competitive and, in fact, to succeed in the day-to-day competition in the marketplace, they have seen that advantage and the hard-won productivity gains eroded by everything from higher energy costs to higher medical and pension costs to higher insurance costs due to a run-away tort system.

Just a few examples might suggest why manufacturers have seen their costs rise. We heard from manufacturers in New Jersey that 30 cents of every dollar of revenue went to pay health benefits for employees. Manufacturers gladly pay for their employee's health benefits because they see their own interest served by a healthy and motivated workforce, but if we are serious about manufacturing, we have to be serious about grappling with the underlying drivers that have created 145 percent increases in health care insurance costs that obviously are not sustainable indefinitely.

In Michigan, I met with auto parts suppliers that faced continuing pressure from the auto companies to lower their prices by 20 percent or face the prospect that the auto companies would turn to overseas sources of supply. Much of the concern those parts suppliers reflected the terms on which they compete with those overseas suppliers, particularly in China. But the auto parts suppliers knew that the ultimate source of the problem lay in an auto industry that is grappling with the same sorts of legacy costs that burdened the steel industry. If we are serious about manufacturing, then these industries will have to get those financial obligations under control.

In Columbus, Ohio, Des Moines, Iowa, and in my hometown of Minneapolis, Minnesota, I met with manufacturers in the plastics and adhesives businesses that are heavy users of natural gas. The companies in the plastics businesses in particular risk seeing whole new markets fall to their foreign competitors who see lower natural gas prices. If we are serious about manufacturing, we have to adopt a national energy plan that will help us access new sources of supply and improved transmission to reduce the cost of energy to our manufacturers as well as to consumers.

Another example we heard from virtually every manufacturing trade association we met with was the need to eliminate the complexity and the disincentives our tax system creates for investing in manufacturing in the United States. Any number of issues fall in that category. Take the bias in the current tax code against equity financing, which raises the cost of capital, thereby reducing the investment. This bias also translates into a preference for debt, which yields highly leveraged companies and a highly leveraged country, all the while encouraging the worst sorts of gaming as clever tax lawyers try to find ways to take what is an equity interest and call it debt in order to qualify for an interest deduction. Taken together, even without cutting rates, reforms of the tax code could make a profound difference to the relative attraction of investing in manufacturing in the United States.

But, perhaps the most egregious example comes out of the tort system in this country. If we are serious about manufacturing, we have to get serious about reforming the tort system.

One issue, in particular, stood out among the manufacturers' concerns about the tort system. That was the ongoing asbestos litigation. There, the continuing litigation has yet to help many individuals who were harmed by prolonged exposure to asbestos, while, at the same time, the litigation hangs over virtually all U.S. manufacturing, raising their insurance costs and dampening their returns.

Manufacturers pointed to declining vocational school programs, declining enrollments in engineering and the funding of scientific research, all of which are essential to the productivity gains that keep our manufacturing sector competitive and keep a skilled workforce employed.

Finally, as I noted above, in addition to keeping our own side of the street clean, U.S. manufacturers demanded a level playing field. For most, that translated into a demand that we negotiate down tariff rates that are higher than ours and break open new markets. Or it translated into a demand for the enforcement of rules barring the theft of intellectual property. It translated into a demand for the enforcement of our unfair trade laws or laws against customs fraud.

What I did not see was an interest in outright protection. Rather, most manufacturers saw trade as a simple question of equity. If we keep our markets open to our trading partners goods, they should do the same for us. But, where our trading partners did not live up to the terms of our agreements or otherwise heed the rules, our manufacturers expected that those trading partners should pay a price.

While we are still in the process of finalizing the report and recommendations across many fronts, Secretary Evans has outlined several new initiatives in response to the concerns we heard from manufacturers, particularly the need for a stronger focus within the U.S. government on manufacturing and the most immediate cases of unfair trade affecting our manufacturers. The first initiative, announced by the President on Labor Day, is a new Assistant Secretary of Commerce to serve as the point person in the Administration and within the U.S. government for manufacturers and as an effective advocate for the manufacturing sector's competitiveness. There are many programs within the federal government that bear on manufacturing, but heretofore there was no one person or one office responsible for bringing their efforts into a coherent strategy. The second would call for the creation of Assistant Secretary for Trade Promotion to boost our exports, particularly to those markets that our negotiators have recently opened to our trade like China. And, the third is the establishment of an Unfair Trade Practices Team to track, detect, and confront unfair competition before it injures an industry here at home.

We expect the report and the remainder of the recommendations to be out soon. In addition to moving on the implementation of those recommendations, we intend to do two things to follow up. The first is to go back to the manufacturers we visited earlier this year to get their reaction on what we have suggested and to help us refine our approach as we move forward. The second is to discuss the next set of issues we intend to tackle as part of our on-going commitment to support our manufacturing sector.

That concludes my testimony. I would be pleased to answer any questions that you, Mr. Chairman, or any other Members of the Committee may have.

"China's Exchange Rate Regime"

by
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Testimony before
Subcommittee on Domestic and International Monetary Policy, Trade, and Technology
Committee on Financial Services
U.S. House of Representatives
October 1, 2003

Mr. Chairman, thank you for the opportunity to testify before this committee on the important issue of China's exchange rate regime and its effects on the U.S. economy. My IIE colleague, Nicholas Lardy, and I have recently been analyzing China's currency regime and this afternoon, I would like to share with the committee five of our main conclusions.[1]

First, so long as China maintains controls on capital outflows, runs surpluses on both the overall current and capital accounts in its balance of payments, and accumulates international reserves in large amounts, there is a compelling case that the Chinese currency, the renminbi (RMB), is significantly under-valued. Our preliminary estimates suggest that the under-valuation of the RMB is on the order of 15-25 percent. These estimates of RMB misalignment can be obtained either by solving a trade model for the appreciation of the RMB that would produce equilibrium in China's overall balance of payments, or by gauging the appreciation of the RMB that would make a fair contribution to the reduction in global payment imbalances, especially the reduction of the U.S. current-account deficit to a more "sustainable" level. Both approaches produce similar answers.

Those who argue that the under-valuation of the RMB is much larger – 30-40 percent or more – often confuse China's large bilateral trade surplus vis-a-vis the United States ($100 billion in 2002) with its much smaller overall current-account surplus ($35 billion). Adjusting for the overheating of the economy and other factors, China's "underlying" current account surplus in the first half of this year was probably about 2 ½ or 3 percent

[1] In drafting this testimony, I have drawn heavily on two recent op-eds done jointly with Nicholas Lardy: (i) "A Modest Proposal for China's Renminbi," Financial Times, August 26, 2003; and (ii) "Two Stage Currency Reform for China," Asian Wall Street Journal, September 12, 2003. I have attached the latter as an appendix to this testimony.

of GDP. Equally relevant, China's surplus on foreign direct investment (4 percent of GDP on average during the 1999-2002 period) has been considerably larger than the surplus on the overall capital account (1 ½ percent of GDP). It is the overall current and capital-account positions that matter for judging the extent of exchange rate misalignment – not bilateral trade balances or components of the current and capital accounts. In a similar vein, those who conclude that the degree of under-valuation of the RMB is small –10 percent or less – often ignore the fact that China makes extensive use of imported inputs to produce exports. China's role as a regional processing center means that it takes a larger revaluation to change the trade balance in China than it does in economies where imported inputs figure less prominently in exports. Admittedly, when China does decide to liberalize significantly capital outflows, it won't take a huge degree of international diversification of household savings deposits to put strong downward pressure on the RMB – but that doesn't alter the conclusion that right now the RMB is under-valued.

