CHINA'S EXCHANGE RATE POLICY

HEARING

BEFORE THE

COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

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CHINA'S EXCHANGE RATE POLICY

WEDNESDAY, MARCH 24, 2010

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, DC.

The Committee met, pursuant to notice, at 10:02 a.m. in 1100 Longworth House Office Building, the Honorable Sander M. Levin [chairman of the committee] presiding.

[The advisory of the hearing follows:]

HEARING ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

Chairman Levin Announces Hearing on China's Exchange Rate Policy

March 15, 2010

Ways and Means Committee Chairman Sander M. Levin today announced a full committee hearing on the exchange rate policy of the Government of the People's Republic of China, and its impact on the U.S. and global economies. **The hearing will take place on Wednesday, March 24, 2010, in the main Ways and Means Committee hearing room, 1100 Longworth House Office Building, beginning at 10:00 a.m.**

In view of the limited time available to hear witnesses, oral testimony at this hearing will be heard from invited witnesses only. However, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the three Subcommittees and for inclusion in the printed record of the hearing.

FOCUS OF THE HEARING:

Economists generally agree that the Chinese currency (the renminbi—"RMB"—or "yuan") is substantially undervalued as a result of market intervention by the Government of the People's Republic of China. This policy artificially raises the price of imports into China and suppresses the price of exports from China. The purpose of this hearing is to consider: (1) the immediate and long-term impact of China's exchange rate policy on the U.S. and global economic recoveries and, more specifically, on U.S. job creation; and (2) steps that could be taken to address the issue.

BACKGROUND:

Since the global economic crisis began, some prominent economists have examined whether China's exchange rate policy contributed to that crisis and is continuing to impede progress on economic recovery and job creation in the United States and around the world.

According to some recent estimates, the RMB may be undervalued by between 30 and 50 percent against the dollar. While there is a growing recognition that China's exchange rate policy is a serious concern and impediment to recovery, the issue itself is not new. The United States has been pressing China for years to allow the RMB to appreciate. President Bush raised the issue with President Hu more than six years ago. At that time, the Treasury Department expressed concern when China's foreign exchange reserves (accumulated as a result of its currency market interventions) rose to $346 billion. Today those reserves exceed $2.4 trillion.

China allowed the RMB to appreciate somewhat beginning in July 2005, but China has not allowed any appreciation since the summer of 2008, when the global economic crisis caused China to redouble its efforts to stimulate exports. Robert Aliber, Professor Emeritus of International Economics and Finance at the University of Chicago, recently wrote in the Financial Times that: "Americans have been patient—too patient—in accepting the loss of several million U.S. manufacturing jobs because of China's determined pursuit of mindless mercantilist policies. The absurdity of the current situation is that China's currency protectionism has more of an impact on American manufacturing employment than U.S. fiscal policy."

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Please Note: Any person(s) and/or organization(s) wishing to submit for the hearing record must follow the appropriate link on the hearing page of the Committee website and complete the informational forms. From the Committee homepage, http://democrats.waysandmeans.house.gov, select "Hearings". Select the hearing for which you would like to submit, and click on the link entitled, "Click here to provide a submission for the record." Once you have followed the online instructions, submit all requested information. ATTACH your submission as a Word or WordPerfect document, in compliance with the formatting requirements listed below, **by close of business Wednesday, April 7, 2010**. Finally, please note that due to the change in House mail policy, the U.S. Capitol Police will refuse sealed-package deliveries to all House Office Buildings. For questions, or if you encounter technical problems, please call (202) 225–1721 or (202) 225–3625.

FORMATTING REQUIREMENTS:

The Committee relies on electronic submissions for printing the official hearing record. As always, submissions will be included in the record according to the discretion of the Committee. The Committee will not alter the content of your submission, but we reserve the right to format it according to our guidelines. Any submission provided to the Committee by a witness, any supplementary materials submitted for the printed record, and any written comments in response to a request for written comments must conform to the guidelines listed below. Any submission or supplementary item not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All submissions and supplementary materials must be provided in Word or WordPerfect format and MUST NOT exceed a total of 10 pages, including attachments. Witnesses and submitters are advised that the Committee relies on electronic submissions for printing the official hearing record.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. All submissions must include a list of all clients, persons and/or organizations on whose behalf the witness appears. A supplemental sheet must accompany each submission listing the name, company, address, telephone and fax numbers of each witness.

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202–225–1721 or 202–226–3411 TTD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

Note: All Committee advisories and news releases are available on the World Wide Web at http://democrats.waysandmeans.house.gov.

Chairman LEVIN. The Committee will come to order. I understand that two of our witnesses need to leave at 12:15. We will start on time. Mr. Camp and I will give opening statements.

Anyone else who has a statement, we will issue it into the record, and then we will start the testimony asking each of you to take the customary five minutes.

Chairman LEVIN. You will see the clock there. It will be helpful if you can condense your statements, which will be entered into the record, so that we can have full participation before several of you have to leave.

As stated, I will give an opening statement and then Mr. Camp. I think you are ready.

I guess we will start in the order that you are seated, with Dr. Ferguson, Dr. Bergsten, Mr. Prestowitz and Dr. Levy.

It is with a sense of urgency that this committee is holding this hearing in the hopes that with the help of our witnesses we can shed light on the problems associated with China's foreign exchange rate policy and consider possible solutions.

What seems undisputed, on this much disputed issue, is that China has a persistent economic strategy, a policy, a key to which is the pegging of its currency to the dollar at an undervalued rate.

Since the mid-1990s, China has clearly pursued an export led growth strategy, focusing on addressing its needs, namely creating jobs and accumulating vast foreign reserves.

Central to this export led growth strategy is China's policy of keeping its currency substantially undervalued. That policy keeps China's exports cheap in the U.S. market and makes imports into China substantially more expensive.

China has combined its cheap currency policy with other policies, including most notably Government directed investments in its manufacturing sector, which in turn creates pressures to keep its currency artificially low in order to get rid of excess production by exporting.

Chinese leaders have argued that these policies are necessary for its development, for its massive need to create jobs, although in recent years more and more economists are questioning that proposition.

While China has had a clear economic policy, a clear strategy, the U.S. on the other hand has not. Why not? One reason is that like so many other trade issues, it gets caught up in the polarization that grips trade issues, "free trade" versus "protectionism," a grip that I have believed harmful and reject.

An illustration of the futility of the polarization is China's argument that any action by the U.S. against China's policies or control of its currency would be "protectionism" or would lead to, as stated recently, "a trade war."

The easy polarization has helped handicap agreement on whether there is a problem. Increasingly, economists and other observers reject this.

As Martin Wolf, the chief economics commentator for the Financial Times has stated, and I quote, "The policy of keeping the exchange rate down is equivalent to an export subsidy and tariff at a uniform rate."

Last week, the New York Times Editorial Board, another somewhat conservative but cautious commentator on these economic issues, wrote and I quote "China's decision to base its economic growth on exporting deliberately undervalued goods is threatening economies around the world. It is fueling huge trade deficits in the U.S. and Europe. Even worse, it is crowding out exports from other developing countries, threatening their hopes of recovery."

These comments are echoed in our trade deficit with China, which for the past three years has been over $220 billion annually, and is a central driver in our overall trade deficit.

Some deny that it has serious consequences for American working families, but the alarm grows that it does indeed.

One economist, Paul Krugman, estimates that China's exchange rate reduces U.S. employment by 1.4 to 1.5 million jobs at a time when the U.S. faces a crisis of unemployment.

China's currency policy and export led growth policy are bad for the rest of the world, and I quote a recent statement by the Financial Times, and we can read it as I distribute this statement.

"While some disagree with the impact of China's policies and others view the issues through a lens that says 'hands off,' is the answer to market disequilibrium and that it is best to let things resolve themselves, I think the status quo is not sustainable.

The U.S./China relationship is a vital one for both countries. We are increasingly interdependent and there are vital policy considerations in addition to economic ones, but the China currency issue itself will not go away."

There is no easy answer to the problem, as is true with other important problems, but the answer is not to deny there is a problem.

It has been difficult, and we know this, to make progress bilaterally. At times talks seem to produce some progress, but that progress then disappears.

Some then suggested unilateral action, addressing China's currency manipulation under U.S. countervailing duty and anti-dumping trade remedy laws. Others have proposed the imposition of an additional duty on all imports from China.

In two weeks, the Obama Administration faces again, as past Administrations have, an April 15 deadline to decide whether to label China a "currency manipulator" in the Department of Treasury's semi-annual report.

The report requirements may well increase discussions about the use of multilateral forums to address the currency issue. The IMF is the most logical place for these discussions. However, to date, the institution has been unable to act effectively. Thus, some have suggested using multilateral negotiations through the G–20 to address the problem.

Some have urged the U.S. to bring a case in the WTO, but the WTO Articles relating to currency have never been tested.

Here we are. We are fortunate today to have with us four experts on China's exchange rate policy, and they will discuss the extent of the problem and alternative responses to address the problem.

I will just mention who you are and then Mr. Camp, you will take over, and then starting with Dr. Ferguson, they will testify.

Niall Ferguson is a Professor of History at Harvard University and Business Administration at the Harvard Business School.

Fred Bergsten is a veteran of this room, Director of the Peterson Institute for International Economics.

Another frequent visitor, Clyde Prestowitz, President of the Economic Strategy Institute, and Philip Levy, who is a Resident Fellow at the American Enterprise Institute.

We welcome all four of you experts and you will start as soon as my friend, Mr. Camp, gives his opening statement.

David.

[The prepared statement of Mr. Levin follows:]

Opening Statement of Chairman Sander Levin

It is with a sense of urgency that the Committee is holding this hearing in the hope that with the help of our witnesses, we can shed light on the problems associated with China's foreign exchange rate policy and consider possible solutions.

What seems undisputed on this much disputed issue is that China has a persistent economic strategy, a policy, key to which is the pegging of its currency to the dollar at an undervalued rate.

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Central to this export-led growth strategy is China's policy of keeping its currency substantially undervalued. That policy keeps China's exports cheap in the U.S. market, and makes imports into China substantially more expensive.

China has combined its cheap currency policy with other policies including, most notably, government directed investments in its manufacturing sector, which in turn creates pressure to keep its currency artificially low in order to get rid of excess production by exporting.

Chinese leaders have argued that these policies are necessary for China's development for its massive needs to create jobs—although in recent years, more and more economists are questioning that proposition.

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Why not?

One reason is that like so many other trade issues, it gets caught up in the polarization that grips trade issues—"free trade" vs. "protectionism"—a grip that I have believed harmful and reject. An illustration of the futility of the polarization is China's argument that any action by the U.S. against China's policies of control would be "protectionism" or would lead to a "trade war."

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Last week, the New York Times Editorial Board, another somewhat conservative and cautious commentator on these economic issues, wrote that "China's decision to base its economic growth on exporting deliberately undervalued goods is threatening economies around the world. It is fueling huge trade deficits in the United States and Europe. Even worse, it is crowding out exports from other developing countries, threatening their hopes of recovery."

And these comments are echoed in our trade deficit with China, which for the past three years has been over $220 billion annually, and is a central driver in our overall trade deficit.

Some deny that it has serious consequences for America's working families. But the alarm grows that it does—Paul Krugman estimates that China's exchange rate reduces U.S. employment by 1.4 or 1.5 million jobs—at a time the U.S. faces a crisis of unemployment.

China's currency policy and export-led growth policy are bad for the rest of the world as well, as a November 2009 Financial Times editorial concluded.

While some disagree with the impact of China's policies, and others view the issue through a lens that says "hands off" is the answer to market disequilibrium, that it is best to let things resolve themselves, I think the status quo is not sustainable.

The U.S.-China relationship is a vital one for both countries. We are increasingly interdependent and there are vital foreign policy considerations in addition to economic ones, but the China currency issue itself will not go away.

There is no easy answer to the problem, as is true with other important problems, but the answer is not to deny there is a problem.

It has been difficult to make progress bi-laterally. At times talk has seemed to produce some progress, but that progress then disappears.

Some then suggested unilateral action addressing China's currency manipulation under U.S. countervailing duty and antidumping trade remedy laws. Others have proposed the imposition of an additional duty on all imports from China.

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Some have urged the United States bring a case in the WTO, but the WTO articles relating to currency have never been tested.

We are very fortunate to have with us today four experts on China's exchange rate policy and they will discuss the extent of the problem and alternative responses to address the problem.

I now yield to ranking member Congressman Dave Camp for his opening statement.

Mr. CAMP. Thank you very much, Mr. Chairman. I also want to thank our witnesses for being here today.

In the 1970s, China injected itself with economic reforms. Now in 2010, China appears inflicted by a menacing strain of that reform that is either constraining a global economic recovery or worse, capable of creating a new economic pandemic.

While China's emergence as an economic powerhouse has rightly grabbed our attention, however, the trends are not new, and there are some predictable similarities between China's economy now and Japan's in the 1980s.

It is critical that China address the serious flaws in its economic structure, but we should remember that we have seen this before, maybe perhaps not on this scale.

This hearing is about China's currency policy and global imbalances. Like the IMF has, I can stipulate that China's currency is undervalued, plain and simple. I can also agree with G–20 leaders that the world has deep imbalances that must be corrected.

Let's not lose sight of the fact that there are fundamental problems with China's economy and let's not pretend that China's intervention in the currency markets by itself is the root cause of our ten percent unemployment or of China's ten percent annual GDP growth.

We will hear today from some pretty bright economists on the problems of China's economy, and I look forward to hearing what they have to say.

My view going in is that China's deliberate and dangerous wealth transfer from everyday households to inefficient export platform factories is standing in the way of the domestic consumption that the Chinese and the rest of the world believe the Chinese and the rest of the world so desperately need.

China must introduce global best practices into its banking sector, mature its financial markets, better protect intellectual property rights, and open more comprehensively to foreign direct investment.

China also should open its markets much more fully to all goods and services, particularly those coming from the United States.

An increase in the value of the RMB will facilitate some of these measures. For others, the much sought currency appreciation will be a happy but perhaps unintended offshoot of the broader reform.

All of these measures will help China move toward liberalizing its capital account, which should be the ultimate goal for all of us, because none of us can know the true extent of RMB under valuation until the currency floats.

In my view, however, when it comes to China, focusing on the currency valuation issue to the exclusion of the others is more likely to lead to a collective frustration and to any improvement in the health of the critical U.S./Chinese economic relationship.

With that said, while we should not obsess over the value of the RMB, it would be an enormous mistake to give up on addressing it.

To that end, I believe the Obama Administration should continue to address China's currency policy in high level bilateral summits, like the strategic and economic dialogue.

I think the Administration should restart languishing bilateral investment treaty negotiations with China and prompt it to make progress on the currency and broader issues as part of the BIT process.

I also believe the Administration should devote time and resources toward attempting to establish a robust multilateral process either in the G–20, IMF or elsewhere, so that other countries, particularly some of China's neighbors in Asia, can bring new points of pressure to bear.

I would hope that China would commit to this multilateral process and participate in good faith. If China wants to be treated as a major international player, it has to own up to the responsibilities of that status.

By a similar token, if the United States wants to maintain its status as the international leader, then we better make sure that whatever we do to address China's currency regime, we do it without losing sight of our international commitments and the over arching value of the multilateral trading system.

I am weary of panicky approaches whose support are inconsistent with our obligations, but then try to justify those inconsistencies by casually asserting that the normally applicable rules just should not apply.

So far, I have focused on China, and let me close by saying I fully admit the United States needs to get its own financial house in order. China would not be accumulating hordes of currency reserves in U.S. Treasuries if the United States stopped racking up debt at the current unsustainable pace.

Thank you, Mr. Chairman, and I yield back.

[The prepared statement of Mr. Camp follows:]

Opening Statement of the Honorable Dave Camp,
A Representative of the State of Michigan

In the 1970s, China injected itself with economic reform. Now, in 2010, China appears afflicted by a menacing strain of that reform that is either constraining a global economic recovery or, worse, capable of creating a new economic pandemic. While China's emergence as an economic powerhouse has rightly grabbed our attention, however, the trends are not new, and there are some predictable similarities between China's economy now and Japan's in the 1980s. It is critical that China address the serious flaws in its economic structure, but we should remember we've seen this before, although perhaps not on this scale.

This hearing is about China's currency policy and global imbalances. Like the IMF has, I can stipulate that China's currency is undervalued, plain and simple. I can also agree with G20 leaders that the world has steep imbalances that must be corrected. But let's not lose sight of the fact that there are fundamental problems with China's economy, and let's not pretend that China's intervention in the currency markets, by itself, is the root cause of our ten percent unemployment or of China's ten percent annual GDP growth.

We'll hear today from some pretty bright economists on the problems with China's economy. I'm looking forward to hearing what they have to say. My going-in view is that China's deliberate and dangerous wealth transfer from everyday households to inefficient export-platform factories is standing in the way of the domestic consumption that the Chinese (and the rest of the world) believe the Chinese (and the rest of the world) so desperately need. China must introduce global best practices into its banking sector, mature its financial markets, better protect intellectual property rights, and open more comprehensively to foreign direct investment. China also should open its markets much more fully to all goods and services, particularly those coming from the United States.

An increase in the value of the RMB will facilitate some of these measures. For others, the much-sought currency appreciation will be a happy—though perhaps unintended—offshoot of the broader reform. All of these measures will help China move toward liberalizing its capital account, which should be the ultimate goal for all of us, because none of us can know the true extent of RMB undervaluation until the currency floats.

In my view, however, when it comes to China, focusing on the currency valuation issue to the exclusion of the others is more likely to lead to collective frustration than to any improvement in the health of the critical U.S.-Chinese economic relationship. But, that said, while we shouldn't obsess over the value of the RMB, it would be an enormous mistake to give up on addressing it.

To that end, I believe the Obama Administration should continue to address China's currency policy in high-level bilateral summits, like the Strategic and Economic Dialogue. I think the Administration should restart languishing Bilateral Investment Treaty negotiations with China and prompt it to make progress on the currency and broader issues as part of the BIT process. I also believe the Administration should devote time and resources toward attempting to establish a robust, multilateral process—either in the G20, IMF, or elsewhere—so that other countries, particularly some of China's neighbors in Asia, can bring new points of pressure to bear. I would hope that China would commit to this multilateral process and participate in good faith. If China wants to be treated as a major international player, it has to own up to the responsibilities of that status.

By a similar token, if the United States wants to maintain its status as the international leader, then we better make sure that whatever we do to address China's currency regime, we do it without losing sight of our international commitments and the overarching value of the multilateral trading system. I am wary of panicked approaches whose supporters concede are inconsistent with our obligations, but then try to justify those inconsistencies by casually asserting that the normally applicable rules just shouldn't apply.

So far, I've focused on China. Let me close by saying I fully admit the United States needs to get its fiscal house in order. China wouldn't be accumulating hordes of currency reserves and U.S. Treasuries if the United States stopped racking up debt at the current unsustainable pace.

Thank you, Mr. Chairman, I yield back.

Chairman LEVIN. Thank you very much.

Dr. Ferguson, take over.

STATEMENT OF NIALL FERGUSON, PH.D., PROFESSOR, HARVARD UNIVERSITY

Mr. FERGUSON. Mr. Chairman, Members of the Committee, it is a great honor and privilege to be invited to address you. Let me begin with a direct question and direct answer. Is China a currency manipulator? Yes. Is its currency fundamentally misaligned? Yes. In the absence of currency intervention by the Chinese monetary authorities, the exchange rate of the renminbi would be significantly different, I believe.

Are we living through the end of what I have called with my colleague, Moritz Schularick, "Chimerica's demise," by which I mean that fusion between China's and America's economy which has been the driving force of global economic growth for the past decade?

How important has the Chinese currency policy been to China's growth?

Mr. Chairman and Members of the Committee, China's gross domestic product has increased by a factor of roughly four over the past ten years, its exports by a factor of roughly five, its current account surplus with the rest of the world by a factor of roughly 17, its share of American non-commodity imports has gone up from 10 percent to 24 percent, and as you are all aware, its share of the U.S. current account deficit has also grown.

In the period of the past ten years when China's exports led strategy was really crucial to its growth, there was minimal appreciation of the Chinese currency relative to the dollar, say about 15 percent between 2005 and 2008.

For the rest of the decade, China pegged its currency firmly to the dollar. Why did it do this? One, because it made its exports more competitive in global markets. Two, because it allowed it to accumulate reserves as a kind of insurance against financial crises. The Chinese did not want to experience what much of the rest of Asia experienced in 1997/1998.

Because the Chinese authorities have considerable control over their own banking system, this policy did not give rise to domestic inflation in the way that standard macroeconomic textbooks predicted it would.

This kind of policy is not supposed to work according to economists. I have the advantage of not being an economist. I am a historian. I can assure you that it does work as long as reserve accumulation is sterilized by the monetary authorities and does not translate into domestic inflation.

It is worth bearing in mind that there is a close link between China's currency policy and the massive financial crisis that we are still living through and have been since August 2007.

Not only did China's policy squeeze other manufacturing exporters but, crucially, it also had the effect of depressing long term interest rates in the United States by between 100 and 200 basis points. Without that stimulus, it is hard to believe the housing bubble in the U.S. would have been as large as it was in recent years.

How does China compare with other countries that have pursued this kind of strategy in the past? That is one of the central points I make in my written testimony.

The answer is that, compared with West Germany and Japan after World War II, this is a very different story. They had export led strategies but they did not accumulate reserves on this massive scale, nor did they resist pressure to appreciate their currencies.

Between 1960 and 1978, the deutsche mark increased by 60 percent, the yen appreciated by around 50 percent.

China's under valuation is very significant today, however you measure it, and we all approach this in different ways.

In our research, Moritz Schularick and I looked at a real exchange rate adjusted for unit labor costs, and we found that on that measure, China has made a competitive gain on the order of 40 percent relative to its trading partners, so that 15 percent appreciation of the renminbi which we saw in the middle of this decade has not really countered that massive benefit which China gets from its productivity gains and its very low unit labor costs.

Can this continue is the crucial question. Many people believe that it can. The U.S. deficit is back with the first green shoots of recovery. China's surplus never went away, although it is said it will disappear briefly this month. The U.S. is still borrowing, indeed borrowing on a much larger scale than ever before in peace time. The Chinese still need Americans to buy their goods.

There are those people that think this strange disequilibrium can somehow be resumed in the aftermath of the crisis. I think this is wrong for two reasons.

One, there is some limit to U.S. recovery as long as China and the other currencies that shadow China's currency policy overvalue the dollar.

Secondly, there is now a sign of dangerous overheating in China's economy. It is in their interest also to do something about this before they have a bubble, the consequences of which would not be confined to China.

We not only need revaluation of the renminbi, we also need a significant change in Chinese policy in order to encourage domestic consumption and we urgently need serious fiscal reform in the United States to do away with the notion that this country can run trillion dollar deficits for the rest of time, which is of course the current implication of policy.

I come in conclusion to what should be done. Yes, I think the Treasury should brand China a "currency manipulator," but no, I do not think this is a good moment to threaten or impose retaliatory tariffs against China, and here is why I think that.

I am an historian. This is not 2005 when Congress last threatened tariffs against China. We are in the middle of something that very nearly became a Great Depression, and we should remember how in the past, in 1930/1931, Congressional policy on protectionism deepened that depression, and some historians would say made that depression.

There is a danger not only of a trade war or a tariff war, there is also a danger of a currency war, and we are already seeing other countries using unorthodox methods to drive their fiat currencies down below the dollar.

Not everybody in Europe is shedding tears over the Greek tragedy as it weakens the euro and benefits European manufacturers. Brazil, too, is trying to soften its currency.

Thirdly and crucially, I do not believe renminbi appreciation on its own will be of massive benefit to the United States. I am very skeptical about Paul Krugman's claims that it would significantly reduce unemployment in this country.

The main beneficiaries of ending the renminbi/dollar peg would not in fact be the United States, but would be China's trade competitors in emerging markets, who are the real losers. They are the ones who have been losing market share when you look at the structure of U.S. imports.

In conclusion, I think we also need to be very wary of the more aggressive and indeed pugnacious attitude of the Chinese today. Not only with respect to Google, but I believe across a broad range of issues from Taiwan to Tibet, the Chinese authorities are spoiling for a fight, and the United States Congress must be very, very careful about giving it to them.