Second, a revaluation of the RMB is in China's own interest as well as in the interest of the global economy. If China does not revalue the RMB, net capital inflows and the large accumulation of international reserves (about $135 billion over the past 18 months alone) will continue. With its mountain of bad loans, China should not permit capital inflows and reserve accumulation to exacerbate the already excessive expansion in bank lending, money supply growth, and investment. In the first half of 2003, the increase in bank loans outstanding relative to GDP rose to 38 percent– an all time high, while the investment share of GDP rose to 42 percent – also an all time high. Although the process of "sterilizing" the effects of reserve increases on the base money supply has so far been less onerous in China than in many other emerging economies, experience shows that sterilization typically becomes more costly and less effective the larger it is and the longer it goes on. The primary domestic risk of an undervalued exchange rate is that it will handicap China's efforts to rein-in the pace of credit expansion and to improve the quality of bank lending decisions.

An appreciation of the RMB is likewise in the interest of the United States and the wider global community. Unless China permits the value of its currency to rise, it will be much more difficult to obtain the broader realignment of key exchange rates in Asia and elsewhere needed to produce a marked correction in global payments imbalances. The uncomfortable truth is that the U.S. current-account deficit (projected to be about $550 billion this year) is much too large, that a further decline in the broad trade-weighted value of the dollar is necessary to reduce our deficit to a more sustainable level (say, $300 billion or so), and that a rise in the value of the RMB is an important catalyst for achieving both a broader-based decline in the dollar and a better global "sharing" of the adjustment burden.

Third, urging China to adopt a flexible exchange rate regime and to open its capital markets – as U.S. Treasury Secretary Snow and others have suggested – is sensible advice for the longer term. But that advice is not appropriate for China's current circumstances – especially its weak banking system, and therefore is not likely to be heeded anytime soon, providing little relief for current exchange rate and payments problems. China is justifiably concerned that if it floated the exchange rate and opened its capital markets today, the weakness of the domestic financial system could generate large-scale capital flight and sharp currency depreciation in response to bad news. In addition, the government still dominates foreign-exchange transactions to a degree that precludes the market functioning properly. These obstacles should recede over time but they are binding at present.

A more practical approach is to urge China to reform its currency regime in two steps. In the first step, China would immediately revalue the RMB by 15 to 25 percent, it would widen the currency band (to between 5-7 percent, from less than 1 percent), and it would switch from a unitary peg to the dollar to a three-currency basket peg (with roughly-equal weights for the dollar, the euro, and the yen). This would remove the incentive for further speculative capital inflows and reserve accumulation. No longer would the foreign component of the money supply be working at cross-purposes with the needs of domestic stabilization. A three-currency basket would increase the stability of China's overall trade-weighted exchange rate, and the basket would also permit the U.S. dollar to depreciate further against the RMB without a series of RMB parity changes. This can't happen if China retains its present unitary peg to the dollar; instead, the RMB would follow the dollar down, much as it has done since early 2002. Step two should be adoption of a managed float, after China takes further reforms to put the domestic financial sector on a sound enough footing to permit significant liberalization of capital outflows. A managed float is the preferred long-run regime because capital mobility in and out of China will increase over time (making a publicly-announced exchange rate target more vulnerable), and because China will want to exercise greater monetary policy independence for stabilization purposes.

The advantage of this two-step approach is that it neither asks the rest of the world to live too long with a misaligned RMB, nor does it ask China to ignore a key lesson of the Asian financial crisis by prematurely opening its capital account. The key to reconciling

China's desire for exchange rate stability with the need for the RMB to play its proper role in global balance-of- payments adjustment is to recognize that a fixed rate for the RMB need not be at the present parity, that "stability" of China's currency should be viewed against a wider set of reserve currencies than the U.S. dollar alone, and that the transition from "fix" to "flex" for the RMB need not occur all at once, since liberalization of China's capital account will almost surely proceed in stages.

Fourth, the United States should take a multilateral tack in persuading China to alter its exchange rate policy and should eschew unilateral trade measures directed against China's exports. Other countries – including members of the European Union and many emerging economies in Asia – also have a strong interest in seeing the RMB rise closer to the level implied by fundamentals. If China resists a rise in the RMB, too much of global exchange rate adjustment will fall, for example, on the euro, exacerbating Europe's anemic growth performance. Conversely, if China does allow the RMB to rise, its emerging-market neighbors would be able to more easily accommodate a rise in their own currencies since then, the loss of competitiveness would be smaller than if each acted alone. The U.S. Treasury should therefore continue to enlist the support of other countries in convincing the Chinese authorities that a more appreciated exchange rate for the RMB is in the common interest. Recall that China received plaudits during the Asian financial crisis for conducting a responsible exchange rate policy and for taking the interest of the region as a whole into account. At that time, China allowed the RMB to appreciate on a trade-weighted basis. China now has another opportunity to demonstrate responsible leadership.

As the institution charged with overseeing the international monetary system and with exercising "firm surveillance" over the exchange rate policies of its member countries, the IMF should take a more activist stance in monitoring exchange rate misalignments and in applying a mix of persuasion and pressure –both private and public --to reduce the duration of such misalignments. It is not useful to identify large-scale, prolonged, exchange market intervention in one direction, and behavior of the exchange rate inconsistent with underlying fundamentals, as implicit pointers of a "wrong" exchange rate and then do little when these pointers signal a problem. In this connection, it is regrettable that the Fund has very rarely made use of a provision to hold (or even discuss holding) special consultations with countries that are undergoing exchange rate problems. Endorsing a vague G-7 call for more exchange rate "flexibility" is not exercising "firm surveillance."

Multilateral does not mean everybody but the United States. The United States also needs to do its part to contribute to global adjustment by improving our savings-investment balance, and in particular, by adopting a workable plan to reverse the now-projected long string of U.S. budget deficits. If we want other countries to act in a cooperative way on exchange rate policy and in implementing macroeconomic polices to promote growth, we too must be willing to put something positive into the package.

What the United States should not do is impose a unilateral import surcharge on China's exports. This would be both misguided and ineffective. As suggested above, bilateral trade imbalances are a bad indicator of overall payments imbalances. China is not the only country to have used -- or now using -- prolonged, large-scale, uni-directional exchange market intervention to maintain an undervalued exchange rate.

China's imports more than quintupled between 1995 and 2002 and its import ratio (to GDP) now stands at a level three times higher than Japan and twice as high as in the United States. An import surcharge directed exclusively at China's exports might well invite retaliation against U.S. exports to China and could risk a wider upsurge in protectionism when the opposite is needed to support global growth. Note too that much of China's exports to the United States compete primarily with exports from other emerging economies – and not so much with U.S. domestic producers. An improvement in U.S. competitiveness calls for a broad-based decline in the value of the dollar (among other measures) – not for a tax on one side of one developing-country's foreign trade.

Fifth, the impact of a medium-size revaluation of the RMB on the external accounts of the United States should not be exaggerated. Even if China did revalue the RMB by say, 20 percent, and even if other Asian emerging economies and Japan followed China's lead by allowing their currencies to appreciate by say, half that amount, the trade-weighted value of the dollar would only decline by roughly 5 percent. This in turn might produce an improvement in the U.S. current account on the order of $50 billion dollars; to reduce the U.S. current-account deficit by say, almost half ($250 billion), would require a much larger and more broadly-based further depreciation of the dollar (in the neighborhood of 25 percent on a trade-weighted basis). The long-running decline in U.S. manufacturing employment started well before the Chinese currency became undervalued and has a much wider set of origins (including rapid productivity growth) than exchange rate factors. Given that the political campaign leading up to our presidential elections is now in full swing, it is perhaps not surprising that the China exchange rate issue has taken on increased visibility. But overblown expectations are apt to produce disappointment. An appreciation of the RMB will be helpful but not sufficient for reducing concerns about U.S. external imbalances and their effects.