A best seller on economic policy in recent years in China has the title "Currency Wars" by Song Hongbing. I believe we are on the verge, maybe already in the middle of currency wars, and we should be careful that the market reaction to a trade war or currency war between the United States and China does not exceed in its negative effects the benefits which I believe would be minimal of renminbi revaluation. Chimerica is dying, but we must ensure that it is an amicable divorce and not a currency war.

Thank you very much.

[The prepared statement of Mr. Ferguson follows:]

THE END OF CHIMERICA:
AMICABLE DIVORCE OR CURRENCY WAR?

Niall Ferguson, Laurence A. Tisch Professor of History at Harvard University, William Ziegler Professor of Business Administration, Harvard Business School[1]

before the
Committee on Ways and Means
U.S. House of Representatives

March 24, 2010

Introduction

In February 2007, before the onset of the financial crisis, Moritz Schularick and I coined the term "Chimerica" to describe the combination of the Chinese and American economies, which together had become the key driver of the global economy.[2] We called it Chimerica for a reason: we believed this relationship was a chimera—a monstrous hybrid like the part-lion, part-goat, part-snake of legend. We identified it as one of the causes of the asset price bubble that was such a striking feature of the U.S. economy in the years from 2002 to 2006.[3] More recently, we have argued that we may be witnessing the death throes of this strange creature.[4] The central question the Committee must consider is whether U.S. policy should be to slay Chimerica, or to try to keep it alive. Should the U.S. Treasury brand Beijing a "currency manipulator" in its report due on April 15? Should Congress pass the "Currency Exchange Rate Oversight Reform Act",

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[1] Niall Ferguson is the author numerous works of financial history, including *The Cash Nexus: Money and Power in the Modern World, 1700-2000* (New York, 2001) and *The Ascent of Money: A Financial History of the World* (New York, 2008).
[2] Niall Ferguson and Moritz Schularick, "Chimerical? Think Again", *Wall Street Journal*, February 5, 2007.
[3] Niall Ferguson and Moritz Schularick, "'Chimerica' and Global Asset Markets", *International Finance* 10, 3 (2007), pp. 215–239. See also my *The Ascent of Money: A Financial History of the World* (New York, 2008).
[4] Niall Ferguson and Moritz Schularick, "The End of Chimerica", Harvard Business School Working Paper 10-037 (2009). Cf. Niall Ferguson and Moritz Schularick, "The Great Wallop", *New York Times*, November 16, 2009

paving the way for retaliatory tariffs against imports from countries with "fundamentally misaligned currencies", as proposed by Senators Brown, Graham and Schumer?

These are questions of the utmost historical significance. The threat of tariffs has worked before to pressurize the Chinese into revaluing their currency. On the other hand, one of the most important lessons of the Great Depression was that protectionist measures, including competitive devaluations, tended to worsen the situation of the global economy in the early 1930s. A second historical lesson is that conflicts over currencies and trade are often the prelude to conflicts of another sort. The Chinese authorities, and China's state-controlled media, are well aware of both these points, but they seem likely to respond pugnaciously to any pressure from the United States. The stakes are therefore high. We may be less than two decades from a major historical turning point, if there is any truth to the projections that China's gross domestic product will overtake that of the United States in 2027. Yet America's leaders seem to have given little thought to this momentous and imminent shift in the balance of economic power.[5]

1. What is Chimerica?

Chimerica combined Chinese export-led development with American over-consumption; to vary the metaphor, the result was an improbable financial marriage between the world's sole superpower and its most likely future rival. For China, the key attraction of this marriage was its potential to propel the economy forward by means of export-led growth. Thanks to the Chimerican symbiosis, China was able roughly to quadruple its GDP since 2000, raise exports by a factor of five, import western technology and create tens of millions of manufacturing jobs for the rural poor. For America, Chimerica meant being able to consume more, save less and still maintain low interest rates and a stable rate of investment. Over-consumption meant that between 2000 and 2008 the United States outspent its national income by a cumulative 45 percent, i.e. total U.S. spending over the period was 45 per cent higher than total income. Purchases of goods from China in excess of income accounted for about a third of over-consumption.

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[5] Niall Ferguson, "Complexity and Collapse: Empires at the Edge of Chaos", *Foreign Affairs*, April/May 2010.

For a time, it seemed like a marriage made in heaven. Chimerica accounted for around 13 per cent of the world's land surface, a quarter of its population, more than a third of its gross domestic product, and around two fifths of global economic growth in the past ten years. It also seemed like a marriage with benefits for the rest of the world. Global trade boomed and nearly all asset prices surged. Yet, like many another marriage between a saver and a spender, Chimerica was always likely to end in tears.

China's integration into the world economy was by far the most important development of the economic history of the past decade. In the 1990s Zhu Rongji and his right-hand man Wen Jiabao embraced foreign trade and foreign direct investment (FDI) as cornerstones of a new Chinese development strategy. Following substantial renminbi devaluation in 1994 and the opening up of the economy to FDI, the strategy quickly bore fruit as multinational companies started to relocate production to China. The Chinese export machine went into overdrive after World Trade Organization accession in 2001. Exports in 2000 were in the range of $250 billion, but climbed to $1.3 trillion in 2008. China's current account surplus in 2001 was a mere $17 billion. By the end of 2008, it was approaching $400 billion.

As exports expanded, the authorities in Beijing consistently bought dollars to avoid appreciation of their currency. China's currency interventions served two goals: first, to promote export competitiveness, since export industries provided rapid productivity gains as well as new jobs and income; second, to build up reserves as a cushion against the risks associated with increasing financial integration, painfully illustrated by the experience of other countries in the 1997-8 Asian Crisis.

The historical record has shown time and again that policies of real exchange rate undervaluation can be sustained for a long time without generating the inflationary pressures predicted in economic theory. In a standard macroeconomic model, exchange rate intervention should lead to monetary expansion, which in turn drives up domestic prices, nullifying the real effect of intervention. China's financial system, however, is owned and managed by the government. Capital controls are in place for most non-FDI capital flows. Sterilization and bank lending policies are governed by decree, so that the government can force banks to buy trillions of low-yielding renminbi sterilization bonds or alter their reserve ratios. Deposit and lending rates are also set by the government. This has allowed China to intervene in the forex market while retaining control over domestic monetary aggregates.

2. Chimerica and the Crisis

Chimerica worked—for China. But the unintended consequence of sustained currency intervention was a vast accumulation of dollar-denominated securities in the reserves of the People's Bank of China and the State Agency for Foreign Exchange (SAFE). Already by 2000 China had currency reserves of $165 billion, slightly above 10 per cent of GDP. By the end of 2009 currency reserves had reached $2.4 trillion, equivalent to more than 50 per cent of China's annual output.

This unprecedented accumulation of reserves opened up a Pandora's box of financial distortions. Chinese purchases of U.S. Treasuries kept their prices above and hence their yields below where they would otherwise have been. Lower long-term interest rates enabled American households to increase consumption levels and widened the gap between savings and investment. And, because foreign savings were predominantly channeled through government (or central bank) hands into safe assets such as Treasuries, private investors turned elsewhere in search of higher yields. This encouraged financial engineers to develop new financial products such as collateralized debt obligations.

This is not to say that reserve accumulation was the only cause of the financial crisis that began in the summer of 2007. Beijing cannot be blamed for the reckless lending and borrowing engaged in by Western financial institutions, nor for the sins of omission of policy-makers and regulators. Yet had it not been for the Chinese willingness indirectly to fund America's consumption and real estate speculation, long-term interest rates in the United States would almost certainly have been higher, reducing the size of the housing bubble.

3. Export-led Growth and Reserve Accumulation in Perspective

An export-centered growth strategy is nothing new. After all, Western Europe and Japan as well as South Korea and Taiwan all successfully pursued similar strategies. In all cases, productivity gains coupled with wage restraint led to the rapid development of a manufacturing sector focused on foreign markets. Rising corporate profits financed rising investment, which in turn supported manufacturing capacity and productivity. For some commentators, the resemblance between these earlier growth strategies and modern China's was so close that it was legitimate to refer to "Bretton-Woods II", referring to the pre-1971 system of pegged exchange rates and capital controls.

At first sight, the analogy is indeed close. In terms of gross domestic product measured in current dollars, both West Germany and Japan in the 1960s were about 10-15 per cent of size of the United States. China's economy in the year 2000 was also about 12 per cent of the size of the U.S. economy (though it is much bigger on the basis of purchasing power parity). However, there the resemblances end.

At the height of post-war growth in the 1960s, West Germany and Japan grew their dollar reserves in line with U.S. GDP, keeping the ratio stable at about 1 per cent before moving slightly higher in the early 1970s when capital flows and valuation gains led to an increase. On a yearly basis, reserve accumulation was about 1 per cent of GDP on average in Germany, and not even 0.5 per cent in Japan. By contrast, a dramatic shift in Chinese reserve accumulation occurred in the early 2000s. Starting at a level of dollar reserves equivalent to about 1 per cent of U.S. GDP in 2000, China's reserves reached 5 per cent of U.S. GDP in 2005, rising to 8 per cent in 2007 and finally reaching about 10 per cent in 2008. At the end of 2009, China's dollar reserves are likely to be equivalent to 12 per cent of U.S. GDP, compared to about 1 per cent a decade ago.

Moreover, both West Germany and Japan did not resist currency appreciation in the way that China has. Between 1960 and 1978, for example, the deutsche mark appreciated cumulatively by almost 60 per cent against the dollar, while the Japanese yen appreciated by almost 50 per cent. One key lesson from post-war history is that exporters can live with substantial exchange rate revaluations when major gains in productivity are being achieved.

4. The Real Exchange Rate adjusted for Unit Labor Costs

By how much is the Chinese currency undervalued? Estimates for the undervaluation range widely from zero to 50 per cent depending on the methodology adopted. In our view, the most illuminating approach focuses on the unit labor cost based real exchange rate between the renminbi and the dollar. Unit labor costs are defined as the cost of the labor inputs (total wages) needed to produce a unit of output. If these productivity gains (relative to the productivity gains abroad) are not reflected in proportionate exchange rate changes, the economy will gain in competitiveness and more production will be relocated to the cheaper currency area. We find that, while wages and employment in China have grown rapidly in recent years, the increase in output has been even faster thanks to rapid productivity gains. Chinese unit labor costs fell in eight out of last nine years, sometimes substantially. Chinese unit labor costs today are about 40 per cent lower than in 1998, while the nominal exchange rate has only appreciated by 15 per cent, leaving a net gain in wage competitiveness of 25 per cent. Despite some modest currency adjustment, in other words, manufacturing production today in China is much cheaper in dollar terms than it was eight years ago.

5. The Case for Chinese Currency Adjustment

The Chimerican era is drawing to a close. After the bursting of the debt and housing bubbles, U.S. household savings are rising again. Washington has sought to buffer this necessary adjustment by running sizeable budget deficits. Public dis-saving can temporarily compensate for higher private savings to maintain final demand, but the American consumer still faces a lengthy adjustment period and will ultimately also have to pay the bill for today's deficits. Meanwhile, Beijing's response to the collapse in global demand has been to loosen credit and pump money into domestic construction and infrastructure projects. In the first six months of 2009 the government in Beijing ordered the banks to make new loans of close to 10 trillion renminbi or about 40 per cent of GDP. Here, too, stimulating domestic demand was the right short-run policy response.

But while these policies may have averted a second Great Depression, they do not constitute a sustainable answer to the problem of global imbalances. On the contrary, the U.S. trade deficit is widening again, and although China's trade surplus has been somewhat reduced (mainly as a result of increased imports from its Asian neighbors) it is hard to believe—as some claim—that is going to disappear altogether this year. As long as Chinese exchange rate policy implicitly taxes consumption and subsidizes exports, China's surpluses will surely persist. These leads some people in both China and America to hope for a return to the status quo ante. But this is an illusion.

In the depressed conditions caused by the financial crisis, China's dollar peg poses a quadruple threat. First, it limits U.S. recovery by overvaluing the dollar in key Asian markets and therefore artificially raising the price of U.S. exports. (In theory, to be sure, the United States could deflate to regain competitiveness against Asia, but deflation is out of the question for such a highly leveraged economy.) Secondly, with inflows of hot money straining the system of sterilization to breaking point, the renminbi-dollar peg is now contributing to a dangerous overheating of China's economy; appreciation of the currency would complement the recent increases in bank reserve requirements, helping to cool down the rampant over-investment in manufacturing capacity and urban real estate. Thirdly, renminbi undervaluation risks unleashing either a protectionist backlash or a rash of "currency wars" as the world's major fiat currencies jockey for competitive advantage. Fourthly, every additional dollar of reserves increases the potential cost of revaluation to China's monetary authorities, making a change of policy even less attractive.

Proponents of the Chimerican status quo make the following arguments. First, revaluation would seriously slow the Chinese economy in the absence of other major changes in Chinese economic policy—such as the creation of a modern welfare state, which some believe would encourage the Chinese to save more and spend less. We think such changes are indeed highly desirable; revaluation needs to be part of a package designed to reduce China's trade surplus.

Another argument for the status quo is that the United States needs China to continue acting as a source of cheap finance for its explosive fiscal deficit. However, China may already be winding down its accumulation of Treasuries. According to recent estimates, China lent just 4.6 per cent of the money the U.S. government raised in 2009. That compared with 20.2 per cent in 2008 and a peak of 47.4 per cent in 2006. Indeed, China appears to have been a net seller of Treasuries in recent months. But the removal of this prop for U.S. bond prices is also very welcome. It is high time American legislators began steering a course back to fiscal balance over the next decade, instead of imagining that the federal government can run trillion-dollar deficits for the rest of time.

Nothing would focus minds better on the urgency for fiscal reform than significant (say, 200 basis points) upward movement in nominal ten-year yields.

Finally, there is no need for Americans to fear some kind of overnight loss of reserve currency status by the dollar. Even if China adopted full capital account convertibility at some point in the next five years, history shows that it would take many decades for the renminbi to displace the dollar in the majority of international transactions. Path dependence means that transitions from one international reserve currency regime tend to lag behind changes in the geopolitical balance of power.

Conclusion

The world economy's most glaring structural imbalance today is that the second biggest economy in the world has pegged its currency to that of the largest economy at a strongly undervalued rate. There is no point pretending that this is not "currency manipulation", and in its April 15 report the U.S. Treasury should call a spade a spade. A renminbi revaluation would help both sides. By stimulating U.S. exports it would allow a quicker exit from the unsustainable policies currently being implemented by the Fed and the Treasury. It would also solve at a stroke the problem of China's excessively large international reserves and dollar exposure, while at the same time accelerating the necessary shift from the export sector to the consumer sector as the engine of China's growth. In short, revaluation would warm up the U.S. economy and cool down the Chinese. Moreover, as we have seen, history is on the side of revaluation. The lesson of German and Japanese history is that rapidly growing exporters can live with significant exchange rate appreciation when major gains in productivity are being made, as they clearly are in this case.

The question remains how best to persuade the Chinese to follow the German and Japanese example. Some critics of China have for some time been calling for retaliatory tariffs to force China to end its "currency manipulation". Others point to the effectiveness of the import surcharge imposed by the Nixon administration in 1971, which encouraged the Germans and Japanese to revalue their currencies upwards against the dollar. And, of course, the threat of tariffs was sufficient to prompt Chinese revaluation in 2005.

The situation today is very different, however. As an historian, I feel very uneasy about any steps in the direction of protectionism at a time of such economic fragility. I am even more worried about a race to the bottom among fiat currencies, as countries other than the U.S. try to relieve the pressure on their own manufacturers by letting their currencies slide against the dollar and renminbi. Last year, for example, Brazil imposed a tax on "hot money"—large, volatile flows of foreign investment that may exit an economy as quickly as they appeared—to try to slow the appreciation of its currency, the real. In Europe not everyone is sorry that the "Greek tragedy" of recent months has caused the euro to weaken. Similar competitive devaluations were a feature of the worst economic decade of the twentieth century, the 1930s. It goes without saying that not everyone can simultaneously have a weak currency.

It is for these reasons that I would urge the United States to pursue currency realignment on a multilateral rather than solely on a bilateral basis, using the G20 rather than just a Sino-American "G2" as the appropriate forum. After all, we should not fetishize the renminbi-dollar exchange rate.[6] The U.S. trade deficit is growing again not only because of China but also because of relatively high oil prices. The rise of China as an exporter of manufacturers has probably hurt other Asian exporters as much as, if not more than, it has hurt the United States. And if China were to increase its imports, the United States would not be the principal beneficiary.

Finally, there is good reason to doubt that the Chinese leadership will respond positively to pressure from the United States in the form of tariffs, even if these were wholly justified under International Monetary Fund and World Trade Organization rules. As Premier Wen Jiabao's recent statements on the subject have made clear, Beijing is in a more combative mood than it was five years ago, before the global financial crisis took the shine off the "Washington Consensus". And recent dollar strength should not lead is to forget that the longer-term trend has been for the dollar to depreciate relative to other currencies. Indeed, we have now lived through four significant periods of dollar weakness since the end of the Bretton Woods system.

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[6] Here I find myself more in agreement with Stephen Roach, "Consumer-Led China", Morgan Stanley Research Paper, March 22, 2010, than with Paul Krugman, "Taking On China", *New York Times*, March 14, 2010.

It is not by chance that one of the best-selling works of economic history in China in recent years was *Currency Wars* by Song Hongbing. An excessively confrontational approach by the United States would only confirm the thesis of that book and might also contribute to a deterioration of Sino-American relations, the costs of which to financial market confidence might significantly outweigh the benefits of any revaluation that might be forthcoming.

Harvard University, March 22, 2010

Chairman LEVIN. Thank you. That was a Congressional eight minutes. Dr. Bergsten, do your best for five minutes if you would.

There is so much interest here, we have almost a full Committee in attendance.

Dr. Fred Bergsten. Welcome.

STATEMENT OF C. FRED BERGSTEN, PH.D., DIRECTOR, PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS

Mr. BERGSTEN. Thank you, Mr. Chairman. It is a great pleasure to be back.

I want to make six analytical points and suggest a three-part action program for the United States to deal with the problem.

First, the Chinese renminbi is undervalued by about 25 percent on a trade-weighted basis and about 40 percent against the dollar. That is on the basis of at least a dozen studies done at my institute and elsewhere. It is well established, and, if anything, a conservative number.

Second, the Chinese authorities buy about $1 billion of dollars every day in the exchange markets. They sell their local currency and buy dollars. That keeps the price of the local currency cheap and undervalued in the exchange markets to maintain an artificially strong competitive position.

It is very important to keep in mind that several of the neighboring Asian countries, Hong Kong, Singapore, Taiwan, and Malaysia, peg themselves de facto to the RMB. So it is not just China that is competitively undervalued, a lot of Asia is as well, and when you add the others, it almost doubles the ante in terms of global trade effects and impact on the United States.

Third, this competitive undervaluation of the Chinese currency and the currencies of its neighbors is a blatant form of protectionism. It subsidizes all Chinese exports by the amount of the undervaluation, 25 to 40 percent. It equates to a tariff of 25 to 40 percent on all of those Asian imports, sharply discouraging purchases from other countries.

It would thus be incorrect, and I echo you, Mr. Chairman, to characterize as protectionist a policy response to Chinese actions by the U.S. or other countries. Such actions, if skillfully chosen and properly carried out, should in fact be viewed as anti-protectionist.

Fourth, China's global current account surplus soared to almost $400 billion, exceeded 11 percent of its GDP two years ago, an unprecedented imbalance for the world's largest exporting country and second largest economy.

Its surplus, of course, dropped sharply during the recession, but the IMF has forecast that the number is going up again and by 2014 will exceed $700 billion and actually be bigger than the U.S. global current account deficit.

This problem is not about to go away. If anything, it looks like it is getting bigger.

Fifth, China's exchange rate policy violates all relevant international norms. Article IV, Section I (iii) of the IMF commits member countries to avoid manipulating exchange rates "in order to prevent effective balance of payment adjustments or to gain unfair competitive advantage over other members."

Another IMF principle for Fund Surveillance over Exchange Rate Policies rules out protracted large-scale intervention in one direction in the exchange markets, exactly what China has been doing for seven years.

Article XV of the in the World Trade Organization says: “Contracting parties shall not by exchange action frustrate the intent of the provisions of this agreement.”

China is violating all the international norms and rules.

Sixth, the competitive undervaluation of the RMB and the neighboring Asian currencies does have—and here I differ with Niall Ferguson—a substantial impact on the United States.

We have studied this very carefully. China needs an appreciation of 25 to 40 percent even to bring its global current account surplus down to 3 percent of its GDP, which would be $150 billion to $200 billion—still pretty high.

The U.S. global current account deficit would be cut by somewhere between $100 billion and $150 billion per year. That is a lot of money. It is not our whole deficit, which is now on the order of $500 billion, but it would take something like a quarter to a third off it.

If we use the number that the president and the administration have been using—6,000 jobs per billion dollars of exports—the correction in our trading balance due to Chinese revaluation would save or create 600,000 to 1.2 million U.S. jobs.

I agree with Niall Ferguson that Paul Krugman’s number is a little high, but I think the numbers would be very substantial.

The U.S. economy is not a full employment economy. It has 10 percent unemployment. There is plenty of un-utilized capacity. A lower dollar in response to a higher RMB would not mean inflation pressure, it would not mean crowding out; it would in fact mean more U.S. jobs, mainly high-paying manufacturing jobs.

Since the budget cost of this action is zero, revaluation of the Chinese and other Asian currencies is the most cost-effective step that could now be taken to reduce unemployment in the United States.

It certainly would be the most important part of the president’s national export initiative.

The case for a substantial increase in the RMB and the other Asian currencies is clear and overwhelming.

I suggest a three-part strategy to achieve it. First, I agree with Niall Ferguson that Treasury should absolutely designate China as a “currency manipulator” in its report on April 15.

The fact that the United States has been unwilling to apply the law of the land and call a spade a spade for at least five years has undermined any U.S. effort to get an effective multilateral approach to the problem.

I agree with you, Mr. Chairman. The basic thrust has to be multilateral, but the U.S. has no credibility seeking that unless it is willing to be honest itself, follow the law of the land, and designate China a “manipulator.”

That would be step one, but, I would also take two major new multilateral initiatives. I would go to the IMF and seek agreement—it requires a simple majority of the weighted vote—to dispatch the managing director to Beijing on what is called in IMF parlance “a special consultation” or an “ad hoc consultation” to seek

Chinese agreement to move the currency up. If they do not do it, then one can go to the Executive Board for a vote.

The third step in the process is to go to the World Trade Organization. The United States has the right to seek a dispute settlement panel to look at China's obligations under the WTO that I cited before and ask for it to be declared a "violator" under the WTO rules.

Final point, Mr. Chairman.

In my experience, and here I differ a little bit with the historian, no country that has run large trade surpluses and had an undervalued currency has ever been willing to correct itself without external pressure. That pressure may come from the markets, but the Chinese block that through capital controls, or from other governments through political steps.

President Nixon and John Connally had to break a lot of crockery back in 1971 to get the initial revaluation of the European currencies and the Japanese yen.

Jim Baker went to the Plaza Agreement in 1985 on the basis of two bills passed by the U.S. House of Representatives that would have caused great pain to our trading partners had they not agreed to correct the currency imbalances of that period.

I am afraid it is going to have to be external pressure again. The Chinese say they will never move in response to external pressure. I suggest they will never move without external pressure. If we do it skillfully, multilaterally and thoughtfully, we can fashion an effective strategy.

[The prepared statement of Mr. Bergsten follows:]

CORRECTING THE CHINESE EXCHANGE RATE: AN ACTION PLAN

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

before the
Committee on Ways and Means
US House of Representatives

March 24, 2010

The Problem

The Chinese renminbi (RMB) is undervalued by about 25 percent on a trade-weighted average basis and by about 40 percent against the dollar.[2] The Chinese authorities buy about $1 billion daily in the exchange markets to keep their currency from rising and thus to maintain an artificially strong competitive position. Several neighboring Asian countries of considerable economic significance – Hong Kong, Malaysia, Singapore and Taiwan – maintain currency undervaluations of roughly the same magnitude in order to avoid losing competitive position to China.

This competitive undervaluation of the RMB is a blatant form of protectionism. It subsidizes all Chinese exports by the amount of the misalignment, about 25 – 40 percent. It equates to a tariff of like magnitude on all Chinese imports, sharply discouraging purchases from other countries. It would thus be incorrect to characterize as "protectionist" a policy response to the Chinese actions by the United States or other countries; such actions should more properly be viewed as anti-protectionist.

Largely as a result of this competitive undervaluation, China's global current account surplus soared to almost $400 billion and exceeded 11 percent of its GDP in 2007, an unprecedented imbalance for the world's largest exporting country and second largest economy. China's global surplus declined sharply during the Great Recession, as its foreign markets weakened, but it

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[1] C. Fred Bergsten has been Director of the Peterson Institute for International Economics since its creation in 1981. He was formerly Assistant Secretary of the Treasury for International Affairs (1977-81) and Assistant for International Economic Affairs to the National Security Council (1969-71). His 40 books include *The Long-Term International Economic Position of the United States* (2009), *China's Rise: Challenges and Opportunities* (2008), *China: The Balance Sheet - What the World Needs to Know Now about the Emerging Superpower* (2006), and *The Dilemmas of the Dollar: The Economics and Politics of United States International Monetary Policy* (2nd edition, 1996).

[2] William R. Cline and John Williamson, "2009 Estimates of Fundamental Equilibrium Exchange Rates," Peterson Institute for International Economics, 2009, Policy Brief 09-10 and Morris Goldstein and Nicholas R. Lardy. July 2009. *The Future of China's Exchange Rate Policy*. Policy Analyses in International Economics 87, Washington: PIIE. The Cline-Williamson estimates are quite conservative because they aim only to reduce China's global surplus to 3-4 percent of its GDP on the view that such levels would be consistent with a sustainable global equilibrium; their estimate of the RMB undervaluation would of course be much greater if the goal were to fully eliminate the country's external surplus, which would be quite reasonable for a developing country that already has accumulated $2.5 trillion of foreign exchange reserves.

remained above 5 percent of China's GDP (almost $275 billion) even in 2009. The International Monetary Fund estimates that the surplus is rising again and, at current exchange rates, will exceed the global deficit of the United States by 2014.[3] In a world where high unemployment and below-par growth are likely to remain widespread for some time, including in the United States, China is thus exporting very large doses of unemployment to the rest of the world – including the United States but also to Europe and to many emerging market economies including Brazil, India, Mexico and South Africa.[4]

China's exchange rate policy violates all relevant international norms. Article IV, Section 1 of the Articles of Agreement of the International Monetary Fund commits member countries to "avoid manipulating exchange rates or the international monetary system in order to prevent effective balance-of-payment adjustment or to gain unfair competitive advantage over other member countries." Moreover, the principles and procedures for implementing the Fund's obligation (in Article IV, Section 3) "to exercise firm surveillance over the exchange rate policies of members" call for discussion with a country that practices "protracted large-scale intervention in one direction in exchange markets" – a succinct description of China's currency policy over the past seven years. Article XV(4) of the General Agreement on Tariffs and Trade (GATT), which is now an integral part of the World Trade Organization, similarly indicates that "Contracting parties shall not, by exchange action, frustrate the intent of the provisions of this Agreement."

Huge current account imbalances, including the US deficit and the Chinese surplus, of course reflect a number of economic factors (national saving and investment rates, the underlying competitiveness of firms and workers, etc.) other than exchange rates. Successful international adjustment of course requires corrective action by the United States, particularly with respect to its budget deficit and low national saving rate, and other countries as well as by China. But it is impossible for deficit countries to reduce their imbalances unless surplus countries reduce theirs. And restoration of equilibrium exchanges rates is an essential element of an effective global "rebalancing strategy" as agreed by the G-20 over the past year.[5]

The competitive undervaluation of the Chinese RMB and several neighboring Asian countries has a very substantial impact on the United States. As noted, an appreciation of 25-40 percent is needed to cut China's global surplus even to 3-4 percent of its GDP. This realignment would produce a reduction of $100 – 150 billion in the annual US current account deficit.[6]

Every $1 billion of exports supports about 6,000 – 8,000 (mainly high-paying manufacturing) jobs in the US economy. Hence such a trade correction would generate an additional 600,000 –

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[3] Olivier Blanchard and Gian Maria Milesi-Ferretti, March 18, 2010 "Global Imbalances: In Midstream?", Washington: IMF, Table 7.
[4] Note that I make no reference to the United States – China bilateral trade imbalance in this statement. Bilateral balances are irrelevant in a world of multilateral trade. It should be noted, however, that China's global surplus exceeded one half of the US global deficit in 2007 and, as noted in the text, is on a trajectory to exceed it by 2014.
[5] The best analysis of the needed Chinese component of this strategy can be found in Nicholas Lardy, "China: Rebalancing Economic Growth," Chapter 1 in Center for Strategic and International Studies and Peterson Institute for International Economics, *The China Balance Sheet in 2007 and Beyond*, May 2007.
[6] William R. Cline and John Williamson, "2009 Estimates of Fundamental Equilibrium Exchange Rates," Peterson Institute for International Economics, 2009, Policy Brief 09-10 show that the Asian undervaluations equate to a trade-weighted overvaluation of about 6 percent of the dollar. Every 1 percent dollar overvaluation leads to a deterioration of $20-25 billion in the US current account balance so correction of the Asian misalignments would strengthen the US position by $120 – 150 billion over the succeeding two to three years.

1,200,000 US jobs. Correction of the Chinese/Asian currency misalignment is by far the most important component of the President's new National Export Initiative. As its budget cost is zero, it is also by far the most cost-effective step that can be taken to reduce the unemployment rate in the United States.

China did let its exchange rate appreciate gradually from July 2005 until the middle of 2008 (and rode the dollar up for a while after it re-pegged in the fall of 2008). During that time, the maximum increase in its trade-weighted and dollar values was 20-25 percent (which represented good progress although it still left an undervaluation of roughly a like amount at that time). It has since depreciated again significantly, riding the dollar down, so that its net rise over the past five years is only about 15 percent. Moreover, despite China's declared adoption of a "market-oriented" exchange rate policy in 2005, its intervention to block any further strengthening of the RMB against the dollar is about twice as great today ($30 – 40 billion per month) as it was then ($15 – 20 billion per month); on that metric, China's currency policy is now about half as market-oriented as it was prior to adoption of the "new policy."

The present time is highly opportune for China to begin the process of restoring an equilibrium exchange rate. The Chinese economy is booming, indeed leading the world recovery from the Great Recession (and China deserves great credit for its effective crisis response strategies). Inflation is now rising and the Chinese authorities have begun to take monetary and other measures to avoid renewed overheating; currency appreciation would be an effective and powerful tool to this end by lowering the price of imports and dampening demand for exports.[7] Appreciation of the RMB at this time would in fact serve both the internal and external policy objectives of the Chinese authorities, as part of their long-stated intention and international commitment to rebalance the country's economic growth away from exports and toward domestic (especially consumer) demand.

An Action Plan

The case for a substantial increase in the value of the RMB is thus clear and overwhelming. Some observers believe that China is in fact preparing to shortly renew the gradual appreciation of mid-2005 to mid-2008 (5 – 7 percent per year) or even to announce a modest (5-10 percent) one-shot revaluation (with or without resuming the upward crawl in addition). On the other hand, Premier Wen Jiabao recently denied that the RMB was undervalued at all and accused other countries (!) of seeking to expand exports and create jobs by unfairly depreciating their exchange rates.[8]

Unfortunately, the two preferred strategies for promoting Chinese action – sweet reason and implementation of the multilateral rules, especially in the IMF – have to date had limited success. Both efforts should continue, however, and it is particularly important that any stepped-up initiatives toward China be multilateral in nature. The Chinese are much more likely to respond positively to a multilateral coalition rather than bilateral pressure from the United States, especially if that coalition contains a number of emerging market and developing economies whose causes the Chinese frequently claim to champion. Moreover, the multilateral efforts have been half-hearted at best and

[7] China effectively sterilizes most of the monetary effect of its exchange-market intervention so the large capital inflow and upward pressure on the RMB do not have any of the usual inflationary (and hence real currency appreciation) impact.
[8] This was apparently the first time that a high Chinese official has asserted that there is no RMB undervaluation, a substantial step backward if correct.

it is especially important for the United States to exhaust that route before contemplating more severe unilateral steps.

Much of the blame for this failure of policy to date falls on the US Government, which has been unwilling to label China the currency manipulator that it has been so clearly for a number of years. The unwillingness of the United States to implement the plain language of the Trade Act of 1988 has substantially undermined its credibility in seeking multilateral action against China in the IMF, the WTO, the G-20 or anywhere else. A sensible and effective strategy must begin by reversing that feckless position.

Hence I would recommend that the Administration adopt a new three-part strategy to promote early and substantial appreciation of the exchange rate of the RMB:

1. Label China as a "currency manipulator" in its next foreign exchange report to the Congress on April 15 and, as required by law, then enter into negotiations with China to resolve the currency problem.[9]

2. Hopefully with the support of the European countries, and as many emerging market and developing economies as possible, seek a decision by the IMF (by a 51 percent majority of the weighted votes of member countries) to launch a "special" or "ad hoc" consultation to pursue Chinese agreement to remedy the situation promptly. If the consultation fails to produce results, the United States should ask the Executive Board to decide (by a 70% majority of the weighted votes) to publish a report criticizing China's exchange rate policy.[10]

3. Hopefully with a similarly broad coalition, the United States should exercise its right to ask the World Trade Organization to constitute a dispute settlement panel to determine whether China has violated its obligations under Article XV ("frustration of the intent of the agreement by exchange action") of the WTO charter and to recommend remedial action that other member countries could take in response. The WTO under its rules would ask the IMF whether the RMB is undervalued, another reason why it is essential to engage the IMF centrally in the new initiative from the outset.[11]

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[9] It would be desirable to also label the four other Asian economies that clearly manipulate their exchange rates to maintain a close relationship to the RMB: Hong Kong, Malaysia, Singapore and Taiwan. They should in fact be covered by all elements of the recommended three-part strategy. However, including them would complicate the strategy considerably and deflect attention away from China as the central actor (and Taiwan, the most important in economic terms, is not a member of the IMF). It can be safely assumed that all four will let their currencies follow the RMB upward, however, so success in achieving its appreciation should take care of the others more or less automatically and should suffice. Alternatively, they could get together (perhaps with other countries in the region) to work out an "Asian Plaza" agreement that would realign exchange rates among them.

[10] These procedures are spelled out in detail by Morris Goldstein, the former Deputy Director of the Research Department of the Fund, in "The IMF as Global Umpire for Exchange Rate Policies," in Michael Mussa, ed, *C. Fred Bergsten and the World Economy*, Washington: PIIE, 2006, esp. pp. 330 – 331. See also the extensive discussion by Mussa, the chief economist of the Fund for 10 years (1991 – 2001), in "IMF Surveillance over China's Exchange Rate Policy" in Morris Goldstein and Nicholas Lardy, eds, *Debating China's Exchange Rate Policy*, Washington: PIIE, 2008, esp. pp. 328 – 332. These procedures need to be strengthened, as argued by both Goldstein and Mussa, but those presently in place will have to suffice in dealing with the current problem.

[11] The Managing Director of the IMF has repeatedly stated, most recently in a major speech to the European Parliament last week, that the RMB is "substantially undervalued." Hence the required advice should be readily forthcoming.

A three-pronged initiative of this type would focus global attention on the China misalignment and its unwillingness to initiate corrective action to date. The effort would have maximum impact if it could be undertaken by the United States in concert with countries that constituted a substantial share of the world economy, including emerging market and developing economies as well as the Europeans and other high-income nations. Asian countries, such as Japan and India, will be skittish in confronting China in this way but are hit hard by the Chinese undervaluation and should be increasingly willing to join the coalition as its size grows.

The objective of the exercise is of course to persuade, or "name and shame," China into corrective action. Unfortunately, the IMF has no sanctions that it can use against recalcitrant surplus countries.[12] Hence the WTO, which can authorize trade sanctions against violations of its charter, needs to be brought into the picture from the outset.[13] Unfortunately, there are technical and legal problems with the WTO rules too (like the IMF rules) so they may also need to be amended for future purposes.[14]

The United States could of course intensify its initiative by taking unilateral trade actions against China. For example, the Administration could decide that the undervaluation of the RMB constitutes an export subsidy in determining whether to apply countervailing duties against imports from China. Congress could amend the current countervailing duty legislation to make clear that such a determination is legal. In either case, China could appeal to the WTO and the United States would have to defend its actions under the Subsidy Code.[15]

Countervailing duties and other product-specific or sector-specific steps, such as the Section 421 case on tires last year or traditional Section 201 safeguard cases, are basically undesirable, however, because they distort and disguise the across-the-board nature of the Chinese currency misalignment.[16] These measures are intended to address problems that are unique to a particular product or sector rather than affecting trade and the economy as a whole. As noted above, China's competitive undervaluation represents a subsidy to all exports and a tariff on all imports. Hence it requires a comprehensive response via the exchange rate itself since there is no good alternative. A US effort that encompasses unilateral, IMF and WTO dimensions to that end is likely to be the most effective strategy we can undertake at this time.

[12] It can of course withhold funding from recalcitrant deficit countries, like Greece at present, that need both to borrow from it directly and to receive its blessing for adjustment policies that will permit them to resume borrowing in private capital markets.

[13] The entire range of WTO options are described and analyzed in Gary Clyde Hufbauer, Yee Wong and Kekti Sheth, August 2006. *US-China Trade Disputes: Rising Tide, Rising Stakes*: Policy Analyses in International Economics 78, Washington DC, Peterson Institute for International Economics.

[14] As proposed by Aaditya Mattoo and Arvind Subramanian, "Currency Undervaluation and Sovereign Wealth Funds: A New Role for the World Trade Organization," Peterson Institute for International Economics, 2008, Working Paper 08-02.

[15] Any new legislation on this issue should require that the Treasury Department make the exchange rate calculations and that the United States withdraw its cases if they are rejected by the WTO Dispute Settlement Mechanism.

[16] There are likewise a number of China's trade and industrial policies of current concern, most notably of late under the heading of its National Indigenous Innovation Policy and particularly including protection of intellectual property rights, that are product-specific or sector-specific and need to be addressed via policy actions of that type rather than the across-the-board measures discussed here in the currency context.

Chairman LEVIN. Thank you very much.
Clyde Prestowitz, welcome.

STATEMENT OF CLYDE V. PRESTOWITZ, JR., PRESIDENT, THE ECONOMIC STRATEGY INSTITUTE

Mr. PRESTOWITZ. Thank you, Mr. Chairman. It is an honor and a pleasure to be back.

Looking at my "yes" to Niall Ferguson and Fred Bergsten, yes, China is manipulating its currency. Yes, it is in violation of commitments to the IMF, to the World Trade Organization, and to the United States. Yes, it is harmful.

It is harmful to many developing countries. Mexico being high on the list. It is also harmful to the United States.

Fred has pointed out estimates of increased unemployment in the U.S. as a result of China's distortion of the markets. I would take it even further. I think that we have to look at the impact of the currency management not just in terms of trade but also in terms of investment.

Companies make long term investment decisions on where to place factories. If they anticipate that a currency is going to be chronically undervalued, the tendency, particularly in the case of China, is going to be for them to locate their new investments in China, so this has an impact not only on employment but also on technology development and on the placement of capital investments.

None of this is even in dispute. Virtually all analysts and economists who look at these numbers come to pretty much the same conclusions.

I would just add that China is not alone. Japan pioneered this development model of export led growth fostered particularly by undervalued currencies, and there are a number of other countries that are currently participating or pursuing the same models.

Nor is currency undervalue the only element in the model. Another very important aspect of it is subsidization of investment. For example, companies like Intel that have recently invested in China have calculated that because of the tax rebates, because of the capital grants and other financial investment inducements, they are able to save as much as $1 billion over the lifetime of an investment.

The financial investment incentives are twined with the currency under valuation to create a powerful incentive to move investment, technology and jobs out of the U.S. and out of Europe and out of other countries.

What to do? First, I agree with Fred Bergsten that in my experience, which is about as long as his, no country that has been running a trade surplus has voluntarily agreed to take steps to reduce it unilaterally. It typically takes pressure from the outside and I am sure it will also in the case of China.

Certainly, the initial thrust of any U.S. response needs to be multilateral. I agree, in fact, I would say in terms of the immediate question, should China be labeled a "currency manipulator," I do not see how the President can avoid doing so. Everybody knows that China is manipulating its currency. If the President fudges that, he looks weak and dishonest. I do not see how he can really avoid that.

Having said that, once he does it, where do we go? Obviously, first steps are to the IMF, to the WTO, in pursuit of persuading

China to observe the agreements that it has already made in those bodies.

I think we have to be realistic and anticipate those could be very difficult discussions, and they might not go anywhere, or they might not go anywhere very quickly.

I think it is also important to anticipate that China might respond by some nominal revaluation of its currency. A revaluation of three, four, five percent might be presented as flexibility on the part of China, but it would have no real significance in terms of the distortion of the markets that we are talking about.

I think we have to think very seriously about not only the time period but the size of revaluation or readjustments we are talking about, and I think we have to think not only about China but we have to think about the other countries that are involved in this restructuring, let's say, of globalization.

A second step here is to think about things that we can do that we should be doing ourselves. Mr. Camp talked about steps that we need to take domestically to become more competitive. I wholeheartedly agree with that.

I would add one very important point. Let me come back to this issue of financial investment incentives.

Chairman LEVIN. Mr. Prestowitz, if you could do that quickly. I have been told we are going to have votes in about an hour.

Mr. PRESTOWITZ. My last point is that the United States can and in my view should establish a war chest to match the investment incentive offers of countries like China and others who are using tax holidays and capital grants to induce investments that otherwise would not be made.

Thank you.

[The prepared statement of Mr. Prestowitz follows:]

Testimony of Clyde Prestowitz
President, Economic Strategy Institute

March 24, 2010

Chairman Levin, Ranking Member Brady, and members of the subcommittee on trade, thank you for the opportunity to speak to you this morning. My name is Clyde Prestowitz, President of the Economic Strategy Institute.

In answer to the question of whether or not China is manipulating its currency, the answer is, of course, that it is doing so by intervening constantly in currency markets to maintain the nominal value of the Renminbi (RMB) at a fixed rate to the dollar. Such action does not make China unique. A number of other countries (Saudi Arabia for example) also peg their currencies to the dollar and also intervene from time to time in currency markets to maintain those pegs, and their actions do not attract much attention.

What makes the China case such an important issue is the same factor that made Japan's currency policies so contentious in the 1980s. The currency manipulation is only one aspect of an economic development strategy that emphasizes export led growth. Countries that pursue this strategy attempt to achieve the economies of scale beyond those arising from supplying their domestic markets by expanding production capacity to supply foreign markets as well. The strategy typically entails strong incentives and even compulsory measures to assure high savings rates, high rates of investment in so called strategic, export industries (typically steel, machinery, electronics, aerospace, chemicals, textiles, and autos), a variety of subsidies for exports, currencies that are kept undervalued in order to provide an indirect subsidy to exports, and various constraints on imports and foreign participation in domestic markets. The objective of these strategies is not only to achieve strong exports, but also to realize continuous current account surpluses and to accumulate large dollar reserve holdings. These policies typically result in huge global imbalances and are essentially "beggar thy neighbor" in their impact on other countries. It is important to understand that it is this latter element that leads to discontent, international friction, and demands for a response. Commentators often discuss the trade deficits and attribute trade frictions to the size and chronic nature of such trade deficits. But the truth is that we have trade deficits with countries (like the oil producers) with whom we have no trade frictions. It is not the deficits, per se, that are the problem. Rather it is market distortions and predatory displacement of industries that arise in strategic trade situations that give rise to dissatisfaction and complaints. And this would be true even if we had trade surpluses with China and other strategic trading countries. The issue is not imbalances. Rather, it is strategic trade or what some might call mercantilism.

A large majority of analysts and commentators agree that China has long been pursuing strategic trade and globalization policies and that part of this has been and is an effort to keep the RMB undervalued as a subsidy to exports. It is further agreed that this currency undervaluation has proved economically beneficial to China's export industries while also proving harmful to the economies of a number of other countries including that of the United States. Our trade balance, our international debt, the continuing erosion or our industrial output – these are all important economic issues that can be in some way at least partially linked to China's currency manipulation and its broader strategic export and development strategies. Interestingly, the Japanese example indicates that these policies are eventually likely to be harmful to China as well. . China is still a developing country, and needs to cultivate domestic demand and promote sustainable growth. The continued policy of an artificially devalued yuan is not in China's best interests. Greater exchange rate flexibility will help reinforce a shift in the composition of growth, and allow them to weather fluctuations in global supply and demand.

The problem, however, is far bigger than China's currency, and let's be clear that China is not the only one in this game. Many of the East Asian countries are managing their currencies to facilitate their export competitiveness into the U.S. market. But currency is just the tip of the iceberg. We've all been engaging in a huge charade. We in the United States have been acting on the basis of the presumption that in a world of globalization, with a majority of countries being IMF and WTO members, that all countries are playing the same globalization game. And that it is a game of win-win free trade. This has never been true and is increasingly less true. In fact, the world is divided – some important countries (the U.S., the UK, a few others) are more or less free traders, but many other countries are neo-mercantilists pursuing export-led growth strategies guided by elaborate industrial policies. We've seen this movie before. We've seen Japan pioneer the export-led growth strategy, followed by the Asian Tigers, and now we're seeing the last tiger, or perhaps the first dragon, perfecting the model. A model, it should be noted, that is not unique to Asia. Indeed, we see Germany pursuing accumulation of chronic trade current account surpluses and insisting that it can never buy more of the products of its partners in the EU.

That this is being discussed now is due in large part to the semiannual Treasury report due this April 15th on the exchange rate policies of foreign countries. What complicates the issue is the fact that the report necessitates a presidential action fraught with considerations far beyond the narrow sphere of currency devaluation. Moreover, the report is structured such that it puts the United States in an accusatory position, labeling China as being unfair. Not surprisingly, the possibility of such an accusation by the United States leads Chinese leaders not to want to appear to be submitting to U.S. pressure, even if the U.S. position is on the issue is correct.

On the other hand, a large majority of economists and informed observers agree that China is manipulating its currency, intervening in currency markets, accumulating huge reserve surpluses, and harmfully distorting markets, including its own. If the President doesn't declare China to be doing what everyone knows it is doing, he will lose face and appear weak. It will look like he is being dishonest, and kowtowing to China. When we consider some scenarios that may emerge, the picture does not improve. For instance, there has been much talk of late that China will soon allow some small degree of revaluation. While that may appear to be a mutually beneficial outcome that would save faces all around, the truth is that a nominal revaluation is not a solution to the problem. Only a major revaluation over a relatively short period can have the necessary impact. If China were to make a token move – say, three or four percent – that is not a gesture we should view as significant. Though small enough to prevent the Chinese leadership from losing face at home, yet appear to us as though they are capitulating to our concerns, such a minor change will have no significant impact. It is not enough for the Chinese to make token gestures in order to appease us diplomatically – real change must be accomplished. We cannot fall into the trap of being satisfied with occasional nominal adjustments.

Rather than making this a bilateral issue, it is clearly preferable that some multilaterally negotiated arrangement be achieved, perhaps in the G20 or in the WTO or even in the IMF. Another option is negotiating with China in a multilateral context, such as the G20 or the WTO. But if that can't be achieved in some reasonable period of time, countries, including the United

States, will be obliged to defend their interests in whatever way they deem appropriate, unilaterally or as a coalition of concerned countries. A difficulty is that the global institutions and many of their key underlying concepts such as most favored nation and national treatment are not cognizant of the present structural realities and not adequate to deal with the problems of a world that is half neo-mercantilist/strategic trade and half free trade. How laughable is it that countries put enormous effort into the WTO to lower tariffs while ignoring exchange rates which can easily move by a magnitude greater than the value of the tariffs the WTO system has reduced, or that the IMF can discuss currency values and exchange rates without reference to trade and investment? Yet they do. We should recognize and use this opportunity to begin establishing 21st century institutions for the 21st century. The first step is to recognize the realities.