To sum up, as one of the four largest trading countries in the world, it is important that China take seriously its obligation (under IMF rules) to avoid manipulating exchange rates to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other countries. There is also a powerful domestic reason for seeking an early end to the existing medium-size under-valuation of the RMB: exchange rate under-valuation will increasingly handicap China's efforts to achieve and maintain long-term financial stability – to say nothing of potential protectionist threats against its exports. By adopting a two-stage reform of its currency regime, China can become part of the solution to the unsatisfactory global pattern of payments imbalances – not part of the problem. The currency regime that served China well over most of the last decade is not the currency regime that will serve China best today or in the future. If the United States wants to persuade China to reduce the serious under-valuation of the RMB, it should drop its doctrinaire insistence that China move in one great leap forward to a free float and to completely open capital markets in favor of a currency and capital market regime that China could actually adopt now with good effect and that could contribute now to reducing serious global imbalances. I believe the Goldstein-Lardy proposal for a two-step currency reform passes that test. The United States can push the ball forward by working in a multilateral fashion with other concerned countries to convince the Chinese authorities that RMB revaluation is seen as a legitimate remedy for a widely perceived imbalance, by refraining from unilateral protectionist measures, and by demonstrating a readiness to address its own longer-term saving-investment imbalance in the public sector. It's also long past time for the IMF to do more seriously one of the things it was created for –namely, to monitor the agreed international "rules of the game" on exchange rate policy, to provide objective assessments of exchange rate misalignments for important currencies, and yes, to help mobilize some pressure on countries that resist correction of under-valued or over-valued exchange rates. With some compromise by all parties and with the right sequencing of China's currency reform, a workable solution can be achieved.

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The Asian Wall Street Journal

12 September 2003

COMMENTARY

Two-Stage Currency Reform For China

By MORRIS GOLDSTEIN and NICHOLAS LARDY

It was the unstoppable force meeting the immoveable object. During his recent visit to Beijing, U.S. Treasury Secretary John Snow stated that his objective was to get China to commit to moving to a "free-floating" currency, while senior Chinese officials stressed the contribution that a "stable" yuan had made to economic stability and development in China, Asia and the world. How then to square the circle that seems to call for three objectives: a near-term revaluation of the yuan, greater stability of the yuan in the medium term and greater flexibility and market determination of the yuan a little later down the road?

Most proposals for Chinese currency reform fall prey to one of two problems. If revaluation of the yuan has to wait until China is willing to undertake full capital-account liberalization, then the rest of the world has to live for too long with a misaligned yuan. Alternatively, if China is asked to free float the yuan and adopt capital-account convertibility before it puts its domestic financial sector on a firmer footing, it would be casting aside one of the main lessons of the Asian financial crisis.

Our answer to this dilemma is that China should view reform of its currency regime as a two-step process. The first step should be a medium-size (15% to 25%) revaluation of the yuan, a widening of the currency band (to between 5% and 7%, from less than 1%), and a switch from a unitary peg with the dollar to a three-currency basket peg, with weightings of roughly a third each for the dollar, euro and yen. Step two should be adoption of a managed float, after China strengthens its domestic financial system enough to permit a significant liberalization of capital outflows.

The Chinese leadership implicitly recognizes the yuan is undervalued. But they apparently believe the disequilibrium in the foreign-exchange market can be ameliorated by selective liberalization of current- and capital-account transactions while leaving unchanged the current fixed parity with the dollar.

The authorities recently increased the amount of yuan that Chinese tourists can convert to foreign currency and began to allow Chinese firms with certain types of foreign-exchange earnings to retain them rather than surrender them to the central bank. They have given the green light for a state-owned bank to issue its first dollar-denominated bond on the domestic market and have already signaled that requests for outward foreign direct investment are now more likely to be approved.

They are also discussing a reduction in the value-added tax export rebate rate to 11%, down from its current level of 15%. And they may allow mainland residents and certain financial institutions to purchase limited amounts of foreign securities. The authorities hope that these steps will either increase demand for, or reduce supply of foreign exchange, thus relieving the upward pressure on the currency.

While the go-slow approach presumably appeals to the leadership because of its limited short-run effect on China's exports, incoming FDI, and trade-related jobs, it is likely to do little to remove the misalignment of the yuan that has pushed China's overall balance of payments into a larger surplus, fed a huge reserve accumulation over the past 18 months, and increasingly concerned many of China's trading partners, including the United States, Euroland, Japan and South Korea. Very small adjustments could simply stoke further capital inflows by persuading market participants that speculation on the yuan is a one-way bet. Although the low interest rates paid on domestic central bank bonds has meant that sterilization of international reserves has so far been less onerous in China than in many other emerging economies, experience shows that sterilization becomes more costly and less effective the larger it is and the longer it goes on.

With its mountain of bad loans, China cannot afford to let capital inflows exacerbate the already excessive expansion in bank lending, money-supply growth and investment. The recently announced increase in reserve requirements for banks indicates that overextension of the financial system is now clearly visible on the central bank's radar screen.

In contrast, consider the advantages of our proposal for a medium-size revaluation. This would immediately deal with the existing undervaluation of the yuan and remove the incentive for further speculative capital inflows and reserve accumulation. No longer would the foreign component of the money supply be working at cross-purposes with the needs of domestic stabilization. It would show trading partners that China is not attempting to manipulate its exchange rate, thereby lessening the threat of protectionist measures against China's exports. It would make the yuan part of the solution to the global pattern of payment imbalances -- not part of the problem.

In doing so, it would add to the plaudits that China received during the Asian financial crisis for conducting a responsible exchange rate policy and for taking the wider interest of the region into account. It would also increase the odds that Japan and emerging economies elsewhere in Asia would be willing to allow their exchange rates to appreciate, reducing the burden on the euro contributing to the needed downward adjustment of the dollar and limiting the deterioration in China's competitiveness. By adopting a wider band, China would gain valuable experience in allowing the exchange rate to be more responsive to market forces.

Just as important, by moving to a three-currency basket peg, China would increase the stability of its overall trade-weighted exchange rate. In a context where the dollar needs to depreciate further to help reduce the unsustainable U.S. current-account deficit, a basket peg would permit the dollar to depreciate against the yuan without a series of yuan parity changes. That could not happen if China retains its present unitary peg to the dollar.

The key to reconciling China's desire for exchange-rate stability with the need for the yuan to play its proper role in global balance of payments adjustment is to recognize that a fixed rate for the yuan need not be at the present parity. Stability of China's exchange rate should be interpreted against a wider set of reserve currencies than the dollar alone. The transition from "fix" to "flex" need not occur in one fell swoop, since liberalization of the capital account will proceed in stages.