While the WTO has instituted rules about national treatment and most-favored nation status, application varies by country. Although we have created a trade regime that works in theory, we need to be addressing not just trade but the issues that are inextricably linked to it, including exchange rates. What we need is not the trade regime we've developed, but a globalization regime. Can we really have deep economic integration between authoritarian, strategically guided economies and democratic/laissez faire economies? This is one example of the dichotomy between mythology and reality. While China's currency is part of the bigger problem and must be honestly dealt with, by itself it won't solve the problems we face unless we deal with the other aspects of the issue as well. Investment incentives (capital grants, tax holidays), antitrust policies or lack thereof, industrial targeting policies, structures of distribution and so forth. We have a WTO, but what we really need is a world globalization organization.

Negotiations similar to those of the Plaza Agreement of 1985 should be launched immediately to coordinate a substantial (40 to 50 percent) revaluation of a number of managed Asian currencies versus the dollar and the euro over the next two to three years. This would also have to entail an agreement to halt strategic currency management activities. A second longer term objective of the deal would be a reversal of savings and consumption patterns in the United States and Asia. Once the current recession is behind us, Washington would promise to balance the federal budget over the business cycle and to reform poorly targeted consumption incentives like the tax deductibility of interest on home equity loans, while key Asian and oil producing countries and Germany would undertake to increase domestic consumption. China could upgrade its social safety net, and a true liberalization of Japan's housing and consumer credit markets might do wonders. The oil countries also need to improve social safety nets and greatly upgrade their infra-structure.

After this initial deal, the IMF or a new body representing the major currencies (dollar, euro, yen, and yuan) must continue to coordinate policy and manage appropriate currency adjustment. Its mission must be to push the global system toward balance. To this end it should effect a transition to a more stable global currency system. One possible option would be a basket of currencies. Indeed, the IMF's Special Drawing Rights (SDRs) already represent a currency basket and an exchange of dollars for SDRs (China has actually suggested something like this recently) might be used as a device to get away from excessive reliance on the dollar. Regardless of how it is done, the end result must be a system that makes neo- mercantilist currency management and U.S. abuse of the privilege of printing the dominant currency impossible.

If starting such discussions proves difficult, the United States in concert with other affected countries could initiate unfair trade actions under their domestic laws and also under the anti-subsidy and nullification and impairment provisions of the WTO. It could also formally call for official consultations by the IMF with certain of its members regarding their currency management practices. This, of course, would be strong medicine, but it would surely stimulate discussion, and it is all perfectly legal and in keeping with both the rules and spirit of open, rules based trade.

Over the longer term, the currently prevailing half-free trade, half-mercantilist system of globalization must be replaced by the establishment of a one economy-one system regime. To do this the WTO will have to be completely revamped with new standards, rules, and authority. Most Favored Nation and National Treatment standards are no longer sufficient. There must be just one kind of WTO Treatment in all economies. Global rules must be created to break up and regulate cartels. Distribution and marketing channels must be equivalently open in all markets not only de jure but de facto. It must be possible to appeal on such issues not just to national courts but to objective international dispute settlement bodies. Sovereign investment funds and state controlled enterprises must be subject to international scrutiny and to transparency and rules that assure they are operating completely outside the political realm. Likewise, tax holidays, capital grants, and other financial incentives used to bribe global corporations with regard to location of plants, labs, and headquarters must be subject to common WTO and IMF discipline. Nor should the WTO and other international bodies wait for complaints to address these issues. Rather, they should maintain continuous monitoring of real market developments and apply discipline wherever and whenever necessary.

Again, it may be difficult to obtain agreement on negotiating such rules. Therefore, the United States and other interested countries should not hesitate to file WTO and IMF complaints and take the actions allowed by international law against measures and policies that distort globalization. Financial investment incentives targeted to particular industries and companies can be attacked under the anti-subsidy rules while toleration of cartels and favored positions for state related enterprises can be attacked under the nullification and impairment rules. Again, the U.S. authorities should not wait for complaints. Because of their greater sensitivity to authoritarian regimes than to democracies, global corporations will hesitate to bring complaints for fear of retaliation from authoritarian neo-mercantilist regimes. Therefore, U.S. and other affected officials should monitor conditions proactively and self-initiate appropriate actions. Again, these are sure to stimulate negotiations.

Of course, if negotiations are not possible, then we will be forced to defend our own interests as best we can unilaterally.

Testimony of Clyde Prestowitz
President, Economic Strategy Institute

March 24, 2010

Business Times - 20 Mar 2010

Time to cool China, US tempers

A failure may result in another economic recession, and perhaps even a new cold war, from which no side would be able to decouple

By LEON HADAR
WASHINGTON CORRESPONDENT

MEMBERS of a bipartisan coalition of US lawmakers are accusing the Chinese of a plot to manipulate the value of its currency in order to boost its exports and make American imports harder to sell in China.

And the lawmakers have introduced legislation that would force the US Treasury to impose stiff penalties against China and other countries that are engaged in such unfair currency manipulation.

In the House of Representatives 130 members of the House of Representatives signed a letter protesting China's manipulation of its currency while in the Senate, a group of 14 Democrats and Republicans are pressing the Obama Administration to act against the Chinese.

The senators, led by liberal Democrat Charles Schumer from New York and conservative Republican Lindsey Graham from South Carolina, are arguing that past US administrations, worried about the rising economic power of China, had refrained from identifying Beijing as a 'currency manipulator' which would then have required Washington to impose duties on Chinese imports. But with unemployment rate remaining high and as the US trade deficit with China - its second largest trading partner - keeps growing, American lawmakers are responding to public anger by blaming China for using its currency to gain a trade advantage.

The senators want to ensure that the US Treasury's semi-annual report on foreign exchange rate practices that is scheduled to be released next month will, indeed, label China as a 'currency manipulator' and force the administration to come up with 'remedial' legislation that would supposedly compel China to revalue its currency.

Their Bill - 'Currency Exchange Rate Oversight Act' - was introduced following a war of words between the US and China in recent days over the allegedly misaligned Chinese currency, the yuan, as well as other policy issues, including the meeting between President Barack Obama and the Dalai Lama at the White House, the US decision to sell arms to Taiwan as well as complaints from American companies about Chinese trade practices and Sino-American disagreements over climate change.

And while the American economy has just started recovering from a painful recession and is showing some growth, the World Bank this week has upped its forecast for China's 2010 GDP growth to 9.5 per cent after it grew at 8.7 per cent last year.

American lawmakers say that some of this impressive export driven economic growth has been achieved in part through Chinese currency manipulation.

The Chinese policies amount to 'cheating', according to Democratic Senator Debbie Stabenow which represents Michigan, a state whose manufacturing sector, including a struggling car industry, has been devastated by the Great Recession and where the official unemployment rate is around 15 per cent (and among African-Americans, close to 50 per cent).

She and her colleagues are complaining that the Chinese government is essentially subsidising its exports by keeping its currency value low and want Washington to stop talking and to finally walk the walk. The Obama Administration needs to pull 'the trigger on (currency) manipulation, explains Mr Graham, whose own state of South Carolina has been experiencing an unemployment rate of more than 13 per cent.

He told reporters that 'we're all living in fear of what China might do' since 'we borrow way too much money from them', adding that 'we need to break that fear and do what's right'.

China has approximately US$2.4 trillion of accumulated foreign reserves which explains why many economists believe that the yuan is undervalued as a result of a calculated policy pursued by China's financial authorities. They buy US dollars and sell their own yuan, a policy that helps to keep the greenback's exchange rate fixed to their own currency. The result is a distortion of trade flows - cheap Chinese exports to the US continue while imports from the US into China remain expensive.

But since the Chinese do not allow their currency to float freely, the same economists also disagree over the degree to which the Chinese undervalue their currency. Economists also differ in estimating the extent to which the appreciation of the Chinese currency will lead to the narrowing of the US trade deficit with China. After all, reducing that deficit seems to be the main rationale for the proposed legislation on Capitol Hill.

In fact, according to the Cato Institute's trade analyst Dan Ikenson, from 2005 to 2008, at a time when the yuan was appreciating against the US dollar, the US trade deficit with China actually increased from US$202 billion to US$268 billion. Thus, the think tank's analyst suggests, the level of the US deficit is determined by many factors other than just the value of the Chinese currency.

For example, Mr Ikenson points out that the yuan was growing stronger between 2005 and 2008, US imports from China increased by US$94.3 billion, or 38.7 per cent. He suggests that one reason for continued US consumption of Chinese goods despite the relative price increase may have been the shortage of or even the lack of substitutes for Chinese-made goods in the US market.

Moreover, only somewhere one-third and one-half of the value of US imports from China is actually Chinese value-added, with the other half to two-thirds reflecting costs of material, labour and inputs from other countries.

Hence, a stronger yuan actually makes imported inputs cheaper for Chinese producers, who may respond by reducing their prices for export, which means that the currency appreciation may lead to a rise - not a reduction - of American imports from China.

Unfortunately, much of this economic common sense is probably not going to counter the political pressure from Congress on the administration to 'do something' that is fuelled, in turn, by America's economic distress and the ensuing populism that makes China such an easy target.

A key Chinese official responded to this pressure from Congress by saying that his government has become a convenient scapegoat for America's trade problems. But this official needs to recognise that that kind of behaviour is a mirror image of sort of the way that some members of the Chinese communist establishment have been exploiting anti-American nationalist sentiment as part of a strategy to mobilise public support for the regime in Beijing.

Testimony of Clyde Prestowitz
President, Economic Strategy Institute

March 24, 2010

In a way, scapegoating the 'other' seemed to have become the favourite political weapon by both Americans and the Chinese.

The problem is that the back and forth sniping between Washington and Beijing over China's currency policy is more than just a 'normal' economic dispute between two countries that has been exploited by politicians on both sides.

Indeed, the global financial imbalances between the US (consumption that created deficits) and China (savings that produce surpluses) helped create the conditions for the financial melt-down.

And unless the two sides take steps to deal with these imbalances, the global financial system could experience more disasters in the future.

From that perspective, China's massive trade and foreign exchange surpluses - reflecting the huge surpluses of exports over imports and saving over investment - should be seen not so much as a challenge to American economic interests but as a threat to the entire global economy, and eventually to China itself.

The Americans need to cut their consumption and borrowing. But that could only take place if the US dollars in China's government-controlled banks are being spent to buy American products as opposed to its debts. And if and when that happens, the appreciation of the Chinese currency would be inevitable.

In the meantime, a Chinese refusal to revalue its currency is bound to bring about retaliatory action by Washington and ignite a destructive economic war between the two nations.

And the situation is only going to be aggravated if China continues to respond in a somewhat frantic way to not-very-unusual actions by the Obama Administration (meetings with the Dalai Lama or arms sales to Taiwan).

If anything, China's rising economic and diplomatic power require it to embrace a more nuanced, if not refined, diplomacy that one expects from a great power, especially when it is dealing with the more accommodating administration in Washington.

More important, there is no reason why China and the US should not be able to settle their differences over currency in the same amicable way that the US and Japan were able to during the 1980s.

A failure to do that would be a recipe for another economic recession and perhaps even a new cold war from which no side would be able to decouple.

Chairman LEVIN. Thank you very much. Dr. Levy.

STATEMENT OF PHILIP I. LEVY, PH.D., RESIDENT SCHOLAR, THE AMERICAN ENTERPRISE INSTITUTE

Mr. LEVY. Thank you, Mr. Chairman. I very much appreciate the opportunity to appear here today and I will follow your suggestion and offer just a brief summary of my extended testimony.

China's currency undervaluation is both real and problematic. The conclusion that the RMB is significantly undervalued has been reached by a wide range of analysts, including the IMF. The clearest indicator is the dramatic accumulation of China's foreign exchange reserves, now estimated at roughly $2.4 trillion.

The most acute problems stemming from this policy appear in China itself. For that reason, the situation is vexing but not hopeless. It is in China's own interest to move toward an appreciated currency.

China's undervalued exchange rate and mounting reserves post serious difficulties for controlling Chinese money supply and in turn inflation.

One analyst recently argued that Chinese policy is cultivating a real estate bubble to compare with that of Japan before its bust in the 1990s.

Under its policy, China has been extending large volumes of loans to the rest of the world. For a relatively poor country that is rapidly getting richer, such lending makes little economic sense.

Of course, the primary concern of this committee and the Congress is the effect of Chinese practices on the United States. Whether or not Chinese currency practices hurt the U.S. is the subject of vigorous debate among economists and, apparently, historians as well.

Even if one is convinced of the harm, we must be very clear on the likely costs and benefits of potential remedies. In normal times, there are strong arguments that China's exchange rate policies do not hurt the United States.

As you mentioned, however, recent arguments made by Nobel laureate, Paul Krugman, make a contrary assertion. He links Chinese policies to U.S. unemployment and that linkage relies on the argument that the United States is temporarily in abnormal times.

By this, he does not mean a steep recession, which is obvious, but a time when monetary policy has become completely ineffective, a so-called "liquidity trap." It is during such a special situation that an increase in net Chinese demand could stimulate the U.S. economy, presumably in a way that the Fed is incapable of doing.

By Krugman's reasoning, this offers a relatively short window of time in which a Chinese policy change could have any serious effect. Yet, none of the actions that China might plausibly undertake are likely to do this.

A gradual currency appreciation of the sort China followed from 2005 to 2008 would not be large enough. A more sudden appreciation, on the order of 20 to 30 percent, could jolt the Chinese economy so seriously that it would not increase its demand for global goods, at least not in the short run.

What determines whether China will act? There are two major sources of legitimacy for the Chinese regime: economic performance and nationalism.

China's reluctance to revalue the renminbi hinges on worries of economic performance, specifically the potential demise of large numbers of low margin businesses in China's export sector.

Nationalism, in turn, is likely to mean that China would not react well to unilateral U.S. pressure.

In the interest of time, I would like to focus on just one major proposal to encourage change, the idea of an unilateral tariff on Chinese goods.

Compared to other proposals, this would impose the most immediate economic pain on China, but it would also maximize the likelihood of a strong nationalist backlash within China that would preclude Chinese compliance with U.S. demands.

By blatantly violating U.S. commitments under the WTO, a unilateral tariff would do lasting damage to the rules based multilateral economic system. This could be disastrous for a U.S. economy that is globally integrated. Nor should one expect, as Dr. Ferguson also said, that the breakdown in cooperation relationships would be limited to the narrow confines of trade and currency.

Advocates of a tariff have set aside these long term consequences and argue that it could achieve U.S. short term goals whether or not China complies. This is highly dubious.

Such a bilateral measure could be readily circumvented by a reordering of world trade flows, effectively reversing the shift in trade patterns that accompanied China's recent rise.

For many of the low cost goods that China produces, its chief competitors are not U.S. firms but those in other developing nations.

Even if the United States were to enter lines of business from which China had been excluded, such adjustments take time. Thus, there are few likely short term benefits to offset the potentially staggering long term costs.

In contrast, multilateral approaches would be neither quick nor easy but would offer a better chance of eventual success. The United States could work through the WTO, the IMF, the G–7 or the G–20. By avoiding the antagonisms of bilateral conflict, a multilateral approach could make it politically easier for China to accede to new rules.

This is not really a choice between short term benefits and long term costs. It is hard to discern a feasible action that China might take that would significantly improve U.S. employment and output in the short run. It is even harder to imagine a scenario in which China would adopt such a policy under the unilateral threat of U.S. punishment.

We would be wise to show patience and pursue an approach that relies upon multilateral diplomacy.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Levy follows:]

U.S. Policy Options in Response to Chinese Currency Practices

Written Testimony of
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Before the
House Committee on Ways and Means

24 March 2010

Chairman Levin, Ranking Member Camp, and members of the committee, thank you for the opportunity to testify today on the challenges posed by the currency practices of the People's Republic of China. This issue raises difficult questions about economics, diplomacy, and international institutions. It is also one where U.S. missteps could have serious and lasting consequences.

In my testimony, I will argue that China's currency undervaluation is both real and problematic. While it poses problems for global economic rebalancing, the most acute problems appear in China itself. For that reason, the problem is vexing but not hopeless. It is in China's own interest to move toward an appreciated currency.

Of course, the primary concern of this committee and the Congress is the effect of Chinese practices on the United States. Whether or not Chinese currency practices hurt the United States is a subject of vigorous debate among economists. Even if one is convinced that the undervalued Chinese currency has been harmful, the United States must be very clear on the likely costs and benefits before adopting policies to address the problem. I will contend that neither U.S. actions nor any ensuing Chinese reforms are likely to improve U.S. unemployment significantly. It is not clear that the benefits of trying to force an appreciation of the Chinese currency would outweigh the potential harm to long-term U.S. interests.

The cost to policy errors could be very large. A number of the proposals that have been put forward by prominent commentators could do lasting damage to the international economic system while failing to alter Chinese policies. To reach this conclusion, I will offer some thoughts on the factors driving Chinese decision-making and on the courses of action China might plausibly follow in response to U.S. pressure.

This is not to argue that the United States is impotent. There are a number of potentially fruitful paths the country might follow. These all require patient diplomacy, however, and none guarantees results. This sort of patience is exceedingly difficult in a time of economic distress.

1. Chinese practices and their global repercussions

China has held its currency roughly fixed against the U.S. dollar for most of the last 13 years. From October 1997 to July 2005, the official exchange rate was 8.28 RMB to the dollar.[1] The currency appreciated to 6.83 RMB to the dollar between the summer of 2005 and late 2008, an appreciation of roughly 20 percent. Since then, the RMB has held steady against the dollar.

It is worth noting that in the late 1990s, China held its rate fixed in the face of the Asian financial crisis and pressures to *depreciate*. Nor is there anything objectionable about a fixed exchange rate per se. Until the breakdown of the Bretton Woods exchange regime in the 1970s, most of the globe operated under a system of fixed exchange rates. This was seen as one means of promoting stability and predictability in an economy.

In recent years, however, the undervaluation of China's currency has become apparent. This undervaluation has occurred as China has assumed a steadily more important role in the global economy. The clearest indicator of a misaligned renminbi is the dramatic accumulation of China's foreign exchange reserves. With a closed capital

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[1] Goldstein, Morris, and Nicholas Lardy, "China's Exchange Rate Policy: An Overview of Some Key Issues," Peterson Institute for International Economics, October 19, 2007.

account and an exchange rate that makes Chinese exports appear cheap and imports expensive, there is an excess demand for Chinese currency. To maintain the value of the renminbi, the Chinese government essentially accumulates this excess demand in the form of foreign exchange reserves. Chinese reserves were estimated at $286 billion at the end of 2002. In early 2010, they are estimated at $2.4 trillion. They are forecast to exceed $3 trillion by the end of next year.[2]

Just as there are benign explanations for fixed exchange rates, there are benign explanations for the accumulation of foreign exchange reserves. In the Asian financial troubles of the 1990s, the climax of the crises came when China's neighbors exhausted their foreign exchange reserves and were left to turn to the International Monetary Fund (IMF) for assistance. Many Asian nations learned the lesson that substantial reserves were a form of insurance against such humiliation and China is hardly alone in having accumulated a significant stockpile. But China's reserves far exceed the levels that are needed for such precautions.

The conclusion that China's currency is significantly undervalued has been reached by a wide range of analysts. The Peterson Institute has estimated that the renminbi is 20 to 40 percent undervalued.[3] In its latest update on the Chinese economy, the World Bank recommended that China appreciate its currency to head off inflation.[4] The new European Union trade commissioner, Karel De Gucht, last week stated his view that the renminbi was underpriced.[5] Perhaps most telling from a policy standpoint were the comments of Dominique Strauss-Kahn, the Managing Director of the IMF. He said last week, "The opinion of the IMF… is still that the renmimbi is very much undervalued."[6]

Because of the tight integration between China and other Asian trading nations, it has been difficult for China's neighbors to appreciate their currencies while the renminbi has remained fixed. Thus, the global impact of China's practices extends beyond China's rapidly-growing but limited economic heft. When there are important imbalances in the global economy, exchange rates are a key mechanism by which adjustment would take place. The world is at a point where much of it is trying desperately to stimulate growth while China is concerned with the effects of overheating. In an ideal world, an appreciation of the Chinese currency would relieve pressures on China while increasing the net demand for goods from the rest of the world.

2. This poses serious problems for China

In the world of international relations, the most pernicious transgressions are those which help the transgressor and hurt others. In such cases, there is no reason to expect the behavior will change without some intervention. This is not the case with China's currency practices.

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[2] World Bank, China Quarterly Update, March 2010.
[3] See discussion by Peterson Institute Director C. Fred Bergsten, March 12, 2010. http://www.epi.org/resources/event_20100312/
[4] World Bank, China Quarterly Update, March 2010.
[5] Chaffin, Joshua and Alan Beattie, "EU's De Gucht airs concern on U.S. trade stance," *Financial Times*, March 18, 2010.
[6] *Wall Street Journal*, "IMF Strauss-Kahn: China's Currency Is Undervalued," March 17, 2010.

China's undervalued exchange rate poses serious difficulties for controlling Chinese money supply and, in turn, inflation. The exchange rate is not the only driver of inflation; China's recent stimulus was important as well. But the exchange rate makes monetary control more difficult and imports more expensive. Appreciation of the renminbi would directly cut into import costs, which is particularly important for an economy that assembles foreign inputs and is heavily dependent on getting natural resources from abroad.

This threat is taken seriously in China. The leadership has a longstanding fear of inflation because of the public unrest it can cause. Some analysts have described a burst of inflation as one contributing cause of the Tiananmen unrest in 1989.[7]

The distinguished Japanese economist Takatoshi Ito has recently argued that Chinese policy is cultivating a real estate bubble to compare with that of Japan before its bust in the 1990s. He writes:

> "The [Chinese] central bank is… hesitating to take up the best policy - interest rate hikes and appreciation of the Chinese renminbi. The property bubble is a clear sign of overheating. China's reported inflation rate does not show rampant inflation, but that was also the case in Japan in the 1980s. If the renminbi is appreciated, any overheating of China's export sectors will be slowed, while standards of living will improve with higher purchasing power."[8]

More fundamentally, the accumulation of foreign exchange reserves that accompanies China's currency undervaluation has meant that China has been extending large volumes of loans to the rest of the world. Given that China is a relatively poor country that is rapidly getting richer, such lending makes little economic sense. For comparison, China's income per person is between $3,000 and $6,000. The comparable figure for the United States is over $45,000.[9]

One common misperception is that China at least has the benefit of its $2.4 trillion hoard, which it ought to be able to use to address its problems. This sum is often misinterpreted as a measure of the success of China's policy. In fact, this collection of I.O.U's from abroad is not a ready account to pay for China's substantial needs. If China were to attempt to spend the foreign exchange on domestic needs, it would first need to convert it into renminbi. That would serve to appreciate the currency. So long as China maintains its currency peg, it cannot use the money at home.

What may be worse, from a Chinese perspective, is that China faces the prospect of significant capital losses on its foreign exchange holdings. Either an increase in global interest rates or an appreciation of the renminbi would cut into the RMB value of China's foreign exchange holdings. As the reserves grow, so do the potential losses.

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[7] See, for example, Keidel, Albert, "China's Looming Crisis – Inflation Returns," Carnegie Endowment for International Piece, Policy Brief No. 54, September 2007.

[8] Ito, Takahashi, "China's property bubble is worse than it looks," *Financial Times*, March 17, 2010.

[9] World Bank, World Development Indicators Database, September 2009. The broad range of estimates for Chinese income reflects different methods of accounting for exchange rates. Indirectly, this is another measure of currency misalignment.

Chinese officials are aware of the dangers of inflation, of the unmet domestic needs, and of the potential for capital losses. The counterbalancing fear is that appreciation could lead to significant unemployment at a time when global demand for Chinese exports fell. Chinese central bank governor Zhou Xiaochuan said this month that China's currency peg is a temporary response to the global financial crisis and that China will eventually move away from it. Just not yet.[10]

3. Does an undervalued RMB hurt the United States?

In normal times, there are strong arguments that China's exchange rate policies do not hurt the United States. The flip side of China's currency undervaluation is excess lending to the rest of the world. In general, if a country is borrowing, it benefit when another country offers low-interest loans. It can certainly be argued that the United States misused the funds it borrowed, but that is not the fault of the lender.

If the United States is to borrow from the rest of the world, it must run a capital account surplus (sending bonds and other financial instruments abroad, on net) and a current account deficit (roughly equivalent to the trade deficit). There are good reasons to think that borrowing and macroeconomic factors drive the trade deficit rather than the other way around.[11]

While the current account surplus of China and deficit of the United States are economically significant, the bilateral trade deficit the U.S. runs with China is not. Even if China and the United States each had balanced current accounts, there is no reason to think there would be bilateral balance in a world of many countries. If a country with balanced overall trade imports from one country and exports to another, it will run bilateral surpluses and deficits.

To illustrate how misleading bilateral measures of trade can be, consider China's share of U.S. imports. In 1997, China accounted for 7.2 percent of U.S. imports. By 2009, this share had more than doubled to 19.0 percent. Yet over that same time period, the share of U.S. imports coming from Asia – including China – fell from 38.4 percent to 37.6 percent.[12] This reflects the extent to which China globalized by linking itself to a vibrant Asian production network. Goods that were labeled as Chinese often had very limited Chinese value added; they were simply completed there. If those goods had previously been completed in a country like Malaysia, the switch would alter the share of U.S. goods coming from China while leaving Asia's share untouched.

This is a cautionary tale not only about interpreting trade deficit statistics. It also has two important policy implications. First, policies that target only China's trade could prompt a straightforward reordering of trade patterns within Asia that would have little net effect. Second, to the extent that Chinese value added is limited and it imports partially finished products and supplies, an appreciation of China's currency would cut the cost of these imported supplies. That could temper the effect of more expensive final goods.

If we return our attention to worldwide current account deficits, these should not be equated with unemployment and poor economic performance. If we go back to the years

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[10] *Wall Street Journal*, "Zhou Signals Yuan Policy Shift," March 8, 2010.

[11] Levy, Phil, "Do trade deficits call for a sledgehammer?" *Foreign Policy*, April 15, 2009. http://shadow.foreignpolicy.com/posts/2009/04/15/do_trade_deficits_call_for_a_sledgehammer

[12] Author's calculations from U.S. International Trade Commission Tariffs and Trade database.

before the financial crisis, from 2004-2006, the United States, the United Kingdom and Australia all ran current account deficits of 2 to 6 percent of GDP. Their unemployment rates ranged from 4.5 to 5.5. Meanwhile Germany ran current account surpluses from 4.6 to 6 percent of GDP and suffered unemployment rates around 10 percent.[13] Looking at just U.S. data, the U.S. current account deficit shrank from 5.2 percent of GDP in 2007 to 2.9 percent in 2009, while the unemployment rate rose from 4.6 percent to 9.3 percent.[14]

This is all anecdotal, but it illustrates that trade deficits are compatible with low unemployment, while surpluses are compatible with high unemployment.

As the unemployment number well illustrates, there has certainly been hardship felt by the U.S. workforce. There has been a steady decline in manufacturing employment, wage stagnation, and wage inequality. The decline in manufacturing employment dates back to 1979.[15] It appears to have had more to do with an increase in manufacturing sector productivity, which allowed manufacturing production to continue or grow with fewer and fewer workers. Economic studies have shown that the primary drivers of inequality and wage stagnation are differing returns to education and the changes wrought by new technology.[16] Trade affects both wages and prices, of course, and one careful study of the impact of trade with China found that it had significantly reduced U.S. inequality.[17]

It can be difficult to make blanket statements about whether one nation's economic policies help or hurt another nation. Whereas Chinese distortions may hurt one U.S. firm and its workers, they may help another U.S. firm as well as American consumers. Even more frequently, changes in wages and employment that are attributed to trade may in fact be due to technological change, education, domestic competition, and the functioning of labor markets. On balance, there is little reason to think that in normal times, with the United States already borrowing money on world markets, Chinese exchange rate misalignment had a significant negative impact.[18]

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[13] IMF World Economic Outlook Database, October 2009.

[14] Current account statistics calculated from Bureau of Economic Analysis data, http://bea.gov/index.htm, unemployment data are annual averages from the Bureau of Labor Statistics, http://www.bls.gov/cps/prev_yrs.htm.

[15] See Levy, Philip I., "Doing a Job on NAFTA," March 6, 2008. http://www.american.com/archive/2008/march-02-08/doing-a-job-on-nafta. While employment declined, U.S. manufacturing output quantity grew by more than 50 percent from 1987 to 2007, http://www.bea.gov/industry/gpotables/gpo_action.cfm.

[16] See Robert Z. Lawrence, Blue-Collar Blues: Is Trade to Blame for Rising U.S. Income Inequality?, Peterson Institute, January 2008; and Claudia Goldin and Lawrence F. Katz, The Race Between Education and Technology, Harvard, 2008.

[17] See Broda, Christian, "China and Wal-Mart: Champions of equality," Vox, July 3, 2008. http://www.voxeu.org/index.php?q=node/1353.

[18] Nobel Prize-winning economist Gary Becker has written: "On the whole, I believe that most Americans benefit rather than are hurt by China's long standing policy of keeping the renminbi at an artificially low exchange value…The main beneficiaries of this policy are the poor and lower middle class Americans and those elsewhere who buy Chinese made goods at remarkably cheap prices…I believe the benefits to American consumers far outweigh any loses in jobs, particularly as the US economy continues its recovery, and unemployment rates come back to more normal levels…" Becker, Gary, "Should China Allow its Currency to Appreciate?" November 23, 2009, http://www.becker-posner-blog.com/2009/11/should_china_al.html

What about abnormal times?

I distinguish between normal and abnormal times because the distinction is central to recent arguments made by leading international economists Paul Krugman and Fred Bergsten. Krugman has been most explicit in his arguments that the United States is in a liquidity trap. Whereas a conventional argument might say that the Federal Reserve will adjust interest rates to achieve full employment, in a liquidity trap situation, interest rates are stuck at zero and the Fed is unable to do this. Krugman writes:

> Right now we're in a liquidity trap, which… means that we have an incipient excess supply of savings even at a zero interest rate. …In this situation, America has too large a supply of desired savings. If the Chinese spend more and save less, that's a good thing from our point of view. To put it another way, we're facing a global paradox of thrift, and everyone wishes everyone else would save less.19

In this scenario, Krugman and Bergsten argue that a full revaluation of China's currency (perhaps by 25 to 40 percent) could boost demand for the rest of the world's exports, cut the U.S. trade deficit, and expand U.S. employment.[20] Even if China's policies do not hurt in normal times when we are eager for cheap loans, the argument goes, they are hurting now.

Krugman plays out the scenario that Bergsten described orally:

> First, the United States declares that China is a currency manipulator, and demands that China stop its massive intervention. If China refuses, the United States imposes a countervailing duty on Chinese exports, say 25 percent. The EU quickly follows suit, arguing that if it doesn't, China's surplus will be diverted to Europe. I don't know what Japan does …
>
> [F]or those who counsel patience, arguing that China can eventually be brought around: the acute damage from China's currency policy is happening now, while the world is still in a liquidity trap. Getting China to rethink that policy years from now, when (one can hope) advanced economies have returned to more or less full employment, is worth very little.[21]

There are several separate parts to this argument. First, there is the argument that we are in a liquidity trap (stuck at zero interest rates with ineffective monetary policy). Second, there is the contention that Chinese appreciation would result in a rapid increase

[19] Krugman, Paul, "China and the liquidity trap," The Conscience of a Liberal, *New York Times*, May 15, 2009. http://krugman.blogs.nytimes.com/2009/05/15/china-and-the-liquidity-trap/
[20] Dickson, David M., "China's yuan value hits U.S. economy, two experts say," *Washington Times*, March 15, 2010.
[21] Krugman, Paul, "Capital Export, Elasticity Pessimism, and the Renminbi (Wonkish)," The Conscience of a Liberal, *New York Times*, March 16, 2010.
http://krugman.blogs.nytimes.com/2010/03/16/capital-export-elasticity-pessimism-and-the-renminbi-wonkish/

in demand for U.S. products. Finally, there is the issue of how long the liquidity trap window will last, after which, as Krugman notes, the change would be worth very little.

Is the United States in a liquidity trap? This is not a universally accepted point.[22] After all, while short-term interest rates are near zero, the U.S. ten-year bond is trading at roughly a 3.7 percent interest rate. Paul Krugman has argued that this simply reflects expectations that we will emerge from a liquidity trap in the future. As an example, a 3.7 percent ten-year bond could reflect the expectation that interest rates are zero for two years, then 4.6 percent for the next eight. If that were so, and the rest of Krugman's argument applied, then there would be a two-year window in which we would care about additional Chinese demand, followed by a much longer period in which we would return to welcoming other countries willing to lend us money and hold down our interest rates.[23]

Next, we can consider the effects on China of a 25 to 40 percent sudden currency revaluation. Large swathes of Chinese low-margin producers would fail and the weak Chinese financial system would be ill-equipped to reallocate the economy's resources quickly. Beijing University Professor Michael Pettis describes the likely consequences of a rapid appreciation:

> "… China cannot adjust too quickly. If Beijing removes the implicit subsidies, including those caused by the undervalued exchange rate, too rapidly, that could force large-scale bankruptcies as Chinese manufacturers found themselves unable to compete globally or at home. If these bankruptcies forced up unemployment, then … household income would … decline as unemployment soared. In that case Chinese manufacturers would find themselves becoming uncompetitive in international markets just as domestic markets are collapsing.
>
> The conclusion? A rebalancing is necessary for China, as nearly everyone in the leadership knows. This will involve, among other things, a significant revaluing of the currency. But rebalancing cannot happen too quickly without risking throwing the economy into a tailspin. That cannot and should not be a part of the US or Chinese policy objective. By the way if China is forced to revalue the currency too quickly, it will have to enact countervailing policies — lower interest rates, suppress wages, increase credit and subsidies — to protect the economy from falling apart, and these will exacerbate other imbalances that may be even worse than the currency misalignment."[24]

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[22] See, for example, Reynolds, Alan, "Krugman's Liquidity Claptrap," *Forbes*, June 19, 2009. http://www.forbes.com/2009/06/18/paul-krugman-new-york-times-liquidity-romer-opinions-contributors-alan-reynolds.html

[23] On a technical note, it can be argued that the higher rate for longer bonds poses a more fundamental problem to the liquidity trap argument. The premise of that argument is that monetary policy is ineffective. While standard monetary policy works by manipulating short term interest rates, it is also possible to affect the money supply by "quantitative easing" – the purchase of non-traditional bonds. If the Fed can expand the money supply and drive down interest rates by buying other bonds, then monetary policy is still working. The U.S. Federal Reserve has been doing just that during the crisis.

[24] Pettis, Michael, "How will an RMB revaluation affect China, the US, and the world?", China Financial Markets, March 17, 2010. http://mpettis.com/2010/03/how-will-an-rmb-revaluation-affect-china-the-us-and-the-world/

Thus, if China were to try to revalue too quickly, the ensuing turmoil could prevent China from significantly boosting world demand. If China were to try to revalue slowly, then the policy would not have the near term impact that Krugman and Bergsten describe.

As a final set of caveats to the argument that China's failure to act is hurting the United States in these abnormal times, we note that any increase in net Chinese global demand that might result from a policy shift would not necessarily translate into a quick boost in U.S. production. In many cases, the United States is not producing the goods it imports from China. If the price of those goods were to rise, it could shift demand to other countries that had more similar production, such as those in the developing world.

4. What would we like China to do?

Before considering specific policies the United States might pursue to effect change in China, it is worth considering which Chinese policy would be best for U.S. interests.

One possibility is that China could resume the pace of appreciation that it employed from 2005 to 2008. At that time, China was appreciating at an average rate of roughly 6 percent per year. If China experiences higher inflation than the United States, the effective rate of appreciation could be somewhat faster. This policy would be unlikely to have a dramatic impact on the United States in the short term. To the extent history is a guide, China's earlier appreciation was accompanied by continued current account surpluses and foreign exchange reserve accumulation.

As a matter of economic policy, there is a significant downside for a country that attempts steady, predictable currency appreciation: It provides investors with a one-way bet. With a predictable 6 percent annual appreciation, any investor who could convert dollars into renminbi would achieve an additional 6 percent return beyond any interest rate differential. This creates great pressures for 'hot money' flows into China and complicates the task of tamping down Chinese inflation.

Such considerations have helped prompt calls for a rapid, 'one-off' appreciation. But such a rapid appreciation threatens economic turmoil, as described earlier. There is no easy solution to this dilemma. China should have appreciated its currency some time back when the necessary adjustment was more manageable. This highlights the pressure for China to act on currency sooner rather than later. The delay to date has made China's choice more difficult. Any further delay exacerbates the problem.

A third possibility is that China could avoid the question of how quickly to appreciate by leaving it up to market forces. It could open its capital account and let the renminbi trade freely against other major currencies. While such an approach has a certain appeal to an advocate of market forces, it is worth noting at least two potential downsides. First, this could just add uncertainty to the problems of economic shock described above. Second, it is not obvious that China's currency would appreciate. China is full of avid savers who have been compelled to choose between limited investment choices offering low interest rates. If they were free to put their money anywhere in the world, there could be a large outflow of renminbi into other currencies that would cause it to depreciate.

The current and past U.S. administrations have wisely advocated for a market-determined exchange rate, but that term suggests a longer-term goal and is different from a call for a freely floating rate.

These are not the only options, of course. One could imagine policies that were less ambitious, more ambitious, or that lay somewhere in between. In fact, this poses a difficult problem for U.S. policy: there is not a bright line between acceptable and unacceptable Chinese behavior. Krugman, Bergsten and others have rightly argued that the extent of Chinese reserve accumulation is extraordinary and beyond the pale. But as soon as the United States puts itself in the position of issuing ultimata, it will need to be able to distinguish between sufficient and insufficient Chinese responses. Would a 1 percent annual rate of RMB appreciation be acceptable? What about a 5 percent rate? Is the acceptability of China's behavior determined by the level of the exchange rate, the pace at which it appreciates, or the extent of Chinese intervention? There are no clear economic answers to these questions.

While China's accumulation of reserves may represent an unprecedented extreme, a multilateral rules-based system requires transparent criteria on behavior. Without such a principled basis for action, a U.S. response will appear arbitrary and may encourage countries to pursue their advantage however they can. In the absence of clear economic answers, the only credible approach would be to work with like-minded major countries to clarify international rules.

In sum, the United States government should be wary of demanding action if it is not clear what action it wants. The most likely possibilities are fraught with problems and none seems likely to deliver major benefits for the United States. Without firm technical grounds for distinguishing between acceptable and unacceptable behavior, the most defensible basis for U.S. demands of China would come from agreement among leading nations.

5. What determines Chinese response – sources of legitimacy

The preceding discussion considered what policies the United States should hope China adopts. In assessing the desirability of different courses of U.S. action, it is also useful to think about the determinants of Chinese behavior and consider the forces driving any Chinese response. It should be emphasized that this is not an argument for putting Chinese interests above U.S. interests. Rather, it is a basic rule of strategy to base actions upon a counterpart's likely response.

As the basis for this analysis, we can presume that the Chinese Communist Party is interested in its survival. Although the CCP is not accountable in elections, it does behave as if Chinese public opinion matters. It is commonplace among analysts of Chinese politics to emphasize two sources of legitimacy for the current regime: economic performance and nationalism.[25] Some of the obstacles to maintaining economic performance have already been discussed. The Chinese government must steer a difficult course between inflation and unemployment. Its misguided currency policies have made this increasingly difficult.

The constraints of nationalist sentiment within China are no less real. The Chinese government has occasionally stoked and occasionally been scared by outbursts of anti-

[25] See, e.g., Shirk, Susan, Fragile Superpower: How China's Internal Politics Could Derail Its Peaceful Rise, Oxford, 2007.

Japanese nationalist sentiment.[26] Historical grievances have generally been behind such movements. These grievances may be specific, as with China's war with Japan, or they may relate more generally to the "century of humiliation" dating back to the opium wars of the mid-19th century – an earlier attempt to open China to trade.

The practical implication of Chinese nationalism in this context is that there is a sensitivity to slights on the international stage. While restrictions on the freedom of inquiry in China make it very difficult to make an objective assessment of public opinion, there is evidence that nationalist sentiment is not entirely under government control. Government officials thus may feel constrained in their actions and may play to this sentiment.

In reporting this month from Beijing, a New York Times reporter described the dynamic:

> After decades of comparatively quiet diplomacy, China has taken increasingly muscular stances in the past year on relations with the United States and on global economic and environmental matters. Many analysts say the shift is due not only to China's sudden arrival as a global economic power after the financial crisis, but also to domestic political issues.
>
> The ruling Communist Party will select successors to President Hu Jintao and Prime Minister Wen Jiabao in 2012. In the jockeying to choose new leaders, some analysts say, there is scant incentive to take positions that rivals could criticize as weak.[27]

In the context of Chinese currency appreciation, Chinese leaders would likely consider not only the economic implications, but the domestic political repercussions of acquiescing to foreign threats or demands. From the leadership's perspective, the worst possible outcome would be a policy concession that combined economic turmoil with a loss of face from crumbling in the face of Western pressure.

6. Options for Action

What, then, are the options for U.S. policy? To date, the past two administrations have pursued a strategy of quiet diplomacy with mixed success. As noted earlier, China did appreciate its currency by 20 percent from 2005-2008. Outside of that period, however, the RMB has remained fixed against the dollar. China has described the current peg as a temporary measure, but has not given a clear indication of a timetable for change.

Alternative approaches can be divided into unilateral and multilateral tacks. I base this classification not on the adjudicating authority in the case of a complaint, but on whether the United States is alone in pressing a case or whether it is joined by others.

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[26] Chellaney, Brahma, "Japan-China: Nationalism on the Rise," *International Herald Tribune*, August 15, 2006. The recent conflict with Japan followed a Japanese prime minister's visit to a shrine for Japanese war dead.

[27] Wines, Michael, "China Blames U.S. for Strained Relations," *New York Times*, March 7, 2010.

When the United States acts alone, it is most likely to trigger a negative political response from the Chinese government.

Unilateral

- Currency manipulation label. The Treasury will need to determine within a few weeks whether China has been manipulating its currency. Whatever the legal considerations behind such a decision, there would be no immediate policy impact. Applying the pejorative label would make it more difficult politically for China to change its policies but would apply no additional economic pressure unless it were coupled with more substantial accompanying measures.
- Countervailable subsidy. Another prominent idea is to treat China's currency undervaluation as a countervailable subsidy. While I am in no position to offer a legal analysis, there are three broad potential problems with such an approach. First, countervailing duty (CVD) cases are generally narrow in scope and slow to conclude. This limits the extent to which they can have a significant economic impact during the current downturn. Second, it appears doubtful that this approach is consistent with WTO requirements. Gary Hufbauer, a Peterson Institute scholar and leading authority on these matters, has argued that countervailable subsidies must feature a government financial contribution and must be specific rather than general. Broad exchange rate policies would seem to be general, rather than specific to an industry, and there is no precedent for considering such policies as a financial contribution.[28] Finally, a succession of CVD decisions would likely annoy China but would not seem to be of sufficient magnitude to outweigh the concerns mentioned earlier.
- WTO case. A third idea would be to press a case against China under WTO Article XV. That article says, in part: "Contracting parties shall not, by exchange action, frustrate the intent of the provisions of this Agreement…".[29] If a WTO dispute settlement panel were to rule in favor of the United States in an Article XV complaint, the United States could be authorized to raise tariff barriers against China if the Chinese refused to change their practices. There are two major problems with this approach. First, WTO dispute settlement cases can take years; thus, this would be unlikely to get results in the near term. Second, there are no precedents for interpreting Article XV nor is there any negotiating language or guidance that would help a dispute settlement panel distinguish between acceptable and unacceptable behavior. Nor is there much expertise within the WTO to render judgment on acceptable macroeconomic practices; Article XV generally suggests the WTO turn to the IMF on such matters. Thus, a panel

[28] "Gerard Optimistic WTO Will Uphold Currency Initiation on China," *Inside U.S.-China Trade*, March 17, 2010. It has been proposed that currency manipulation be considered a *de jure* "export subsidy," which would not require specificity. However, such prohibited export subsidies, under WTO rules, must be "contingent… upon export performance," whereas the Chinese exchange rate is available to everyone trading on the current account.

[29] General Agreement on Tariffs and Trade, Article XV: Exchange Arrangements, Para. 4.

would either decide against the United States, or it would have to engage in creative elaboration of vague principles. Despite the fact that the U.S. government has long inveighed against such overreach by panels, this strategy would *require* it.

- Unilateral tariff. The boldest unilateral action would be the sort of across-the-board tariff recently advocated by Krugman and Bergsten. Compared to the other actions, this would impose the most immediate economic pain on China, but it would also maximize the likelihood of a strong nationalist backlash from China that would preclude Chinese compliance with U.S. demands. By blatantly violating U.S. commitments under the WTO, a unilateral tariff would do lasting damage to the rules-based multilateral economic system. The United States would be setting the precedent that countries should act whenever they object to trading partner's practices, without regard to agreements and rules. This could be disastrous for a U.S. economy that is integrated into the world economy and that aspires to grow by doubling exports in the next five years. Nor should one expect that the breakdown in cooperation and relations would be limited to the narrow confines of trade relations and currency.
Advocates of this approach have set aside these long-term consequences and argued that a high tariff could achieve U.S. short-term goals whether or not China complies. This is highly dubious. Such a bilateral measure could be readily circumvented by a reordering of world trade flows, effectively reversing the shift in trade patterns that accompanied China's recent rise. For many of the low-cost goods that China produces, its chief competitors are not U.S. firms but other developing nations. Even if the United States were to enter lines of business from which China had been excluded, such adjustment takes time. Thus, there are few likely short-term benefits to offset the staggering long-term costs.

Multilateral approaches

Each unilateral approach is marred by the inescapable bilateral tension that would accompany it and by the difficulty of setting global rules without a broader consensus, particularly in the absence of clear technical answers. Multilateral approaches avoid both these difficulties. In their stead, they present the difficulty of coordinated action, which can be slow and unwieldy.

- Currency agreement under the WTO. The economists Aaditya Mattoo and Arvind Subramanian have argued for new and clearer currency behavior rules under the WTO.[30] The appeals of WTO jurisdiction are the obvious link to trade and the potential for more effective enforcement through trade retaliation. Mattoo and Subramanian acknowledge the limited competence of the WTO secretariat in such matters, but argue that it could work in close collaboration with the IMF. There are serious obstacles to adopting such

[30] Mattoo, Aaditya and Arvind Subramanian, ""Currency Undervaluation and Sovereign Wealth Funds: A New Role for the World Trade Organization," Peterson Institute Working Paper WP 08-2, January 2008.

WTO rule changes in the near future, however. The most obvious vehicle for adopting such changes, the Doha Development Agenda, is stalled. The Obama administration does not even have trade negotiating authority to assure trading partners that it could meet its trade promises. Further, whether the change was proposed as part of the Doha talks or separately, it would need to win consensus support by WTO members, including China.

- Firmer action by the IMF. As noted earlier, the Managing Director of the IMF has stated the Fund's view that the renminbi is undervalued. This is clearly a topic on which the IMF has great expertise and its Articles of Agreement assign it a role in engaging with member countries to right such wrongs. The difficulty is that the IMF's power to compel action on the part of a member is generally limited to attaching conditions to loans. This has effect only when a country is seeking to borrow and has no relevance when a country like China engages in excessive lending. Setting aside enforcement problems, the IMF would be the appropriate institution under which to establish new norms for international financial behavior, if agreement on those norms could be reached.
- Explicit norms set by like-minded countries. If agreement on new norms could not be reached under the auspices of the IMF, an alternative would be to push for an agreement on principles through a grouping such as the G7.[31] That group and its heads-of-state successor the G8 (including Russia) have fallen to the wayside as international economic diplomacy has turned to more inclusive fora, particularly the G20. While the G20 offers enhanced legitimacy by including countries like Brazil, China, and India, it necessarily makes consensus more difficult to achieve. The return to a smaller grouping could facilitate consensus and action.