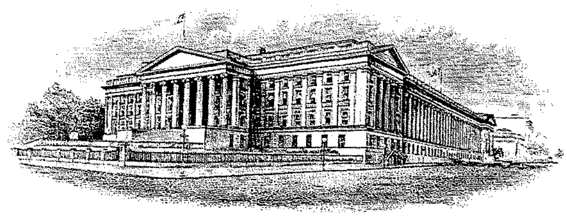
Looking farther down the road, China will find it in its interest to move to a regime of managed floating because capital mobility in and out of China will increase and because it will want to exercise greater monetary-policy independence for stabilization purposes. It would be unwise to float now because the domestic financial system is still far too fragile to rule out large-scale capital flight in response to bad news. In addition, the government still dominates foreign-exchange transactions to a degree that precludes the market functioning properly. But these obstacles to floating the exchange rate should lessen as China reduces its large stock of nonperforming loans in the banking system, government involvement in the credit-allocation process declines in favor of market forces, and the progressive dismantling of restrictions on international capital flows widens and deepens the scope and liquidity of foreign-exchange trading.

As a host of emerging-market crises of the past decade have demonstrated so dramatically, high capital mobility vastly increases the vulnerability of a publicly announced target for the exchange rate. With China's public debt burden rising under the weight of bank recapitalization and assumption of pension liabilities, fiscal pump priming will be more constrained and monetary policy is likely to take on an increased share of stabilization duties. Thus China will want to increase the flexibility of its exchange rate regime.

But this need not mean slavish adherence to a pure float. If and when market forces push the yuan beyond the levels consistent with its economic fundamentals, China, like other countries, should retain the option to manage the float by intervening in the exchange market -- so long as that intervention is not prolonged and not just in one direction. In short, a managed float should be the preferred regime choice for the second stage of reform.

The currency regime that has served China well in the past is not the currency regime that will serve China best today or in the future. Likewise, if the U.S. wants to persuade China to reduce the serious undervaluation of the yuan and to play a larger role in the global adjustment process within the next year or so, it too will have to alter its opening negotiating position by dropping the suggestion that China move in one great leap forward to a free float and completely open its capital markets. With some compromise by all parties and with the right sequencing of China's currency reform, a workable solution is in sight.

Messrs. Goldstein and Lardy are senior fellows at the Institute for International Economics.



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"China's Exchange Rate Regime and its Effects on the U.S. Economy"

John B. Taylor
Under Secretary of Treasury for International Affairs

Testimony before the Subcommittee on
Domestic and International Monetary Policy, Trade, and Technology
House Committee on Financial Services

October 1, 2003

Chairman King, Ranking Member Maloney, Members of the Subcommittee, thank you for giving me the opportunity to testify on China's exchange rate regime and its effects on the U.S. economy.

This is the fifth time that I have appeared before this Subcommittee as an Administration witness. Each time I have been asked to focus on an important facet of our international economic policy. I have testified on our policy toward emerging markets, on our policy for developing countries—including reforms at the Multilateral Development Banks and the new Millennium Challenge Account, and on our policy to remove barriers to the free flow of capital in our trade agreements—including those with Singapore and Chile. In each of these cases, an underlying goal of our policy has been to raise economic growth and increase economic stability around the world, and in doing so benefit the American people with more jobs, more security, and a better life. My testimony today on China's exchange rate regime will be no different in this respect.

The Overall International Economic Strategy for Growth and Stability

The Administration's major economic endeavor now is to strengthen the economic recovery in the United States. The President's Jobs and Growth package, enacted into law this summer, was essential, as are his proposals for tort reform, regulatory reform, and health care reform. But there are barriers to economic growth and stability in other countries— in Europe, in Asia, in Latin America, in Africa—as well as in the international trade and financial systems that have important implications for growth in the United States.

This is where our overall international economic strategy fits in. Our policy toward China—and China's exchange rate regime in particular—is part of that overall strategy. The strategy has been to urge the removal of rigidities and barriers wherever they exist, and to encourage pro-growth, pro-stability policies that benefit the U.S. and the whole world. It is a *two-track approach*—domestic and international. The international component is applied bilaterally and multilaterally.

Progress on Growth and Stability

I am pleased to report that this endeavor is working. Thanks to the fiscal and monetary policy responses, economic growth in the United States is picking up significantly now after the severe shocks of the terrorist attacks, the corporate accounting scandals, and the stock market drop of 2000. Global growth is also improving. There is more evidence of stronger economic growth in the world's second largest economy, Japan, and in Canada and the United Kingdom, as well as several emerging market countries.

There is also a notable improvement in economic stability around the world, despite the uncertainties about terrorist attacks and the ongoing war against terror. The number and severity of financial market crises are down, capital flows are up, and interest rate spreads are down compared with the late 1990s. This improvement in global economic stability is important for the United States. Greater economic stability is essential to creating a long lasting recovery, which is needed for sustainable job creation.

Agenda for Growth

Despite this progress on the growth and stability front, we need to do more. During the summer months, Secretary Snow embarked on an international pro-growth tour starting in Europe, continuing on to Asia (including China as I will shortly discuss in more detail), and culminating in the annual meetings of the World Bank and the IMF in the Middle East where he forged an agreement on a new "G7 Agenda for Growth." This milestone agreement creates for the first time *supply side surveillance* – a process of benchmarking and reporting in which each G7 country takes actions to spur growth and create jobs. It focuses on supply-side policies that increase flexibility and remove structural barriers to growth, because such policies are most needed to raise growth among our G7 partners, especially those in the European Monetary Union. For its part the United States will work to lower health care costs, reduce frivolous lawsuits, and streamline regulations and needless paperwork. The other G7 countries are endeavoring to implement other supply side policies. For example, Germany is focusing on labor, health, and pension reforms.

Our engagement to foster pro-growth, pro-stability policies extends to the emerging markets and developing countries. For example, we recently created a new United States-Brazil "Group for Growth" through which the two countries will work together to identify pro-growth strategies at the micro as well as macro levels. And the Millennium Challenge Account is aimed at encouraging pro-growth policies in the developing countries. Our reforms also call on the World Bank to encourage economic growth by using IDA funds for the private sector as, for example, in the new IDA/IFC small business loan program for Africa. And we will continue to promote trade through the bilateral, regional, and global trade agreements. While the outcome at Cancun was a missed opportunity for global trade liberalization, our free trade initiatives, including the U.S. proposal to cut tariffs to zero in manufacturers will continue.

Policy Principles Regarding Alternative Exchange Rate Regimes

Exchange rate policy also has bearing on growth and stability. The move by several large emerging market countries—such as Brazil, Korea, and Mexico—to flexible exchange rates combined with clear price stability goals and a system for adjusting the policy instruments is one of the reasons we are seeing fewer crises and greater stability.

We emphasize that the choice of an exchange rate regime is one where country ownership is particularly important. We also recognize that, especially in the case of small open economies, there are benefits from a "hard" exchange rate peg, whether dollarizing, as with El Salvador, joining a currency union, as with Greece, or using a credible currency board, as in Bulgaria or Hong Kong.

The Economy of China

With this context, let me now address China's economy and its exchange rate regime. Economic reforms in China have increased economic growth and have made China one of the largest economies in the world. China is now a major economy, and it is still growing rapidly. It is already an engine of global growth. With per capita income of only about $1,000 per year and with financial, legal and regulatory systems in need of reform, China still faces challenges in its effort to catch up with developed economies.

China's Exchange Rate Regime

For nearly ten years now, the Chinese have maintained a fixed exchange rate for their currency, the yuan, relative to the dollar. The rate has been pegged at about 8.28 yuan/dollar for the entire period. Thus, as the dollar has appreciated or depreciated in value relative to other currencies, such as the Euro, the yuan has appreciated or depreciated by the same amount relative to these other countries.