None of the multilateral approaches offer a quick or easy course of action. They do, however, offer the possibility of a carefully-developed set of rules for international financial behavior that could govern the international economy for years to come. Further, by avoiding the antagonisms of bilateral conflict, a multilateral approach could make it politically easier for China to accede to the new rules.

7. Conclusion

In the midst of a severe economic downturn and high unemployment, it is difficult to focus on the long-term repercussions of U.S. actions, but for the issue at hand it is essential. It has been a long-standing goal of the United States for China to join international institutions, to follow their rules, and to help share responsibility for ensuring that the global economic system works well. In its currency practices, China has not been meeting that responsibility.

The United States, in its response, faces a choice of whether to strengthen multilateral institutions or to risk tearing them apart. The latter option could destroy a system that administrations dating back to Franklin Roosevelt have worked to build, a system on which future U.S. prosperity will depend.

[31] The United States, the United Kingdom, Canada, France, Germany, Italy, and Japan.

Nor is this really a choice between short-term benefits and long-term costs. As I have described, it is hard to discern a feasible action that China might take that would significantly improve U.S. employment and output in the short run. It is even harder to imagine a scenario in which China would adopt such a policy under the threat of U.S. punishment.

A first precept in crafting a response should be to do no harm to U.S. interests. Many of the policies currently under discussion would, in fact, be harmful. Other policies that stand a reasonable chance of doing good are likely to take a frustrating amount of time. We would be wise to show patience and pursue an approach that relies upon multilateral diplomacy.

I commend the committee for its attention to this important issue and I very much appreciate the opportunity to share these views.

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Chairman LEVIN. Thank you to each of you for very stimulating testimony. I had my crack at the beginning and we have an hour, perhaps an hour and a half. Let me go right to Mr. Rangel and then Mr. Herger, and we will go down the line.

Mr. Rangel.

Mr. RANGEL. Thank you, Mr. Chairman. Let me thank this panel. At the end of my short questions, I will be asking you what do you suggest that the Congress of the United States do.

There is no one here that doubts China is a manipulator. There is one here that doubts it has had an economic impact on the United States of America.

Is there anyone here who truly believes that the United States and the Secretary of Treasury is prepared on April 15 to declare China a manipulator? Do you think they will be doing it? Do you believe that the United States really has provided the leadership to encourage other countries to join in this multinational effort?

Lastly, and I want Dr. Bergsten to respond, I get the impression that we are playing good cop and bad cop. Our constituents, our business people, get frustrated. They come to us. We have to put some control over China's manipulation of currency. We get excited. We want to respond and we do, and then Treasury goes to China and we could write the press release before they leave. China is making an effort, we have to do this in a multinational way, they are very sensitive to American needs.

At the same time, nothing really happens. My biggest concern is we cannot explain to the unemployed people of America why their dreams are shattered. We cannot explain how they lost their homes, their savings, tuition for their kids. It is tragic.

It is not an economist or historian problem. It is really a threat to the national security and the hopes and dreams of Americans to be working.

My question, as I said earlier, Dr. Bergsten, and I direct it to you because we can get a handle on you—if you are right, we will thank you, and if you are wrong, we know where to find you. You have been with us over all these years.

What would be your direction to the Congress without causing a big conflict with our State Department or Treasury in terms of what we should be doing? What is our obligation in terms of sending a message to the People's Republic of China?

Mr. BERGSTEN. My answer to your first premise is that the administration has not followed the law of the land, and you and the Congress have not really held their feet to the fire either.

Under the Trade Act of 1988, the Treasury is supposed to label a manipulator, but the Congress is supposed to monitor them very closely. You are given the authority, and I would say the responsibility, to bring the Secretary of Treasury before you if he does not do what you think he should, hold his feet to the fire, ask him why he has not carried out the law of the land, and put substantial pressure on him to do so.

I actually think there is a reasonable chance this time that the Treasury will designate China as a manipulator.

The economic situation has changed. The U.S. is still facing high unemployment, but we are now sufficiently out of the crisis that an effort with the Chinese would not be viewed as wrecking the world economy or even the markets. I think people understand and actually expect the United States to pursue such an initiative.

The fact that the Treasury has never been willing to designate China has in my view totally undermined its ability to engineer a multilateral strategy.

I think you are quite right, Mr. Rangel and Chairman Levin as well, to be cautious for the reasons Niall Ferguson said. You do not want to launch a trade war, but as I said, it is the Chinese who are being protectionist here. If we can fashion a sensible strategy, it would be anti-protectionist.

Between now and April 15, I hope you will strongly urge the Treasury to designate the Chinese and the other four Asian countries I mentioned but also simultaneously, and based on the promise they are going to do that, go to their allies, the Europeans, some of the other emerging markets, and many developing countries. We have all made the point that as badly as the U.S. is hurt by Chinese misalignment, other countries are hurt worse.

This is a set up for a multilateral alignment. I mentioned the earlier cases, 1971 and 1985. Then it was the U.S. versus the world. The U.S. had a big deficit. The rest had a surplus. We wanted everybody else to revalue.

Now, it is different. It should be the world against China. We should be able to mobilize a coalition of not just the willing but of almost everybody to join in the IMF and in the WTO to bring multilateral pressure to bear, and if that happens, the Chinese cannot ignore or resist it.

If it becomes multilateral as it should and can be, I believe that changes the whole game. I do not believe we can launch that multilateral initiative unless we are willing to follow the law of the land, call a spade a spade, stand up ourselves, and then on that basis, go to the potential allies and mobilize the multilateral approach.

Chairman LEVIN. That is a good place for a period.

Mr. RANGEL. Thank you.

Chairman LEVIN. The latest information is we may vote as early as 11:45. Let me go down the list. Sometimes we go to the Subcommittee chairs. Sometimes we just go down seniority. I think we will reach both.

Mr. Brady, I think you have agreed to go after Mr. Herger, and Mr. Tanner, I think we will get to you. Is it all right if you wait your turn or do you want to go now?

Mr. TANNER. That is fine.

Chairman LEVIN. Next, Mr. Herger. Let's try to do it in three minutes. That way, almost all of us will have a chance. Then we are going to have a number of votes. If you could try, Mr. Herger, in three minutes. That means the four of you, if asked, will have to answer briefly.

Mr. Herger.

Mr. HERGER. Thank you, Mr. Chairman.

Dr. Levy, there are a number of questions about whether an appreciation of the RMB would reduce U.S. trade deficits with China. During the Bush Administration, China allowed the RMB to appreciate by about 20 percent; is that correct?

Mr. LEVY. Yes, sir.

Mr. HERGER. Yet, China's bilateral trade deficit during that time increased from about $202 billion in 2005 to about $266 billion in 2008. Given this record, what do you think are the other factors that are impacting this trade imbalance and do you believe the exchange rate issue is the most pressing commercial issue between the United States and China?

Mr. LEVY. Thank you for the question. I think you are entirely correct to suggest there are a number of factors that affect bilateral deficits. It is one reason economists frequently shy away from them, although obviously they are at the center of a lot of the political debate.

What we have seen in trade flows with Asia is that while China's share of U.S. imports has skyrocketed, the share of Asian countries, including China, in U.S. imports has held fairly constant over an extended period of time.

It encompasses not only the overall trade balances, which are what economists prefer to focus on, but also the shifting of trade flows within. This has the implication that we cannot be guaranteed that a change in the exchange rate would necessarily lead to an improvement in the bilateral balance, and as you suggest, that is not what we have seen in recent experience.

On the other question that you posed, is this the most important factor, I would argue it is not. As I believe Chairman Levin said, there are a whole range of Chinese practices that go into stifling consumption and determine the overall outcome of Chinese policy.

I think it would be strongly in the U.S. interest to focus on, for example, Chinese financial practices with directed credit, which can directly disadvantage U.S. competing firms.

I think some of these are less sensitive issues where we might have greater results.

Mr. HERGER. We have a number of issues here. It is not just this is placing all our apples into one basket here on this RMB. There are big associated problems that we have with China that we would be well to place our emphasis on as well, not just RMB.

Mr. LEVY. Absolutely. Fixing the one problem does not necessarily fix the situation.

Mr. HERGER. Thank you, Mr. Chairman.

Chairman LEVIN. Mr. McDermott.

Mr. MCDERMOTT. Thank you, Mr. Chairman.

I represent the city that is the closest to China. It was the city where the first ship came in with goods after the 1977 changes. People are deeply involved in my area on this whole question of China.

I am a doctor and I believe in above all things, do no harm. The question that is going to come at me in a community meeting is going to be if we force the Chinese to revalue the renminbi, what happens to us and what happens to them. We know there is a real estate bubble in China. We know there is a lot going on over there. We know our own problems.

Tell me how I answer my constituents in non-economic terms or economic garble.

Mr. PRESTOWITZ. I think that is fairly straightforward. Right now, several people have used the term that we do not want to "launch a trade war." We are in a trade war in a sense, as Mr. Bergsten pointed out.

China has taken strongly protectionist measures. Those are distorting trade and distorting the global economy and causing damage to our economy, to your constituents, they are reducing wages, they are reducing jobs here and in many other countries.

In a way, as I said, we are kind of in a trade war, and I agree with Dr. Levy, just changing the value of the RMB is not going to solve all these problems. It may not be a sufficient condition but it is a necessary condition to achieve the kind of shift that we want, and if it happens, it will have the tendency to create more jobs and higher wages for your constituents.

Mr. BERGSTEN. Two points to answer your constituents. One, if they revalue, it is going to improve the U.S. competitive position and we are going to sell more goods through the Port of Seattle to China. That is straightforward and clear.

Two, if they let the currency strengthen in value, it will help hold down inflation pressures in China. That is one of the main reasons they should do it now; they are worried about rising inflation. They are taking domestic steps against it. A rise in the value of their currency would help very much in that direction, and it would help head off property bubbles.

It is win/win. I agree with what several people said. Revaluation of their currency is very much in China's own interest, particularly right now. They are leading the world recovery and are worried about inflation coming back. They can have a much more sustained expansion if they include currency appreciation as part of an overall re-balancing of their strategy.

Mr. MCDERMOTT. If it is in their best interest, why have they not done it?

Mr. FERGUSON. If I could answer that question, I think "do no harm" is a very good maxim, and I think we are perhaps in danger of underestimating the down side risks here off a Chinese revaluation.

Their economy already has bubble like characteristics, and they are walking a very fine line between cooling it down and causing a major crisis in their own financial system.

We must be very careful that we do not have to say to your constituents oh, we thought it would help U.S. unemployment but we kind of overlooked the possibility that it would tip China into a serious slow down or you might find yourself having to say to them we thought it would really help but we kind of overlooked the fact that the Chinese would stop buying a billion dollars of U.S. denominated securities every day and our long term interest rates went up and so did your mortgage rates.

We kind of thought it would help if the dollar weakened slightly, but we did not realize it would weaken by so much and bring back the specter of stagflation.

There are a lot of things that can go wrong in a global economy as complex as the one we have today.

Back in the 1970s, which Fred Bergsten was talking about earlier, it was possible for the United States to say to the rest of the world, as John Connolly famously did, our currency, your problem.

Right now, the Chinese are in a position to say that to us. That is kind of what they are saying. The reason they are not simply doing what we would like them to do is they have good reason to be cautious about what could go wrong in their economy.

If something goes wrong in China right now, it is very bad news not only for the U.S. but for the whole world because China is now the engine of growth.

Mr. MCDERMOTT. Thank you.

Chairman LEVIN. Mr. Brady.

Mr. BRADY. Thank you very much. Mr. Chairman, I would like to ask unanimous consent to submit a statement for the record.

Chairman LEVIN. Without objection.

[The prepared statement for Mr. Brady follows:]

COMMITTEE ON WAYS & MEANS
FULL COMMITTEE HEARING ON CHINA CURRENCY

STATEMENT OF CONGRESSMAN KEVIN BRADY
Ranking Member, Ways and Means Trade Subcommittee

March 24, 2010

The topic of discussion today has long been an issue that causes blood pressure to rise among many Members of Congress. We are all concerned that China, a major trading partner, is leveraging an unfair advantage over American businesses through use of an artificially low currency. To be blunt, no one likes an unfair playing field, especially when it's tilted against American families. For that reason, Mr. Chairman, I commend you for holding this hearing to examine whether such practices harm American competitiveness and to look at the most appropriate response to such acts.

The global economic downturn has hurt workers all over the world. It is important to recognize that international trade will be a vital tool for attaining a sustainable economic recovery and for creating jobs everywhere. Our experience at home confirms the benefits to our workers when we expand our exports.

I firmly believe that our trading partners need to play by the rules. I also firmly believe that if we expect this of our trading partners, the United States has a duty to lead responsibly and uphold our WTO obligations. Therefore, I am very concerned about some proposals to unilaterally impose new duties on imports from China, either outright or through questionable expansion of our trade remedy laws. These duties could well run afoul of our WTO obligations, which could expose our exporters and our workers to retaliation. In addition, they could raise prices here and cause inflation, so we must consider the broader impact on our economy and the worldwide economy.

Mr. Chairman, I look forward to working with you and the rest of my colleagues on a bipartisan basis as we continue our work on this important issue.

Mr. BRADY. Thank you for holding this hearing, very important. I think it is critical that on this issue America and Congress especially wield a scalpel, not a sledge hammer, in addressing it, to make sure the repercussions do not damage our consumers or our businesses.

I do think along with this issue there are other issues, such as intellectual property rights, the directed credit and the government procurement that are also concerns in this re-balance of trade.

I am skeptical that levying a 25 percent tax on American consumers, raising prices, limiting their choices, will be either fair or effective in reducing our trade deficit with China, because China imports so many of its components and inputs, assembles and sends out, appreciating the RMB simply reduces the cost of their inputs, I think it offsets the impact on that final product.

Also, I wish I knew more about the products that the U.S. And China exchange with each other. I do not think there is a direct match up, to try to achieve a 25 percent reduction that Dr. Bergsten talked about, I would be interested from any of the panelists about how we match up in those products and services, so we can see where we would gain from that. I am very interested in that.

Dr. Levy, on the issue of a new tax, a new duty on imports from China, there is debate about how effective that would be at the WTO level. If we impose a new duty that does violate our WTO commitments, does that help or hurt our ability long or short term to get China to live up to its commitments?

Mr. LEVY. Thank you. I think it would seriously hurt our ability to get China to live up to its commitments. China has to date been fairly responsive to the findings of WTO dispute settlement panels, and if we were to demonstrate that one should simply not do that when one feels one has stronger concerns, we would be very unlikely to see more compliance.

Mr. BRADY. Thank you, Dr. Levy. Dr. Bergsten, I am a big fan of yours, continue to be, not sure about the 25 percent duty.

You make the point there are a couple of options on the multinational, but which one do you think stands the greatest chance of success?

Mr. BERGSTEN. Just to be clear, I did not propose a 25 percent duty. I was trying to get a currency realignment of 25 percent.

Mr. BRADY. Okay. Thank you. We are in good shape. Thank you.

Mr. BERGSTEN. Just to be clear.

Chairman LEVIN. Which do you prefer?

Mr. BERGSTEN. We don't have to choose. We go to the IMF and to the WTO simultaneously. The point Phil Levy just made is correct. We want to go through the WTO rules, as you said. There is a clear provision, Article 15 of the WTO, that proscribes the kind of practices that China is now carrying out.

Would it be effective to take a case? Would we win the case? It has never been tried. We don't know. I am not optimistic we would win the case in a legal sense. But using it to multilateralize the issue and publicize, name, and shame the Chinese for causing the problem ought to be part of our strategy.

Mr. BRADY. Great. Thank you.

Chairman LEVIN. Mr. Lewis.

Mr. LEWIS. Thank you, Mr. Chairman. Thank you, Mr. Chairman, for holding this hearing. Thank you for being members of this panel.

When we travel to the rest of the world, we hear people referring to China as using checkbook diplomacy. Dr. Ferguson and I think one or the other of you used a saying "you should call a spade a spade." How can we—and what can we do to send China the strongest possible message?

Mr. FERGUSON. Can I suggest that not only should China be branded a currency manipulator, but the United States should seek the G20 to consider the issue of currency alignments. I am not convinced the IMF or the WTO routes will deliver.

But in the G20, there are many other countries represented that are losing out from China's policy. The more unilateral U.S. action is, the less effective it will be. If the U.S. acts in concert with other countries, including other emerging markets, who, as I have said, would be the principal beneficiaries of renminbi revaluation, then I think we stand a much better chance of success.

Chairman LEVIN. Dr. Ferguson, do you think Japan is sharing lessons learned with China?

Mr. FERGUSON. Well, the Japanese experience is one that the Chinese are very anxious to avoid. One of the arguments of the book that I mentioned, "Currency Wars," is that the United States used currency policy to push Japan into recession and prevent Japan's bid for economic parity.

The Chinese have learnt the lesson that if they are not careful, they will be put in that position, too, where currency appreciation will ultimately shift their economy into the situation that Japan's was in in the 1990s, that is, to have a lost decade or now two decades.

I think that is one reason the Chinese are so reluctant to be seen to move. We had leverage over the West Germans and we had leverage over the Japanese that we don't have over the Chinese. After all, we had troops on the former losers of World War II's soil. This is not the situation with respect to China, and the Chinese look at the Japanese experience as one that they would very much like to avoid.

Mr. LEWIS. Thank you, Mr. Chairman.

Chairman LEVIN. Mr. Ryan.

Mr. RYAN. Thank you, Chairman.

Two questions. Dr. Ferguson, this is the first time I have met you. I have been reading your stuff lately. Walk us through—this is slightly off-topic, but walk us through the debt trajectory we are on, what that means for our currency, and how that is going to impact just the future sustainability of our system in one and a half minutes, if you could. And then I want to ask Fred a question.

Mr. FERGUSON. Well, there are two trajectories that the Congressional Budget Office says we could follow, one in which current law stays as it is and the debt to GDP ratio rises towards 300 percent of GDP, and one in which you ladies and gentlemen behave in the way that you traditionally do, in which case the debt GDP ratio rises above 700 percent. Now, that is not going to happen because that is an impossible number.

The United States is in a fiscally unsustainable position. Justifying this on the basis of Keynesianism is a fraud on the public because it conceals the fact that there is a structural crisis of public finance. This is of crucial importance to our discussion here because the Chinese have acted as a support for U.S. bond prices for some years now through their interventions.

The big question which we have to ask ourselves is: Are they going to stop doing that? And would they be willing to take a hit on their large holdings of U.S. dollar-denominated bonds in order to teach us a geopolitical lesson?

I believe this regime in Beijing is well capable of doing that when it feels the time is right. So I think, Congressman, you are very right to raise this issue. It is our fiscal improvidence that makes us vulnerable geopolitically as well as economically, and we would be much better advised to address the unsustainable fiscal position than to worry about the renminbi/dollar exchange rate.

Mr. RYAN. That is——

Mr. PRESTOWITZ. Could I just add, though, that I agree with what Dr. Ferguson says. But there is this point that in the global economy, there is one major consumer of last resort. That is us. So if we are going to get our fiscal house under control and increase our savings and become a more fiscally stable economy, we need China and some of the other——

Mr. RYAN. Right. I want to get Fred a question.

Mr. PRESTOWITZ [continuing]. Economies to play the game with us.

Mr. RYAN. Fred, okay, your projections on jobs from revaluation—I am curious. So are you basically saying that a one-dollar drop in our current account deficit necessarily translates into a one-dollar increase in our exports, and then you translate the export to jobs?

How is that a one-for-one replacement? I am not sure how that number adds up, necessarily the linkage between if the current account deficit goes down by a buck, it is going to necessarily translate into a dollar increase in exports.

Mr. BERGSTEN. Technically it is an increase in net exports. And some of it would be on the import side, although for various technical reasons, most of the gain from currency realignments actually does come on the export side.

But since we think there is a roughly equivalent number of jobs per billion dollars on the import-substituting side as on the exporting side, it works out about the same in terms of your job calculations.

The number that the government is now using—the Secretary of Commerce has put it out; the President has used it—is quite conservative, I think, about 6,000 jobs per billion dollars of exports. That is an average across the whole economy, but I think it is a fair one to use.

Mr. RYAN. All right. Thanks.

Mr. RANGEL. [Presiding.] The gentleman from Georgia, Mr. Tanner, is recognized for five minutes. Tennessee.

Mr. TANNER. Some people think it is all the same.

Mr. RANGEL. How soon we forget.

Mr. TANNER. Thank you. I will be humanely brief, Mr. Chairman, because you covered a couple of the questions that I had.

To the panel: Thank you very much. Very enlightening and very informative. There was an article in the Wall Street Journal this morning about China expecting their first trade deficit in six years or so. Would you give us your interpretation of how that will affect the current issue under discussion here? Thank you.

Mr. FERGUSON. If I might go first.

First, this will give the Chinese a political advantage in their negotiations with us, and they will point to this as evidence that there is no need for significant revaluation.

Secondly, I think they will probably introduce some minimal revaluation just to fob us off.

The third point, which is really important, is that it tells us how China operates as an engine of growth in the wake of its very successful stimulus program. Yes, China has been growing very rapidly indeed despite the near-Great Depression in the western world.

But it is very interesting to look at who have been the beneficiaries of China's increased imports because this is not a story of reduced exports; China's exports are at an all-time high. It is a story of massively increased imports.

Unfortunately, it is not the United States that has been increasing its exports to China. It has been other Asian countries that have been the main beneficiaries—which, incidentally, gives China some real geopolitical leverage in that region. It is now clearly the engine of growth in Asia Pacific, and we are not.

Mr. BERGSTEN. The simple answer is the number is an aberrant. It is because there were holidays in China during the February period due to Chinese New Year and such. There were a lot of days when work was not being done, moreso than in previous years because of the irregularities of the calendar. So I don't think it is to be taken seriously.

They will use it, as Dr. Ferguson said. But I don't think we should be put off by that. I mentioned in my testimony that the IMF has now done a five-year projection of where Chinese trade is likely to go. And their projection, certainly not biased against the Chinese, is that the surplus is likely to again rise from this year forward and out to 2014; goes back to about 8 percent of the Chinese economy, something like $600 billion; and would, by IMF's judgment, exceed the whole global U.S. current account deficit at that point. So on that metric, the Chinese trade problem is getting worse, not better.

Mr. PRESTOWITZ. One other point. We focus a lot on the deficit. But, you know, bilateral deficits are not the whole point of the subject.

Mr. BERGSTEN. No. I never mentioned bilateral deficits.

Mr. PRESTOWITZ. I am not criticizing you, Fred. But the point I want to make is that if we had a trade surplus with China, this would still be a problem. The real issue here is distortion of trade. Let me give you an example.

Applied Materials recently was in the newspapers: Major American company, leader in production of high technology, high capital-intensive semiconductor manufacturing equipment, moving significant production to China.

Now, if you look at the thing in terms of comparative advantage, the kind of products that Applied Materials makes are products in which the United States has a comparative advantage. Therefore, you would expect, under normal market conditions, we would export those.

But Applied Materials is moving that production to China. That would a problem even if we had a trade surplus with China because it would be distorting our trade and reducing our competitiveness.

Chairman LEVIN. [Presiding.] Thank you.

Mr. Nunes.

Mr. NUNES. Thank you, Mr. Chairman.

Dr. Ferguson, I am going to give you all of my three minutes, or what is remaining after I ask my question here. But you mentioned, in the early 1930s, steps that the Congress at that time took to take action on unemployment and joblessness.

Do you see similar policies occurring now by the Congress? And also, do you see this potential trade war or currency war with China as contributing more to, you know, increased joblessness as we move forward? And I apologize, but we are giving you all the time that I have because I know that is a long—you could go on for 20 minutes on this. But thank you.

Mr. FERGUSON. I will be more brief than that, Congressman. I think there is a serious danger that we overlook the parallels that still exist between our situation and that of the early 1930s. This is much more like the early 1930s than anything we have lived through.

And one of the common mistakes I encounter time and again in the United States and in Europe is that people look back to the 1970s or the 1980s or the 1990s because they simply didn't experience the Great Depression.