To maintain this fixed exchange rate, the central bank of China has had to intervene in the foreign exchange market. It sells yuan in exchange for dollar denominated assets when the demand for the yuan increases and it buys yuan with dollar denominated assets when the demand for the yuan decreases. Recently the central bank has intervened very heavily in the markets to prevent the yuan from appreciating. Since the end of 2001, dollar buying has been so great that the foreign reserves held by the Chinese government have risen by $153 billion to over $360 billion.

This accumulation of foreign exchange reserves would tend to expand China's money supply, although in recent months the Chinese central bank has moved to reign in monetary expansion. Among other measures to sterilize reserve accumulation, the central bank has – for the first time – begun issuing central bank paper to restrict growth of the monetary base. Nevertheless, the broader money supply continues to grow very rapidly: M2 climbed 22 percent over the 12 months ending in August 2003.

It is also important to recognize that China still has significant capital controls. China's capital controls allow for more inflows than outflows, thus bolstering foreign exchange reserves. China is gradually loosening some controls (on securities rather than debt), and outflows are likely to grow as new channels develop for Chinese to seek diversification and better returns than those offered by low domestic interest rates. Indeed, there is already significant leakage of capital. A relaxation of controls on outflows would reduce upward pressure on the yuan.

Impact on the United States

U.S. imports from China are equal to about 1 percent of U.S. GDP, or 11 percent of total U.S. imports. Although this share may seem small, China's imports to the U.S. have been increasing rather rapidly, between 20 and 25 percent in recent years and months. In general, these imports result from China using low-skilled labor to assemble and process imported parts and materials originating in other countries—mostly from other Asian countries that have traditionally exported directly to the U.S. Consequently, the share of U.S. imports from these other countries has declined just as China's share has increased. Asia's share of U.S. imports has declined slightly. Much of the increase in U.S. imports from China has come at the expense of imports that once came directly from other Asian countries.

At the same time, growth of U.S. merchandise exports to China has been accelerating recently and grew 22 percent in the first 7 months of this year. Growth has been especially rapid in recent years for U.S. exports to China of transportation equipment (including aircraft engines), machinery, steel-making materials, chemicals, and semiconductors.

China has a large trade surplus with the United States. However, because China has a large deficit with the rest of the world, it does not have a large overall current account surplus. China's bilateral trade surplus was $103 billion in 2002 with the U.S. while China's deficit with the rest of the world was about $73 billion. Thus, China's current account surplus was under 3 percent of GDP in 2002 and likely to decline to less than 2 percent in 2003. Many imports from China are goods from other Asian economies that are processed or finished off in China before shipping to the United States. Other East Asian economies increasingly send goods to China for final processing before they are shipped to the United States. China accounted for 11 percent of U.S. imports in 2002, up from 3 percent in 1990. Meanwhile, the combined share of Japan, Korea and Taiwan declined to 17 percent from 27 percent over the same period.

The overall trade deficit of the United States is spread across many countries of the world in addition to China. For instance, the overall trade deficit reached $468 billion last year with 1) the Americas accounting for $105 billion, 2) Western Europe $89 billion, 3) Japan $70 billion, and 4) China $103 billion. The U.S. overall trade and current account deficit is due to the excess of investment over saving in the United States. If this gap were reduced through an increment in savings, the overall deficit could shrink as would the size of the bilateral deficits.

What impact would a change in the value of the yuan relative to the dollar have on the United States economy? An appreciation would make U.S. exports to China less expensive and it would make U.S. imports from China more expensive. The price of Chinese goods in the United States would not change by as much as the change in the exchange rate, because only a portion of most exports from China are produced in China, and because the retail price in the United States includes marketing, transport, and other logistical costs. And with a higher yuan, substitutes for Chinese products would likely come from countries other than China.

The United States Policy Position

With its rapid growth and substantial foreign exchange reserves, China is now in a position to show leadership on the important global issue of exchange rate flexibility. China represents one of the largest economies in the world, and a flexible exchange rate regime would be a good policy for China. It would allow China to open the nation to capital flows and reduce macroeconomic imbalances.

We have also been urging the Chinese to build on their strong record of economic reform by moving forward in two other areas: reductions in barriers to trade and capital flows. In the area of trade, it is important for China to fully implement, and even surpass, the commitments it made to the World Trade Organization. Tariffs on manufactured goods are scheduled to come down from an average of about 17 percent to an average of about 9 percent. This will still be well above the average of the United States and other large economies, which stand at about 4 percent. It is important that China continue to reduce its tariff barriers. It should also open its markets to agricultural products such as soybeans, as well as effectively enforcing intellectual property laws.

China's restrictions on capital flows are one of the major rigidities interfering with market forces. The authorities understand this and are beginning to reduce barriers to capital flows and develop more open and sophisticated capital markets. In fact, China has taken a number of steps in this area recently, including developing measures that will allow for some cross-border portfolio investment. At the same time, the Chinese authorities are working to strengthen the banking system and liberalize capital flows in order to prepare for a more flexible exchange rate.

Secretary Snow encouraged each of these steps in his trip to Beijing last month. He met Premier Wen, Vice Premier Huang, Central Bank Governor Zhou and Finance Minister Jin. In all his meetings discussions were detailed and candid. He also stated publicly, "the establishment of flexible exchange rates, of a flexible exchange rate regime, would benefit both our nations as well as our regional and global trading partners." The Chinese reported that they intend to move to a market-based flexible exchange rate as they open the capital account.

Secretary Snow's visit to Beijing was associated with announcements by China's central bank, including liberalized regulations for foreign firms managing their foreign exchange and significantly liberalized provisions to allow Chinese travelers to take foreign currency out of the country and to do so more frequently. We will continue to urge the Chinese to make rapid progress in these areas.

We are working on a possible technical cooperation agreement in the financial area. We intend to continue the high level conversations on this subject begun by Secretary Snow.

In addition, following Secretary Snow's visit, the Chinese and the G7 agreed to engage in talks about economic issues. This represents another example of how China, the U.S. and other affected parties can come together to work on an issue of vital interest to them all. The first meeting between senior officials from the G-7 and China's finance ministry and central bank took place last week in Dubai, where the Chinese economy, the G7 economies, and other economic issues, were discussed. Further meetings will be scheduled on a regular basis with China, the United States and the other G7 countries. After the Dubai meeting, China's central bank representative said that China is moving as fast as it can in its reform.

Conclusion

I am pleased to report that our efforts to engage in financial diplomacy are bearing fruit. Active engagement with China and other countries is paving the way toward freer markets. The Administration's effort to raise growth in the United States and abroad, and thereby create jobs at home is already showing signs of success.

National Association of Manufacturers

Testimony

of Franklin J. Vargo
Vice President, International Economic Affairs
National Association of Manufacturers

on behalf of the National Association of Manufacturers

before the Subcommittee on Domestic and International Monetary Policy, Trade, and Technology of the House Committee on Financial Services

on China's Exchange Rate Regime and Its Effects on the U.S. Economy

October 1, 2003

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Hearing On
China's Exchange Rate Regime and Its Effects on the U.S. Economy

October 1, 2003

Mr. Chairman and Members of the Subcommittee:

I am pleased to testify today on behalf of the National Association of Manufacturers (the NAM) regarding China's exchange rate regime and its effects on the U.S. economy.

The NAM represents 14,000 U.S. manufacturing companies, including 10,000 small and medium-sized firms. No other trade subject comes close to commanding the attention that China is getting from both large and small NAM member companies. China is simultaneously the greatest concern of many of our import-competing members and the fastest-growing global market for many larger companies that operate internationally.

The NAM seeks a positive and balanced trade relationship with China that reflects market forces as closely as possible. There is no question that the Chinese currency is seriously undervalued is having a major effect on U.S. bilateral trade and on the trade of other nations as well. The bilateral trade situation with China is already serious, but will reach critical proportions if not addressed soon. The problem is still manageable if quick action is taken, and the currency imbalance is at the heart of the problem.

At that same time, the currency situation and trade with China must be seen in their proper perspectives. While the undervalued Chinese yuan appears to be the single most important aspect in our growing bilateral trade imbalance, it is not the only factor. Growing concerns over China's shortcomings in implementing World Trade Organization (WTO) commitments and other factors are important factors in the imbalance as well. Additionally, China's undervalued currency has broader implications beyond the bilateral effects.

It is also important to recognize that while the rising trade imbalance with China is a growing factor affecting U.S. manufacturing production and employment, it is far from the only factor. Domestic costs, falling U.S. exports, dollar overvaluation with other currencies, structural factors, regulatory pressures, and other issues are also at work. China must not be a "scapegoat" and an excuse for not tackling the other problems. Nonetheless, the China currency situation is so important that it must be addressed.

MANUFACTURING: VITAL TO AMERICA

I would like to begin my statement with a review of why manufacturing is vital to the U.S. economy. Since manufacturing only represents about 16 percent of the nation's output, who cares? Isn't the United States a post-manufacturing services economy? Who needs manufacturing? The answer in brief is that the United States economy would collapse without manufacturing, as would our national security and our role in the world. That is because manufacturing is really the foundation of our economy, both in terms of innovation and production and in terms of supporting the rest of the economy. For example, many individuals point out that only about 3 percent of the U.S. workforce is on the farm, but they manage to feed the nation and export to the rest of the world. But how did this agricultural productivity come to be? It is because of the tractors and combines and satellite systems and fertilizers and advanced seeds, etc. that came from the genius and productivity of the manufacturing sector.

Similarly, in services -- can you envision an airline without airplanes? Fast food outlets without griddles and freezers? Insurance companies or banks without computers? Certainly not. The manufacturing industry is truly the innovation industry, without which the rest of the economy could not prosper. Manufacturing performs over 60 percent of the nation's research and development. Additionally, it also underlies the technological ability of the United States to maintain its national security and its global leadership.

Manufacturing makes a disproportionately large contribution to productivity, more than twice the rate of the overall economy, and pays wages that are about 20 percent higher than in other sectors. But its most fundamental importance lies in the fact that a healthy manufacturing sector truly underlies the entire U.S. standard of living -- because it is the principal way by which the United States pays its way in the world.

Manufacturing accounts for over 80 percent of all U.S. exports of goods. America's farmers will export somewhat over $50 billion this year, but America's manufacturers export almost that much *every month!* Even when services are included, manufacturing accounts for two-thirds of all U.S. exports of goods and services.

If the U.S. manufacturing sector were to become seriously impaired, what combination of farm products together with architectural, travel, insurance, engineering and other services could make up for the missing two-thirds of our exports represented by manufactures? The answer is "none." What would happen instead is the dollar would collapse, falling precipitously -- not to the reasonable level of 1997, but far below it -- and with this collapse would come high U.S. inflation, a wrenching economic downturn and a collapse in the U.S. standard of living and the U.S. leadership role in the world. That, most basically, is why the United States cannot become a "nation of shopkeepers."

THE MANUFACTURING RECESSION

Manufacturing went into recession in 2000 and only now – three years later – is beginning to show signs of a turnaround. Shipments of manufactured goods have fallen an astonishing $270 billion since 2000, and over 2.7 million American factory jobs have been lost -- roughly one in every six jobs. The U.S. economic slowdown is essentially a manufacturing recession. The rest of the economy, while not growing at its usual rate, has not felt the same pain. Manufacturing represents 14 percent of the American workforce, but has accounted for nearly 90 percent of all the job losses since total U.S. employment peaked in March 2001.

With the tax cuts that have been enacted, low interest rates, and appreciation of some major foreign currencies from their previously highly-undervalued positions, the stage is now set for a turnaround in manufacturing. However, despite recent promising signs that the manufacturing sector is recovering from its three-year long recession, U.S. manufacturers continue to struggle in the face of weak demand and the most intense global competition in history.

The cost of manufacturing in the United States is rising steadily due to a variety of factors, including increased costs related to energy, health care, litigation and government regulation. At the same time, global competition prevents manufacturers from raising prices to offset these costs. Notwithstanding significant increases in productivity, many manufacturers have found no alternative but to cut back production, relocate plants abroad or stop producing altogether.

The NAM Board of Directors just last week identified the four priority policy areas that demand prompt attention from government policy makers:

- Reducing the cost of producing in the U.S. by containing health care costs, enacting legal reforms, including asbestos litigation reform, ensuring adequate and affordable energy supplies, and reforming the regulatory process to more effectively assess costs and benefits and the impact on industry. This is the single most important problem, and the difficulties of its solution must not be allowed to preclude priority action.

- Leveling the international playing field by ensuring that our major trading partners, including China and other Asian nations, reduce trade barriers, comply with international trade rules and allow markets to determine exchange rates.

- Promoting innovation, investment and productivity through tax reforms that encourage investment and R&D, domestic and international tax rules that keep U.S. manufacturers competitive and promote inward investment, and strengthened government R&D programs.

- Ensuring an adequate supply of skilled workers through greater emphasis on technical education, including engineering and science; strengthened implementation of the Workforce Investment Act; expanded business-government partnerships; and a redirecting of federal programs to assist displaced workers.

Manufacturing is at risk because it has been taken for granted, and burdens and costs have been imposed on manufacturing that are now being reflected in falling unemployment and growing outsourcing. A recent study commissioned by the NAM's Council of Manufacturing Associations, *Securing America's Future: The Case for a Strong Manufacturing Base,* prepared by noted economist and former Council of Economic Advisors member Dr. Joel Popkin, is clear in its warning that, "if the U.S. manufacturing base continues to shrink at the present rate and the critical mass is lost, the manufacturing innovation process will shift to other global centers. If this happens, a decline in U.S. living standards in the future is virtually assured."

The NAM is very pleased with the rising level of awareness on the part of the Administration and the Congress. On September 15, Commerce Secretary Evans gave a major speech in Detroit announcing the launch of a new Administration initiative on manufacturing that includes many of the NAM's own recommendations. In addition, Members of Congress have shown more interest in manufacturing issues and proposed several positive resolutions that address concerns the NAM has raised, notably on China's undervalued currency.

TRADE

In looking at why the manufacturing recession is so sharp and why the sector is behaving differently from the rest of the economy and why recovery is so slow, trade immediately stands out as a huge factor. Of the $270 billion drop in U.S. manufactured goods shipments since 2000 (through July 2003, at an annualized rate), $80 billion stems from a drop in U.S. manufactured goods exports -- accounting for roughly one-third of the fall in production. A one percent increase in import penetration of manufactured goods over that time accounted for a further $40 billion of the production decline -- about 15 percent. All of the increase in import penetration came from China. Import penetration from the rest of the world has been flat since 2000 -- meaning U.S. imports from them grew no faster than U.S. consumption.

Thus, in total, trade may have accounted for about half of the drop in production. That is why we will not see a robust economic recovery without a significant turnaround in net exports of manufactures.