The Great Depression had two legs to it. There was a moment, in early 1931, when it looked as if it might be okay. And then there was another leg down owing to a financial crisis, interestingly, in Europe, the famous Creditanstalt Bank failure of 1931.

I don't think we are entirely out of the woods in the sense that we could have another leg down in our near-depression or Great Recession. Whether you look at the possibility of retaliatory tariffs, which are implicit in the bill that is now, I believe, before the Senate, or whether you look at the more serious problem of currency wars, there is a danger that uncoordinated policy action, unilateral moves by countries—not only the United States but also European countries—could damage international financial confidence just as it is beginning to recover.

And that is my great concern about this discussion. There is no question that China is a currency manipulator. But, one, we should not go around blaming China for all the unemployment that we have seen increase in the last two or three years. I think that would be a highly irresponsible and rather insincere way of handling this problem. And two, we must be aware of the law of unintended consequences.

Talking about a trade war, pushing the Chinese into currency revaluation, in this fragile global economy runs the risk, in fact, of killing off the recovery that we are just beginning to detect and setting off a chain of competitive devaluations.

In the world of fiat money that we entered after 1971, not all currencies can simultaneously weaken. But the way that I begin to look at governments around the world talking, they all seem to want that same thing. And that is a very dangerous situation, in my view. Thank you.

Mr. NUNES. Thank you.

Mr. BERGSTEN. Could I add just one point? And it is really important.

Mr. NUNES. I control the time.

Mr. BERGSTEN. I am sorry.

Mr. NUNES. For now. Go ahead.

Mr. BERGSTEN. Well, it is almost a question to Dr. Ferguson. I couldn't share more his concern about currency wars and competitive undervaluation. But here is the question: What is the lesson of the 1930s applied to today?

China is competitively undervaluing. And, as I mentioned, a number of Asian countries have already emulated them and are undervaluing as well so they won't lose competitive position against China. Other countries, particularly emerging markets, are tempted to do the same thing, build up big war chests of reserves, follow neo-mercantilist policies.

So the question is: What is the lesson of the 1930s? Is it better to let China and the others who are now following the competitive devaluation policies that we rightly say made things much worse in the 1930s stand or to take action against it before it spreads even further, and more and more countries join the parade, and we look back 30 years later and say China began a competitive devaluation race the same way the Americans did Smoot-Hawley in the 1930s, and it brought back the Great Depression?

Chairman LEVIN. Okay.

Mr. FERGUSON. May I answer, Mr. Chairman, very briefly?

Chairman LEVIN. In 15 seconds.

Mr. FERGUSON. Fifteen seconds? The lesson is that competitive devaluation can be the prelude to a geopolitical crisis. That is the real lesson of the 1930s. Get this stuff wrong and you end up with more than just a trade war on your hands.

Chairman LEVIN. All right. It is good to have some back-and-forth, but we do have these time limits.

Mr. Becerra, you are next.

Mr. BECERRA. Thank you, Mr. Chairman.

Gentlemen, thank you for your testimony. To be brief, let me just keep it to one question and preface it with a quick comment.

You always see this happening when someone has been the big kid on the block for ages. All of a sudden some upstart comes around. You don't pay much attention to him. He looks too small. He seems to keep up with you a little bit here and there, but you can always somehow outrun him, outdo him, beat him up.

All of a sudden the little kid starts to grow up and starts to catch up. Sometimes you get a little complacent, and to some degree, with our years and years of running deficits, years and years of having the opportunity to borrow wherever we wanted, years and years of having our industries feel that they were always number one, we are still the most innovative place in the world—sometimes you can't blame people for closing their eyes, sitting on the couch, watching TV a little bit too much.

I think what is happening is the rest of the world is catching up. And China has done a very good job of figuring out how to do this, and they are a little bit more patient than most. They have been around ten times longer than we have as a developed society, and they figure in the last 20, 30 years, they have done a lot.

But that is just a blink of an eye for them. And they are very patient and willing to wait another 40, 50 years before they overtake us, if they think that is what it will take. So I think all we are saying—we are pontificating here. We have got to get up, start doing some exercise, stretching, and recognizing that the rest of the world is catching up to us.

But my question is this: Another part of the world that has, I think, developed a little bit of flab in the midsection is Europe. Europeans are very developed, like us. We are the first world portion of the globe.

Give me your quick comment on how you think the Europeans are handling China, and how we can work with the Europeans to make sure that we work off some of that midsection to keep up with those upstarts that are catching up to us.

Mr. FERGUSON. Well, the——

Mr. PRESTOWITZ. The good thing, I think the Europeans are actually handling China better than we are, particularly if you look at Germany. Germany has a trade surplus with China. And until recently, Germany had the biggest—was the biggest trading—exporting country in the world.

And while Europe does have its problems, and clearly the Greek financial crisis is causing very serious concern about the Euro, and you have kind of a two-speed Europe with Germany and the northern countries doing not so badly and the southern countries doing poorly—but with regard to China, actually what is interesting to me is that Europe, and particularly Germany, with strong currency and very high wages, have been able to compete with China.

And I think that is something that we should take very seriously because it does indicate that there are other elements in this puzzle besides the currency. And they have to do with wage and price discipline. They have to do with coordination between government, labor, and industry.

They have to do with investment incentives, with real strategies to maintain—for example, in Germany to maintain the engineering, the medium- and small-sized high-tech engineering companies. Germany has a real competitiveness strategy, and so do some of the other European countries. We, I think, could learn from them.

Mr. BECERRA. Thank you. Thank you, Mr. Chairman.

Chairman LEVIN. I think, under our rules, Mr. Davis is next.

Mr. DAVIS OF ILLINOIS. Thank you, Mr. Chairman.

Chairman LEVIN. No, no. I am sorry. Mr. Davis from Kentucky. I am sorry.

Mr. DAVIS OF KENTUCKY. The other Mr. Davis.

Chairman LEVIN. No. Good try, Danny. I am sorry.

Mr. DAVIS OF KENTUCKY. I appreciate my colleague's initiative and creativity. Thank you, Mr. Chairman.

When I look at the interconnectedness of the relationships that we have developed with China, I am sometimes stunned at the complexity of the growth, remembering, as an eighth grade student, watching President Nixon land in Beijing, and how far we have come. And those days, or my years in the military, the Military Academy.

But coming to a conclusion, as I am entering old age, that sometimes relationships between two great powers can be kind of like a marriage of an old couple. Rarely does forcefulness by one spouse or the other tend to produce the desired result. And I have a question for Dr. Levy that I would like you to comment on, and just use the balance of your time on this.

In your opening statement, you mentioned about the quiet diplomacy that had been undertaken in the last Administration. And I think, actually, that was building upon what had happened in the prior Administration. So it was, in a sense, a bipartisan view of trying to maintain this integrity of the American economy and balancing each other's interests.

We saw a revaluing of the RMB by about 20 percent. I would like you, just for the context of us here who don't live in your world, if you could simply articulate maybe an example or two of other things that relate to the success of that approach if we were to stop from an immediate response, and maybe take a ten-year approach or a generational approach to this relationship.

Mr. LEVY. Well, thank you, Congressman. As you rightly point out, we did have some movement, and it did come from quiet diplomacy. And there is a long tradition in U.S. diplomacy that reaches across both parties of trying to bring China—not only do this bilaterally, but bring China into multilateral institutions and get China to agree and to take on burdens and responsibilities with the rules.

One of the things that I think I can—helpfully comment upon is the extent to which—it would be misleading to talk about China as a country which is sort of enjoying unmitigated success and a carefree growth and path to world dominance.

In fact, I think the Chinese had many, many concerns, and that was the subject of a lot of this diplomacy. So it was not simply that the U.S. was saying, please, please, please appreciate your currency. It was dealing with questions, for example: If you have exporters who are used to a fixed exchange rate making contracts for delivery forward, what do you do when you don't have forward exchange markets?

And it was these kind of things that our Treasury has worked with the Chinese to try and say, we can address those concerns. We can work together. There are very practical problems that come that one can address and gradually make progress and work constructively.

Mr. DAVIS OF KENTUCKY. Thank you. I yield back, Mr. Chairman.

Mr. DAVIS OF KENTUCKY. Mr. Doggett.

Mr. DOGGETT. Thank you, Mr. Chairman. And thanks to each of you for your testimony.

Dr. Bergsten, you have outlined a very specific three- or four-step plan that you think we should take that involves vigorous congressional oversight action with hearings like we are taking today, but as I understand it, does not involve any legislative action, passing any new laws by the Congress.

Is it your position that it would be a mistake for Congress to take any legislative action in this area?

Mr. BERGSTEN. I would prefer to try the approach I have outlined first because I think Congress can be a lot more activist, a lot more aggressive, and a lot more effective holding the administration's feet to the fire than you have.

If that doesn't work, then you may have to legislate to try to get that kind of forceful action by the executive branch. It is feckless that the executive has not carried out the law when the manipulation is so obvious.

Mr. DOGGETT. Thank you. Short answers: Do our other witnesses also agree that now is not the time for congressional legislative action?

Mr. PRESTOWITZ. Yes. I agree with that. But I would say one other thing. In addition to labeling China as a currency manipulator and pressuring Treasury to do that, I think also you in the Congress have special oversight over trade, and you have a special relationship with the Office of the U.S. Trade Representative.

And as we have pointed out, China is not only in violation of obligations in the IMF, but also possibly in the WTO as well. And so it might be worthwhile for the Congress to also have a chat with the Trade Rep about what action the Trade Rep might take in the WTO.

Mr. DOGGETT. Dr. Levy, no legislation now?

Mr. LEVY. Yes. I think there is nothing——

Mr. DOGGETT. And Dr. Ferguson, I believe that is your position also?

Mr. FERGUSON. That is correct.

Mr. DOGGETT. Let me ask you: Trying to look at it from the effects on the Chinese economy which you have commented on, Dr. Ferguson, particularly, what would be the likely effect within China of, say, even a 10 or 15 percent revaluation now?

Mr. FERGUSON. I recently heard a presentation by a Chinese economist on this subject, which imagined a revaluation closer to 25 percent. In that scenario, revaluation without significant changes to, for example, welfare policy designed to increase Chinese consumption would have a strongly negative effect on the Chinese GDP growth.

And I took this presentation to be a pretty clear signal of what the regime in Beijing thinks. They regard revaluation alone as a very dangerous route to go down because it would hit their export industry so hard.

Mr. DOGGETT. What do you believe will be the effect on the debt we already have with the Chinese and the debt we are likely to have in the future?

Mr. FERGUSON. This is extremely hard to be sure about. Some data suggest that the Chinese have significantly reduced their purchases of U.S. Treasuries already in the sense that direct purchases are way down. 2009 direct purchases were something like 5 percent of new Treasury issuance.

But they may be making purchases indirectly, and Dr. Bergsten and have corresponded on that question. It is very hard to know, in other words, quite how they will respond. But I want to revert to my earlier point.

They have a lever that they can turn. It would cost them, no question. But they know that if they can gain some political advantage from turning that lever, it is there. And I don't think we have an equivalent lever.

Mr. BERGSTEN. Could I just respond to you——

Chairman LEVIN. Let's go on because we are going to run out of time. And hopefully others will ask questions that give you a chance to respond. This is so important.

Mr. Reichert, you are next.

Mr. REICHERT. Thank you, Mr. Chairman.

I want to focus on intellectual property rights real quick. It is clear that China has tolerated an unacceptably high rate of piracy across technologies. U.S. copyright industries estimate that 85 to 95 percent of their members' copyrighted works sold in China were pirated. Despite repeated promises by the Chinese to step up enforcement, this problem persists and the dollar losses keep mounting to nearly 9 billion a year.

If the exchange rate has the effect of lowering these costs, the costs of products, isn't it true that, intensified by China's theft of intellectual property in making these products at issue, will the exchange rate solve—I am sorry—will the exchange rate solve the competitiveness concerns for America's most innovative industries?

And the last question: Shouldn't the Administration press the Chinese on these issues just as hard as the currency issue?

Mr. PRESTOWITZ. The exchange rate won't have as big an impact on some of the leading edge industries as it might on more standard manufacturers or standard service providers. And so you are quite right.

I think that the protection of intellectual property—and let me revert to my earlier point. The power of financial incentives—tax holidays, capital grants, free land, free infrastructure—that is extremely powerful, particularly in capital-intensive, high-tech industries. And some U.S. action on those fronts is extremely important.

Again, let me underline my feeling that the U.S. government at the national level should put together some program to respond to the very aggressive financial incentives coming from not only China, but from many other parts of Asia and even Europe as well.

Mr. REICHERT. Thank you. Dr. Ferguson, you have a comment on that?

Mr. FERGUSON. No. It will have no effect. That is to say, exchange rate revaluation will have no effect on the problem of intellectual piracy, which is rampant, I agree. And yes, we should be pressing just as hard on that issue, where it seems to me China must be in contravention of international obligations.

Mr. REICHERT. Thank you, Mr. Chairman.

Chairman LEVIN. Thank you.

Mr. Kind.

Mr. KIND. Thank you, Mr. Chairman, and thank you for holding this very, very important hearing. I want to thank our witnesses for your testimony here today.

Listen, I think we can all agree that the U.S./China relationship going forth in the 21st century is one of the most important for global economic stability and just for bilateral relations.

And yet I think that if there is a message to the Chinese authorities and the Chinese people here today, it is that we recognize that the China today is not the China of 15 years ago, or 10, or even five years ago. And as they ascend as a true economic global power, and as a member of the WTO, that global power comes with global responsibility.

And yet the patience is waning on our side. When you get more reports like the EPI briefing paper that recently came out about the job loss, given the current Chinese currency situation, and senators like Senators Graham and Schumer citing this report, this becomes more and more politically toxic in our country.

And that is why I think the message is we have got to continue to work with them to figure out how they can assume their true global responsibilities that they have right now.

Dr. Levy and Dr. Ferguson, let me ask you, and if we have time, the others can respond. But it is not unprecedented for China to take some revaluation in their currency. From 2005 to 2008, they had about a 20 percent increase alone.

What made it possible then, given the conditions then, that make it hard for them to do something comparable today? Dr. Levy.

Mr. LEVY. I think that they did recognize the difficulties that came with what was really an unwise currency policy. And I think there was constructive U.S. diplomacy to help address some of the concerns that they had. I think it got stopped when they became frightened, during the financial crisis, of what they faced.

The hope is that those pressures to change are still there. And they have described this stoppage as a temporary measure. The idea would be to work with them constructively to move to a more sensible path, which would be in appreciation.

Mr. KIND. Dr. Ferguson.

Mr. FERGUSON. The key point is the period of appreciation happened during the boom years, from 2005, when they could allow a creeping appreciation against a basket of currencies at really minimal cost to their exporters. Remember, as I tried to point out in my testimony, they were making much bigger gains in terms of unit labor costs than the losses that they were suffering through this appreciation.

The second point, I think, is that—and I think this has been mentioned before, but let me say it again—it shows you how little we gained from that kind of appreciation. I mean, the payoffs in terms of the trade deficit were nonexistent. And that is why I think we must be careful not to pin too much faith on this particular policy.

You know, a parallel was drawn earlier by Congressman Davis to a marriage. This is a kind of marriage, but one of those marriages between one partner who does all the saving and the other partner who does all the spending.

And in my experience, those marriages tend to end rather unhappily. And I think that that is why this one is on the rocks.

Mr. BERGSTEN. Two quick points, if I may. I disagree with Niall and what some others have said that the U.S. got nothing out of the earlier Chinese currency appreciation. Our current account deficit was cut in half between 2007 and 2009.

A lot of it was recession, but part of it was improved competitive position. The dollar had come down in general and particularly against China. So we did get something out of it, and we can quantify that.

I agree with Niall they did it in 2005 for a couple of years because they were enjoying a booming economy. That is why I argued in my statement now is the time they can resume it. Their economy is booming, and growth began already in the first half of last year. They have led the world recovery.

Indeed, they are worried about overheating. They have been tightening reserve requirements of the banks. They have been cutting back on lending. They are worried about inflation. This is a natural step in that context. It would fit with their cyclical position. And it would be wholly consistent with the timing of their strategy in 2005.

Chairman LEVIN. All right. Mr. Boustany.

Mr. BOUSTANY. Thank you, Mr. Chairman.

Let me start by saying, Dr. Ferguson, I deeply appreciate your admonitions that you laid out. But as we go forward, it seems to me that the broader problem is how do we get China to meet its WTO obligations, and what is our role in all of this, and how do we do it without running afoul of our obligations at WTO?

And so as I look at this, I think the problem is bigger and much more complicated than just the currency issue. You know, in talking to the business community, we hear a lot about China's indigenous innovation policy, import substitution policy, and rule of law and IP issues as well.

And of course, we hear the claim from China that they have now evolved to more of a middleman in all this, and that their export margins have narrowed down, and it has created more and more problems for them domestically and socially with regard to potential unemployment.

So I guess my question is: I know we have all talked about a combination of bilateral diplomacy as well as multilateral approaches. One specific question: If we are going to do this, and all of you have outlined the first step being labeling China as a currency manipulator—except for you, Dr. Levy—should we perhaps, instead of taking that step, go broader and look at the other countries, particularly in Asia, that are also manipulating their currencies?

I think, Dr. Bergsten, you have mentioned in your paper, your testimony, your written testimony, Hong Kong, Taiwan, Singapore, Malaysia. Would that be a more prudential approach for Treasury rather than just simply labeling China? And I will throw that question out for discussion.

Mr. BERGSTEN. As I said, those other countries de facto track the Chinese currency. And they have also experienced huge increases in their reserves; they have manipulated. So it would be perfectly legitimate to name them.

I think it would be much in the U.S. economic interest to name them and get them to revalue because when you add them up, they almost double the ante in terms of trade flows and potential payoff.

I think it would also be politically good to group China with some others and not single out China. You would be singling out what I would call a de facto China bloc; you wouldn't call it that, but de facto you would do it.

I don't actually think you have to do it because if the RMB rises, the others will go up along with it in practice. But again, to be honest, to carry out the law of the land and to double the ante from our standpoint, and maybe to make it a little easier for China by not singling it, I think it would make sense to name the several of them.

Mr. BOUSTANY. Would this help China solve or face its problems? I mean, because, you know, given the evolution of its manufacturing to sort of this middleman approach as opposed to what has gone before because of their input costs coming from these other Asian countries, would it stimulate some of these other countries to go to a free float?

Mr. BERGSTEN. Well, it would. It highlights the fact that the Asian countries do have a problem in their exchange rate relationships with each other. And here I would bring in Japan. They talk about coordinating their exchange rate and their monetary policies. They haven't been able to do it. They still view themselves as competitors more than cooperators.

But they really do in fact need to work out an answer to that collective goods problem. Korea, for example, let its exchange rate go up sharply a couple of years ago and looked around and nobody else was there. They wound up on a limb, uncompetitive, and came back down.

I have proposed an Asian Plaza Agreement, where the Asians get together and work out a common move in their own currencies so as to deal with the global rebalancing problem without beggaring each other in the way that otherwise could occur.

Mr. BOUSTANY. Dr. Levy——

Chairman LEVIN. Okay. No, your time is up. Okay. So others can—Mr. Boustany.

So let me just—let's review where we are. We are not quite sure when the bells will ring. Mr. Neal, you are next under our rules, then Mr. Pascrell——

Mr. CAMP. I have not questioned yet.

Chairman LEVIN. Oh, all right. That is true. I skipped my questions, but you don't have to do that. All right. So Mr. Neal and then Mr. Camp, and then Mr. Pascrell, Mr. Crowley, Mr. Davis of Illinois, Mr. Etheridge, Ms. Sánchez, and then Ms. Schwartz. Oh, yes, Mr. Tiberi is here. All right.

Mr. TIBERI. Thank you. Thank you, Mr. Chairman.

Chairman LEVIN. No, no. Wait, wait. You are not—Mr. Neal is next. I think, because there are many more Democrats, we are going to take two at a time and—let's just go. It is going to work out.

So next is—where are we? Mr. Neal is next, and Mr. Pascrell. You are a duo. Okay? Mr. Neal.

Mr. NEAL. Thank you, Mr. Chairman.

Chairman LEVIN. Three minutes.

Mr. NEAL. Thank you. Thank you, Mr. Chairman.

I guess what I am curious about is I agree with Dr. Ferguson that we don't want to ignite a currency war with the Chinese. But at the same time, how are the European Union members and Canada responding to China's position? I mean, the headlines are dominated, even over the last few days, on an array of issues. But how are the European Union members and Canada reacting?

Mr. FERGUSON. I can't speak for Canada, but the European solution is an inadvertent one. When they had a conscious strategy of trying to engage China, when President Sarkozy took a hard line, it was a miserable failure.

But they have solved the problem by having their own massive internal crisis. And the crisis of the Eurozone has the unintended consequence of weakening the Euro. This is part of the currency war story.

You know, listen to those crocodile tears falling in Germany about the dreadful Greeks. In fact, German manufacturers are delighted that the Greeks are screwing up because it is finally weakening the Euro relative to the dollar and other currencies. So that is really the solution that they have inadvertently come up with.

Mr. NEAL. And the pound?

Mr. FERGUSON. The pound is going to be an even weaker currency than the Euro. I would expect you will be shopping in London with parity to the dollar any time—some time this year.

Mr. NEAL. Let me just throw this out to the panel as well. How would the Chinese justify their current position?

Mr. PRESTOWITZ. Well, they justify it on the basis that they are a developing country. They have to create I forget how many million—20 or 30 million—jobs a year just to absorb the population moving from the countryside to the cities.

Mr. NEAL. To the urban areas?

Mr. PRESTOWITZ. They have—you know, they are in catch-up mode. They also argue that they are only—they are the most dynamic economy. They are kind of contributing disproportionately to global growth, partly as a consequence of this policy.

And, you know, they make the same arguments that we have heard here, that even if they revalued their currency, it wouldn't make any difference. They point to our deficits, our low saving rates, our declining competitiveness, and basically they tell us to pull up our socks.

And this is very similar to discussion we had in the 1980s with Japan. You know, we complained in the 1980s that the Japanese were not fulfilling all their obligations, undervaluing their currency, and so forth, and they turned around and said, no. The problem is not us. It is you. And so the Chinese do the same thing.

Mr. BERGSTEN. But the Chinese have implicitly admitted that they have to change their strategy. For six years, President Hu Jintao and Premier Wen Jiabao have said repeatedly, we agree with the need to rebalance our economic growth strategy, put less weight on export expansion and trade surpluses, and put more weight on increasing consumer demand and domestic services sectors.

They have adopted it as policy. The move of the exchange rate for three years back in 2005 was part and parcel of that. Then they got cold feet in the face of the global crisis and put a halt to it. But they have essentially adopted a strategy, rhetorically at least, of changing the composition of their growth, part of which would essentially be a big change in the exchange rate.

So I think they have accepted it implicitly. They have stopped it because of the crisis. The head of the central bank said recently that it was a temporary thing and they would go back to the exchange rate movement at some later point. So it is a matter of timing and how fast they go about it.

One counsel to us would be to be patient and they will get to it. But the problem is a lot of crockery is broken in the meanwhile. But I think they have implicitly accepted, in the G20 and, in the IMF, a need to rebalance their growth strategy, which has to include an important currency dimension.

Mr. NEAL. Thank you. Thank you, Mr. Chairman.

Chairman LEVIN. Thank you.

Mr. PASCRELL. Mr. Chairman, we need an Administration that for once will stand up to China. This is a very serious problem here, not only contributing to the trade deficit with currency manipulation, but this is an even bigger problem in terms of how our goods have become less competitive.

And you tell this—you tell this to the computer industry, the electronic equipment industry in the United States, and parts industries that they will have to continue to wait and be destroyed as the textile industry was destroyed in this country, and we think we are going to solve all these problems diplomatically.

I don't think that works. 2.4 million American jobs have been lost or displaced since China joined the WTO in 2001. As a result of the growing trade deficit with China, and in the state of New Jersey, we have lost in that period of time 68,800 jobs. That is outlined very clearly in the EPI briefing case which was reported, which was referred to before.

In my district, the 8th Congressional District alone, we lost 6,000 jobs, lost or displaced. Those numbers are significant. And when I go back—it will be interesting. When I go back to the district, I intend to talk to some business people about this who are very concerned that they cannot get their product into China, and want to deal with the exports.