Since 1997 the U.S. merchandise trade balance has gone from a deficit of $180 billion to an annual rate of $530 billion so far this year -- an increase of about $350 billion. The fundamental cause has been the extreme run-up in the value of the U.S. dollar since 1997. At its peak the dollar rose about 25 percent over its early 1997 level according to the Federal Reserve Board's (FRB) trade-weighted broad currency index. Using the Institute for International Economics' rule of thumb that each one percent change in the value of the dollar leads to a $10 billion shift in the trade balance, the appreciation of the dollar could account for about $250 billion of the $350 billion increase in the deficit -- or about 70 percent.

This is why the NAM worked hard to obtain a dollar policy based on market-determined exchange rates reflecting economic fundamentals. The Administration began enunciating such a policy last year. More recently, Treasury Secretary Snow has been very definite in his statements that markets must set currency values free of intervention. He has succeeded in achieving G-7 agreement, as reflected in their forceful support for market-determined currencies in the communiqué from their September 2003 meeting.

With the Administration's insistence that currency values should be determined by market forces, major currencies have been adjusting for over a year now. The euro is at $1.15 today, compared to its low of $0.87 in February 2002. (Today's level, however, is still below the euro's value throughout the 1990's, which -- using a constructed euro -- was $1.21). The FRB index of industrial nation currencies peaked in February 2002 at 30 percent above its early 1997 level, but today stands only 8 percent above that level -- a welcome development that will help trade move toward greater equilibrium. However, the FRB's broad index of currencies, which includes most Asian currencies, peaked at 25 percent above its early 1997 level, and today still stands at 15 percent above that level.

Thus, despite widespread press statements about a "weak dollar", the dollar is still excessively strong. In fact, by the FRB's broad currency index, the dollar is stronger today than when former Treasury Secretary Rubin (architect of the "strong dollar policy") left office! The dollar was too strong then, and is even stronger now. The reason why the dollar is still so strong is that Asian countries have been preventing their currencies from reflecting market forces. The Chinese currency stands out, still being pegged at its devalued level of a decade ago; but other Asian governments have been intervening as well -- the Japanese government openly, and others less so.

Together, four Asian economies -- China, Japan, South Korea, and Taiwan -- hold $1.2 trillion of official reserves, up $600 billion in the last four years and up $250 billion in just the last 12 months as they have purchased dollars to prevent an excess supply of dollars from lowering the value of their currencies. It should be pointed out that these four countries account for 60 percent of the entire global U.S. trade deficit in manufactured goods. All the rest of the world accounts for only 40 percent.

CHINA'S CURRENCY

Turning to the Chinese currency, China is accumulating dollar reserves faster than any other country, including Japan. China's reserves at the end of August 2000 stood at $365 billion dollars -- 120 percent of China's annual exports and nearly one-third of China's $1.23 trillion GDP. China has added $110 billion to its dollar reserves in just the last 12 months -- the largest increase in the world.

China devalued its currency by about 30 percent in 1994 and has maintained that value for the last nine years -- despite a huge increase in production capability, productivity, quality, production range, foreign direct investment inflows, and other factors that would normally be expected to cause a currency to appreciate. The currency is controlled by the government, and there is no marketplace for the yuan. The degree of upward pressure that the yuan would feel, however, is amply indicated in the amount of reserves that the Chinese government has to accumulate to maintain its artificial peg.

There are many estimates of where the currency would move if it were able to float -- i.e., what its market value would be. The NAM commends the work of Dr. Ernest Preeg, of the Manufacturers Alliance, as well as that of the Institute for International Economics' Dr. Morris Goldstein, who is testifying today -- as well as other estimates. Most estimates indicate an undervaluation between 15 and 40 percent. Given the price pressures expressed by many NAM member companies, I tend to believe the market price would be toward the upper end of that range.

The Chinese currency is the key, not just because of the huge bilateral imbalance, but also because other Asian countries are all looking over their shoulders at Chinese compëtition and are reluctant to allow their currencies to move up against China's. Once China's currency appreciates, though, they will be less reluctant to allow theirs to move upward as well.

EFFECTS OF UNDERVALUATION

The U.S. trade deficit with China is now the largest in the world, standing at $103 billion last year. China now accounts for more than one-fourth of America's total deficit in manufactured goods trade. As noted earlier, since 2000 the increase in China's import penetration of the U.S. market for manufactured goods represented about 15 percent of the decline in U.S. production. An estimate of the effect on employment is difficult to make and was beyond that which could be undertaken for this testimony.

The important thing is that the trade situation with China is still manageable, if addressed now. While information from our member companies makes it plain that industries such as plastics, machine tools, hardware, furniture, tool and die and others are feeling strong pressures from China now, the situation will become considerably more serious unless corrective steps are taken.

Imports from China last year were $125 billion, while exports to China were $22 billion -- meaning that imports are six times as large as exports, which makes correction of the bilateral deficit extremely difficult. Exhibit 1, attached to my statement, shows alternative U.S. trade balances with China in five years under various import and export growth rates. A continuation of the existing trends would result in a tripling of the trade deficit, to more than $330 billion. There is no question that such a level would result in enormous calls for wide-spread protection. This must be headed off while there is time.

One good development is already apparent. U.S. exports to China have broken their long-term trend and are now growing about 25 percent a year. I believe this reflects the fact that China's market is beginning to open as a result of its entry into the World Trade Organization. Unfortunately, as the matrix in Exhibit 1 makes clear, no feasible sustained rate of export growth to China can slow the growth of the deficit, precisely because imports are six times as large as exports. Even a 33 percent annual rate of export growth would see the deficit grow two and a half times, to $250 billion.

Thus if the deficit is to grow more moderately or fall, the rate of import growth must decline from the rates we have seen. The question, though, is how import growth rates can be moderated without resorting to protectionism. Protectionism must be avoided. We cannot reverse the open trading system that has been such a source of growth for the United States and the rest of the world and risk a downward cycle of trade deterioration. The answer, therefore is that we must rely on market mechanisms -- very importantly, including market-driven currencies.

Would a considerably stronger Chinese yuan have beneficial effects? Many of our member companies tell us that a 20 percent or more price shift would change the competitive situation dramatically. Others say their problems go beyond that. Some commentators state that Chinese wages are so low that no amount of appreciation would make a difference. Labor costs, however, are only one factor in the production process. In fact, production worker wages and benefits are only 11 percent of the cost of U.S. manufactured goods, on average. An exchange rate reflecting market forces would shift the competitive equation so that some Chinese industries would remain extremely competitive, while others would find their artificial advantage diluted. U.S exports would also grow more rapidly, helping to bring about a more sustainable trade position.

The situation is not uniform, though. Some NAM member companies tell us that Chinese products are being offered for sale in the U.S. market at less than the cost of raw material inputs. These situations raise other questions, for even low labor costs and an undervalued currency could not account for this.

Additionally, it is important to recognize that not all of China's rapid export growth to the U.S. market necessarily competes with U.S. production. For example, Japan's share of U.S. imports has fallen as China's has risen -- implying the possibility of considerable substitution of Chinese for Japanese goods. China is now the largest supplier of computers and related components into the U.S. market. Yet in 2000, China was only our 5th-largest supplier. Though total U.S. imports of computers and components fell from 2000 to 2002, imports from China soared nearly 50 percent, while imports of these products from Japan fell 50 percent and from Korea fell over 40 percent.

A more market-oriented currency would benefit China as well as the United States. China's terms of trade and living standard would improve, and investment would tend to gravitate more toward domestic-led growth rather than exports. Additionally, the huge amounts of excess dollars that China must mop up every month are pouring too many yuan into the domestic economy, for one thing. Asset prices in China are beginning to reflect this factor. The International Monetary Fund's (IMF) recent international economic report makes it plain that currency reserve buildups by Asian nations are destabilizing to the world economy and need to be addressed.

The Administration has recognized the importance of having a Chinese currency that reflects market forces, and the NAM applauds the statements by the President and the work that Treasury Secretary Snow has been doing to obtain progress in this direction. The Secretary's discussions with the Chinese, the attention to the issue that he obtained in the recent Asia Pacific Economic Cooperation (APEC) Financial Ministers meeting, and particularly the agreement he obtained among G-7 Financial Ministers are vitally important. We hope the President will also put this issue front and center when he attends the APEC leaders' meeting later this month and meets with the leadership of the Chinese government.

The NAM believes the U.S. government must have all the leverage possible to resolve the issue quickly, and to this end has announced its support for the Coalition for a Sound Dollar's initiative to bring a trade impairment case against the Chinese currency under Section 301 of the Trade Act of 1974. Section 301 is the principal U.S. statute for addressing foreign unfair practices affecting U.S. trade, and is applicable in responding to "unreasonable, unjustifiable, or discriminatory foreign government practices that burden or restrict U.S. commerce." We believe China's currency practices fall within this scope.

China's action in sustained one-way purchases of dollars to maintain its peg are inconsistent both with its obligations in the IMF to avoid currency action for purposes of gaining a trade advantage, as well as with its obligations in the WTO to avoid frustrating trade liberalization through exchange rate action and to avoid subsidization of exports or impairment of trade benefits.

CHINA AS A MARKET

Let me stress that we are seeking a market-oriented approach to U.S. - China trade. The U.S. - China trade relationship needs to be among the largest and strongest in the world, and needs to proceed in a way that clearly benefits both countries. It is also very important to avoid viewing China in a one-sided manner. In addition to being a rapidly rising supplier of imports into the U.S. market, China is also a quickly growing market for foreign goods and services, and this must not be overlooked. Last year China was our fastest-growing export market. While our overall exports fell 5 percent, our exports to China were up 15 percent. Last year China was the second-largest market for U.S. commercial jet aircraft. China has the same potential for many products.

There is enormous potential for expansion. Less than 10 percent of China's imports come from the United States. The European Union, for example, sells 30 percent more to China than we do. We need to examine why the U.S. has only 8 percent of China's import market, and what -- in addition to a currency shift -- U.S. exporters need to do to change this situation and help boost two-way trade.

It is also important to contemplate the significance of the fact that China's trade with the rest of the world as a whole is in deficit. In 2002, using U.S. data, China's surplus with us was $103 billion. China's global trade surplus was $30 billion, implying a $73 billion deficit with the rest of the world. Much of this is imports of oil and other commodities, and large amounts are also comprised of electronic components that China purchases from other Asian countries to assemble into final products for export to the United States.

A POSITIVE AGENDA

We need a positive agenda in addressing China. In building this relationship, we need a combination of steps to ensure that trade follows market principles, and to ensure that U.S. productivity and technology continues to provide us a competitive edge in a productive and more balanced relationship. The first step has already been taken: getting China into the WTO so it will follow global trade rules. In the NAM's view, we now need to pursue a set of steps to ensure more market-driven trade between China and the United States. This would include:

1. **Seek full WTO Compliance.** We must ensure that China complies with its commitments as a new World Trade Organization member to follow all international trade rules and open its internal market in accordance with specific benchmarks set forth in its membership agreement. The NAM has established a WTO compliance monitoring program of its own and submitted its second annual compliance report based on member input to the U.S. Trade Representative (USTR) on Sept. 10. We have also pressed for more Commerce and USTR resources for monitoring and investigating compliance problems.

2. **Stop Currency Undervaluation.** We must press China to end the manipulation of its currency and allow the yuan/dollar exchange rate to be determined by the market. China needs to move toward a market-determined currency as quickly as possible, revaluing its currency significantly in the interim.

3. **End Subsidized and Non-Market Production.** We must ensure that the development of Chinese industry follows market principles and does not benefit from direct or indirect subsidies that distort trade flows.

4. **Address Counterfeiting and IPR Violations.** We must take firm actions to end China's rampant counterfeiting of U.S. and other products. Today, China is the epicenter of world counterfeiting. costing us tens of billions of dollars in lost exports and the related jobs.

5. **Expand Export Promotion to Support U.S. Business.** Finally, we must undertake a massive joint public-private export trade effort to increase U.S. exports to China. In 2003, China is set to become the world's 3rd largest importer ($380 billion) but the United States only has an 8 percent share of all Chinese imports. U.S. companies need to increase their marketing efforts but greatly expanded Commerce Department and other promotion assistance is also needed.

CONCLUSION

I want to conclude by reiterating that we will not succeed in preventing the migration of our manufacturing base to China and other foreign countries if we do not address the high cost of manufacturing in the United States and get the U.S. economy moving again. A fairly valued Chinese currency is important, but we must not forget that the bulk of our problems are home-grown.

U.S. industry is burdened by legal and regulatory systems that retard growth and destroy jobs. Unrestrained asbestos liability alone, for example, could cost U.S. industry $250 billion, resulting in the bankruptcy of even large corporations. Rapidly rising health care costs are a constant worry, particularly for small manufacturers. Uncertainty over sources of energy supply has led to price volatility. Lack of support for research and development threatens to undermine U.S. technology leadership. And shortages of skilled workers have many manufacturers wondering how they can expand in the future. .

Additionally, bilateral, regional and WTO trade agreements must be negotiated as quickly as possible to get foreign trade barriers eliminated, or at least down to our own low level. U.S. tariffs on manufactured goods average less than 2 percent, while in many parts of the world U.S-made goods face tariffs 10-15 times higher -- or even more.

Unless these challenges are also addressed, we can expect a significant further erosion in the U.S. industrial base. Competition with China will only accelerate the trend. However, if we begin to act now, with both a refocused and positive trade policy toward China and a concerted strategy on economic growth and manufacturing renewal, we can restore the dynamism and competitiveness of U.S. industry and ensure the global leadership that is so central to our economic and national security.

Thank you, Mr. Chairman.

EXHIBIT 1

ALTERNATIVE U.S. TRADE DEFICITS WITH CHINA

20-Year Trend: Exports to China up 12% per year; Imports up 20% per year

IF THESE TRENDS CONTINUE FOR 5 MORE YEARS THE CHINA TRADE DEFICIT WILL TRIPLE, TO $330 BILLION

Projected 2008 Trade Deficits with China
Under Alternative Export and Import Growth Rates
(Billions of Dollars)

Import% \ Export%	12%	25%	33%
20%	($330)	($290)	($252)
15%	($246)	($205)	($167)
10%	($178)	($138)	($100)
7%	($144)	($104)	($66)

NATIONAL ASSOCIATION OF MANUFACTURERS

Excerpt from:

Statement of Kathleen P. Utgoff
Commissioner
Bureau of Labor Statistics
before the
Joint Economic Committee
UNITED STATES CONGRESS
Friday, September 5, 2003

"Some observers have speculated that the household survey provides a better indication of the trend in employment at and around turning points in the business cycle. It is our judgment that the payroll survey provides more reliable information on the current trend in wage and salary employment. The payroll survey has a larger sample than the household survey– 400,000 business establishments covering about one-third of total nonfarm payroll employment. Moreover, the payroll survey estimates are regularly anchored to the comprehensive count of nonfarm payroll employment derived from the unemployment insurance tax records."

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