I am going to tell them, well, look. We are going to deal with this diplomatically because we don't want to perhaps cause a situation that occurred in the 1930s. And you know what happened then, wink wink.

This is an absurdity. We also know that China exports five times as much to the United States as we export to China. We have leverage over China to ensure equity in our trade relations.

And my question to you, Mr. Ferguson: What can the U.S. do, and what measures do you suggest, to protect the nation from any possible retribution from China?

Mr. FERGUSON. Well, I think the first thing is to be very careful about assuming that all the lost jobs were lost because of Chinese competition. And it would be an even bigger mistake to assume that they would all magically come back if China's currency were revalued. These would be very misleading assumptions.

I think an important issue that has been raised in our discussion this morning is what the best channel to go through might be. And we have expressed skepticism about legislative action, retaliatory tariffs, for good reason. You may dismiss the parallel with the 1930s as somehow irrelevant, but I can assure you any further blows to global demand dealt by errors of U.S. fiscal, monetary, or trade policy would harm your constituents even more severely than they have so far been harmed.

If you had a choice between the IMF and the World Trade Organization—and this is really an important point that Dr. Bergsten has raised—the World Trade Organization is the better institution for two reasons. It is better at dealing with big guys, and it is better at dealing with surplus countries.

Mr. PASCRELL. Let him finish the sentence.

Chairman LEVIN. So we will follow the rules. Mr. Roskam is next. Mr. Tiberi, Mr. Roskam goes first under our procedures, and then all of the——

Mr. PASCRELL. Mr. Chairman.

Chairman LEVIN. Yes.

Mr. PASCRELL. Couldn't we have at least allowed the gentleman to finish the sentence?

Chairman LEVIN. I think he finished.

Mr. FERGUSON. Just.

Chairman LEVIN. Okay. Finish the sentence. I thought he had.

Mr. FERGUSON. I did finish the sentence. Thank you, Mr. Chairman.

Chairman LEVIN. Okay. So here we go. Mr. Roskam is next, and then under our rules Mr. Crowley, Mr. Davis of Illinois, Mr. Etheridge, Ms. Sánchez, then Mr. Tiberi and Ms. Schwartz. Okay? We are taking the two of you who came in after we started.

So let's go. We may have 20 minutes. It is hard to tell. Mr. Crowley—no, Mr. Roskam.

Mr. ROSKAM. Yes.

Chairman LEVIN. I guess, Mr. Roskam, you will go next and then Mr. Crowley. Excuse me.

Mr. ROSKAM. Thank you, Mr. Chairman. Mr. Chairman, thank you for this hearing. I have really found it insightful and helpful.

Dr. Ferguson, maybe to finish your point from a minute ago, could you give your perspective on sort of the WTO, why it is that that—the subtlety there vis-a-vis the IMF? And could you comment, maybe, on Dr. Bergsten's approach? Would you—Dr. Bergsten's approach, if I understood it correctly, was designate China as a currency manipulator, and then do sort of a special envoy approach with the IMF and the WTO. Could you comment on that?

Mr. FERGUSON. I don't think there is any harm in going to the IMF, but I don't think anything much will come of it. The IMF is only able to exert leverage over countries that are in deficit and in crisis, and they are usually smallish countries. And there are plenty of those it has to concern itself with right now.

The difference is that the WTO is a body quite differently constituted that is able to impose decisions on the biggest countries, including the United States when it has violated its WTO obligations. The WTO is the most powerful of all the international economic institutions, and that is why it is actually our best channel.

China has gained hugely from WTO membership, as I think was pointed out by Congressman Pascrell. But that puts it in a position of vulnerability if we pursue the letter of the law in the WTO. And that seems to me to be the best course of action to take. Is there——

Mr. BERGSTEN. I agree with that and add one crucial point. Under the WTO rules, they ask the IMF for a judgment as to whether a currency is undervalued or overvalued. So technically, the WTO, given a case by the U.S., will ask the IMF for a finding.

The managing director of the IMF has been going around the world saying the RMB is substantially undervalued. So I think the right advice would be provided. But that is the key reason why the IMF technically has to be involved in the process.

Mr. FERGUSON. Very briefly, it is not just the currency issue that we should take to the WTO. There are many, many other issues where you could challenge China's compliance.

Mr. ROSKAM. Is it a conditioned precedent to move forward to name them as a manipulator in April?

Mr. BERGSTEN. Neither technically nor legally. The U.S. has those rights in the WTO or IMF. My point is, and I have heard this from people all over the world for five years, that if the U.S. is not willing to call a spade a spade itself, why is it asking them to stand up and be counted in a coalition of the willing?

Mr. ROSKAM. I understand. Dr. Levy.

Mr. LEVY. Yes, Congressman. If I may, I would just argue—I would take some issue with Dr. Ferguson. There is a serious downside risk to taking a case to the WTO, which is: We do not have clear language at the WTO delineating exactly which conditions are acceptable and which are unacceptable.

The U.S. could lose either way. If it loses the case, we will never hear the end of it from China about how their practices have been justified. If we win the case, we will have established the precedent of panel overreach, that we are counting on dispute settlement panels to essentially legislate and come up with rules.

Mr. ROSKAM. Thank you. I yield back.

Chairman LEVIN. Thank you.

Mr. CROWLEY. Thank you, Mr. Chairman.

I am interested in hearing from all of you, I guess—I don't know if there is enough time for that—in terms of what your thoughts are if China—if you can carry through, if China would begin to or stop the purchasing of Treasury bills, what effect that would have in terms of our market share, what the reaction would be. I would like to hear, if you can give that.

Before you answer that, let me just get the other two, both Drs. Ferguson and Bergsten. I believe you both have stated that you believe that the U.S. should declare China a currency manipulator. Is that correct?

Mr. FERGUSON. [Nodded head up and down.]

Mr. CROWLEY. What do you believe is the worst case scenario if the United States does not do that, and if we take no further action? I don't believe either one of you is suggesting we take further action in terms of congressionally. But at the minimum, you believe the U.S. should declare them manipulators.

Many economists, and we have heard some reports already, have demonstrated the job loss that has taken place here because of—as a result of China's currency manipulation. Do you believe that that has peaked? Has it leveled off, or do we still—or are we still poised to possibly lose millions more jobs?

Mr. BERGSTEN. I think the situation will get worse if we did nothing about it. If China maintains the exchange rate where it is now, but if the IMF forecast is right, its surplus rises again, and in absolute terms gets to about double where it is now, that simply means a bigger deficit for us and more job loss for us.

So the worst case, in my analysis, is if we do not label China. We still have no credibility in trying to line up a multilateral coalition to take the preferred measures.

Mr. CROWLEY. Dr. Ferguson.

Mr. FERGUSON. Well, I think if we don't label China a currency manipulator, we will look like the wimps of the western world. So it is our credibility that will really be the biggest problem. And I think that is the most powerful argument.

Your first question is a really important one. I was at a conference in London last week at which a leading Chinese economist said the following: "My recommendation is that China should buy no more U.S. Treasuries, but should not sell them all at once." And when he said those words, there was a stunned silence in the room.

That seems to me to indicate that there is a fundamental policy change underway, and it will put the pressure on the Federal Reserve to start buying Treasuries if China stops because otherwise there will be a significant runup, maybe of 200 basis points, in 10-year yields. And that would really be devastating for the U.S. economy at this time of depressed demand and very high levels of debt.

Mr. BERGSTEN. I strongly disagree with that, with all due respect. First of all, if they stopped buying Treasuries, like the guy said, we could declare victory. That is what we want. We want them to let the exchange rate of the renminbi go up. The way they keep it from going up is to buy dollars, to buy Treasuries.

Now, what would be the effect on our monetary policy and our macro economy? First of all, since our deficit would come down, we wouldn't need to borrow as much foreign money. We would still have a budget deficit. Maybe it will put some healthy pressure on us to reduce our budget deficit.

But in the meanwhile, other people would have to buy those Treasuries. The Fed itself would, at the end of the day, buy Treasuries, as it does now, under its zero interest rate and quantitative easing policies.

Krugman has argued strongly that more of that could be done without much effect on interest rates. I don't think it would go up 200 basis points, but it would go up some. We have done analysis on it ourselves. We think maybe 50 basis points. There would be some effect on interest rates. There is no free lunch in getting these imbalances down, that is for sure.

Chairman LEVIN. Mr. Davis of Illinois.

Mr. DAVIS OF ILLINOIS. Thank you very much, Mr. Chairman.

You know, I was just thinking that in the community where I live, out on the streets there is a saying that if you see a sucker, bump his head. And I guess if you translate that, it would probably mean if you see opportunity, exploit it or make use of it.

My question really is: How much or what kind of impact do we see revaluation of China's currency helping to make up for the differential in labor and production costs which are enticing American companies and international corporations to flock to China in pursuit especially of consumer items?

And how does the differential in consumption in China versus consumption of these goods in the United States impact our trade deficit?

Mr. BERGSTEN. Well, it would help a lot on both counts. On the latter, remember, if they revalue the exchange rate, it makes imports a lot cheaper. Therefore, they will import more from us and everybody else. That is good for consumers in China. So if they really want to shift the economy more toward consumption, a big revaluation of the exchange rate is very helpful.

In terms of relative labor costs, it also helps. It is not going to solve the whole problem; their labor costs will still be much lower than ours. But remember, their productivity is much lower than ours, too, and what counts is the relationship between the two.

If the RMB were to go up by my full 40 percent, that is like reducing the gap between productivity differentials by about 40 percent. It wouldn't solve the whole problem, but it would help a lot in terms of U.S. competitiveness both in the Chinese market and domestically against products coming from China.

Mr. DAVIS OF ILLINOIS. Anyone else?

Mr. PRESTOWITZ. Well, that is—I agree essentially with what Fred said. But I would add this point. That is that much of what we sell—much of the dynamic you are talking about, the movement of U.S. productive factories and investment abroad, is not so much in response—it is partly in response to the currency. But it is also very much, as I said earlier, in response to these very aggressive investment incentives.

And I think that is another issue that has to be addressed in this context. And I think it is something that can be done in the WTO, as Mr. Ferguson suggested.

Mr. FERGUSON. A very brief remark on this. We would have to keep pressing them because they keep making productivity gains. And we must realize it is a very important point. This isn't a one-time quick fix.

Even if there was a 40 percent revaluation, it wouldn't be long before we would find ourselves once again under pressure because the real gains are coming in the unit labor costs, not from the currency manipulation.

Mr. DAVIS OF ILLINOIS. Thank you very much, Mr. Chairman.

Chairman LEVIN. Under our rules, Mr. Camp wants to inquire.

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

We hear a lot about China's foreign currency reserves. And Dr. Levy, could you help the committee understand the ramifications of holding those reserves? And certainly, you know, the impact on financial markets, for example, and some have argued they may have been the cause of the financial crisis, does this push down U.S. interest rates?

Can they use them to subsidize manufacturing? And are there any other countries that, over time, have had either large foreign currency reserves or large trade surpluses, and what was the impact?

So if you could just enlighten the committee in that area, I would appreciate it.

Mr. LEVY. Yes. I would be happy to. There is a lot of material there.

I would say I do not believe that China's accumulation of foreign currency reserves were a principal cause of the financial crisis.

It does have the effect of increasing the pool of savings in the world, and that does have the effect of driving down interest rates.

But I think for the U.S. as a major borrowing nation, in general seeing lower interest rates is a good thing. If we misuse the funds, that is not really China's fault.

I think there are common misperceptions that the accumulation of reserves is some war chest for China to do whatever they please to, as you suggested, subsidize domestic manufacturers, is one common. In fact, it is a very limited pile of funds, and I would argue that it is in no sense a measure of Chinese success, that it is a growing problem for the Chinese.

Were they to try to use these funds domestically, the first step would be that they would have to convert—whether it is dollars, Euros, yen—they would have to convert them into their currency, and that would bid up their currency.

What they are faced with is as soon as that happens, they face a very serious capital loss. They can have a capital loss both because of the change in the currency and if interest rates were to rise. So it is actually a major point of vulnerability for China.

Were there other points that missed?

Mr. CAMP. No. I mean, that was generally it. I have a few seconds left. Is there anybody else who would care to comment?

Mr. BERGSTEN. I think the Chinese fully understand that they are going to take big capital losses on their dollar holdings. They have viewed this all along as an export subsidy, which leads to a job subsidy. And they know that at some point, they are going to have to pay the price.

It is actually ironic and almost humorous. The Chinese complain about the international value of the dollar and the international role of the dollar. But every day, as I testified, they are buying another $1 billion worth of dollars to keep their currency from rising. They are the ones who are propelling the dollar to an ever greater international role, all the while complaining about it.

So I don't have too much sympathy for them. I think the thoughtful people there know that they are going to take a loss. They don't have to mark it to market, incidentally. It doesn't go into their budget. It doesn't go into any accounting. They will never have to pay any piper for it. But they know that as part of their development strategy, it is a price that they judge to be worth paying.

Mr. CAMP. All right. Thank you. I see my time is expired. Thank you, Mr. Chairman.

Chairman LEVIN. Thank you, Mr. Camp.

Mr. Etheridge and then Ms. Sánchez.

Mr. ETHERIDGE. Thank you, Mr. Chairman. Thank you for this hearing.

Let me follow that a bit because if you look at it internationally and look at some numbers—I am looking on this chart—if you go back to 2000 on the foreign currency exchange reserves that China has accumulated, and with the amount of trade deficits they have accumulated at the same time, it is about a fivefold increase, you know, progressively. It keeps going.

My question is this, though: Because as you look at the loss of jobs in this country in that same period and you look at how the products we manufacture have gone, and it is also having an impact, starting to have an impact, on our agricultural exports that we now still have a balance of payments in, my big question to you, in a state like mine in North Carolina, where we produce pork and poultry and a host of manufacturing textiles and technologies, give me some understanding of where we are headed with all this stuff.

We have talked about it in the broader sense. But through the international or the large corporate entities, you know, they are moving stuff at that level. I want to know what happens on Main Street for the guy and gal who is out there working every day who is trying to make a living and don't understand all this stuff.

Mr. BERGSTEN. Well, I did a quick calculation based on the data your staff aide gave me on North Carolina. And if I understand it right, your population is about 3 percent that of the country.

Mr. ETHERIDGE. Correct.

Mr. BERGSTEN. So if the averages pan out and my numbers are right, then eliminating the Chinese currency misalignment would create somewhere between 18,000 and 30,000 jobs in North Carolina. It actually might be a bit more than that because in agriculture and low-productivity industries like textiles, you actually get more jobs per billion. So you would probably be toward the upper end of that range.

It would be significant in terms of job creation in a trade-oriented state like North Carolina.

Mr. ETHERIDGE. Mr. Ferguson.

Mr. FERGUSON. More jobs have been lost in the United States by the bursting of the real estate bubble and the loss of jobs in housing and construction than have been lost to competition with China in the last three years, far more.

And we must beware of what would be a Pyrrhic victory, in Dr. Bergsten's terms. If we got a currency revaluation at the price of higher interest rates, then it would be very bad news indeed for the people in the housing and construction sectors so badly affected and so very far from a sustainable recovery right now.

Mr. ETHERIDGE. So it is not a very simple answer?

Mr. PRESTOWITZ. But, listen. The course that we are on at the moment, if the Chinese don't revalue and we stay on the track we are on, is unsustainable. And it results in continued erosion of U.S.

competitiveness and U.S. standard of living, and it is just not a sustainable course.

Mr. ETHERIDGE. Thank you, Mr. Chairman.

Chairman LEVIN. Ms. Sánchez, you have the last crack, I think. Thank you for your patience.

Ms. SÁNCHEZ. Thank you, Mr. Chairman. And I want to thank the witnesses for their patience.

All of you seem to agree that China is artificially holding down the value of its currency in order to boost its exports and make imports more expensive there. And it is clear that the use of the favorable exchange rate policy hurts American farms and American workers.

And estimates that are about 1.5 million jobs are lost due to the currency manipulation. And in fact, in the state of California, we have lost the greatest number of jobs due to unfair Chinese trade policies, and sadly, my district ranks No. 32 of all 435 congressional districts in job loss due to unfair Chinese trade.

And so, Mr. Chairman, I would ask unanimous consent to be able to submit the EPI briefing paper, "Unfair China Trade Costs Local Jobs," for the record, if I may. Mr. Chairman?

Chairman LEVIN. Without objection.

[This information follows:]

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UNFAIR CHINA TRADE COSTS LOCAL JOBS

2.4 Million Jobs Lost, Thousands Displaced in Every U.S. Congressional District

BY ROBERT E. SCOTT

Since China entered The World Trade Organization (WTO) in 2001, the extraordinary growth of U.S. trade with China has had a dramatic effect on U.S. workers and the domestic economy. The United States is piling up foreign debt, losing export capacity, and the growing trade deficit has been a prime contributor to the crisis in U.S. manufacturing employment. Between 2001 and 2008, 2.4 million jobs were lost or displaced, including 91,400 in 2008 alone, despite a dramatic decline in total and bilateral U.S.-China trade deficits that began in the second half of that year. Growing trade deficits have cost jobs in every Congressional district, including the District of Columbia and Puerto Rico (this study reports these district-level data for the first time).

The computers, electronic equipment, and parts industries experienced the largest growth in trade deficits with China, leading with 627,700 (26%) of all jobs displaced between 2001 and 2008. As a result, the hardest hit Congressional districts were located in California and Texas, where remaining jobs in those industries are concentrated, and in North Carolina, which was hard hit by job displacement in a variety of manufacturing industries.

But the jobs impact of the China trade deficit is not restricted to job loss and displacement. Competition with low-wage workers from less-developed countries has also driven down wages for other workers in manufacturing and reduced the wages and bargaining power of similar workers throughout the economy. The impact has affected essentially all production workers with less than a four-year college degree—roughly 70% of the private-sector workforce, or about 100 million workers. For a typical full-time median-wage earner in 2006, these indirect losses totaled approximately $1,400 per worker (Bivens 2008). China is the most important source of downward pressure from trade with less-developed countries, because it pays very low wages and because it was responsible for nearly

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40% of U.S. non-oil imports from less-developed countries in 2008.

This study finds the following:

- The 2.4 million jobs lost/workers displaced nationwide since 2001 are distributed among all 50 states, the District of Columbia, and Puerto Rico, with the biggest losers, in numeric terms: California (370,000 jobs), Texas (193,700), New York (140,500), Illinois (105,500), Florida (101,600), Pennsylvania (95,700), North Carolina (95,100), Ohio (91,800), Georgia (78,100), and Massachusetts (72,800).
- The hardest-hit states, as a share of total state employment, are New Hampshire (16,300, 2.35%), North Carolina (95,100, 2.30%), Massachusetts (72,800, 2.25%), California (370,000, 2.23%), Oregon (38,600, 2.19%), Minnesota (58,800, 2.17%), Rhode Island (10,600, 2.01%), Alabama (39,300, 1.97%), Idaho (13,500, 1.97%), and South Carolina (38,400, 1.97%).
- Rapidly growing imports of computer and electronic parts (including computers, parts, semiconductors, and audio-video equipment) accounted for more than 40% of the $186 billion increase in the U.S. trade deficit with China between 2001 and 2008. The $73 billion deficit in advanced technology products with China in 2008 was responsible for 27% of the total U.S.-China trade deficit. The growth of this deficit contributed to the elimination of 627,700 U.S. jobs in computer and electronic products in this period. Other hard-hit industrial sectors include apparel and accessories (150,200 jobs), miscellaneous manufactured goods (136,900), and fabricated metal products (108,700); several service sectors were also hard hit by indirect job losses, including administrative support services (153,300) and professional, scientific, and technical services (139,000).
- The hardest-hit Congressional districts had large numbers of workers displaced by manufacturing trade, especially in computer and electronic parts, apparel, and durable goods manufacturing. The three hardest hit Congressional districts were all located in Silicon Valley in California, including the 15th (Santa Clara county, 26,900 jobs, 8.3% of all jobs in the district), the 14th (Palo Alto and nearby cities, 20,300 jobs, 6.3%), and the 16th (San Jose and other parts of Santa Clara county, 18,200 jobs, 6.0%).
- The hardest hit Congressional districts were concentrated in states that were heavily exposed to growing China trade deficits in computer and electronic products and other industries such as furniture, textiles, and apparel. Of the top 20 hardest hit districts (see Table 5, below), eight were in California (in rank order, the 15th, 14th, 16th, 13th, 31st, 34th, 50th, and 47th), four were in North Carolina (10th, 6th, 4th and 5th), three were in Texas (31st, 10th and 3rd), two were in Massachusetts (5th and 3rd), and one each in Oregon (1st), Georgia (9th), and Alabama (5th). Each of these districts lost more than 8,600 jobs (2.8% of total jobs in the district).

Currency manipulation

A major cause of the rapidly growing U.S. trade deficit with China is currency manipulation. Unlike other currencies, the Chinese yuan does not fluctuate freely against the dollar. While the value of its currency should have increased as China exported more and more goods, it has instead remained artificially low, and China has aggressively acquired dollars to further depress the value of its own currency. China has tightly pegged its currency to the U.S. dollar at a rate that encourages a large bilateral surplus with the United States. China had to purchase $453 billion in U.S. treasury bills and other securities between December 2008 and December 2009, alone, to maintain this peg.[1] China has acquired a total of $2.4 trillion in foreign exchange reserves as of December 2009 (Chinability 2010). About 70% of these reserves are held in U.S. dollars. This intervention makes the yuan artificially cheap relative to the dollar, effectively subsidizing Chinese exports. The best estimates place this effective subsidy at roughly 40% of the U.S. dollar, even after recent appreciation in the yuan (Cline and Williamson 2010).[2] Currency intervention also artificially raises the cost of U.S. exports to China by a similar amount, making U.S. goods less competitive in that country.

TABLE 1

U.S. China trade and job displacement, 2001-08

U.S. trade with China ($billions, nominal)

				Changes in: ($billions)			Percent change
	2001	2007	2008	2001-07	2007-08	2001-08	2001-08
*U.S. domestic exports**	$18.0	$61.0	$67.2	$43.1	$6.2	$49.2	274%
U.S. imports for consumption	102.1	323.1	337.5	221.0	14.4	235.4	231
U.S. trade balance	84.1	262.1	270.3	178.0	8.3	186.2	221
Average annual change in the trade deficit				29.7	8.3	26.6	18

U.S. trade-related jobs supported and displaced (thousands of jobs)

				Changes in: (thousands of jobs)			Percent change
	2001	2007	2008	2001-07	2007-08	2001-08	2001-08
U.S. domestic exports	166.2	470.0	518.8	303.8	48.8	352.6	212%
U.S. imports for consumption-jobs displaced	1,188.2	3,819.3	3,959.5	2,631.1	140.3	2,771.3	233
U.S. trade balance-net jobs lost	1,022.0	3,349.3	3,440.7	2,327.3	91.4	2,418.8	237
Average annual job displacement				387.9	91.4	345.5	19

* Domestic exports are goods produced in the United States. Total exports as reported by the U.S. International Trade Commission include re-exports, i.e. goods produced in other countries and shipped through the United States. Total exports were $71.5 billion in 2008 while U.S. re-exports to China represent 6.0% of total exports. The employment estimates shown here are based on domestic exports only.

SOURCE: EPI analysis of Census Bureau, USITC, and BLS data

Other policies by the Chinese government also encourage exports. China extensively suppresses labor rights, which lowers production costs within China. An AFL-CIO study estimated that repression of labor rights by the Chinese government has lowered manufacturing wages of Chinese workers by 47% to 86% (AFL-CIO 2006, 138). China has also been shown to provide massive direct subsidization of export production in many key industries (see, e.g., Haley 2008, 2009). Finally, it maintains strict, non-tariff barriers to imports. As a result, China's exports to the United States of $337.5 billion in 2008 were more than five times greater than U.S. exports to China, which totaled only $67.2 billion (**Table 1**). China's trade surplus was responsible for 68.5% of the U.S. total non-oil trade deficit in 2008, making the China trade relationship this country's most imbalanced by far.

Unless China raises the real value of the yuan by at least 40% and eliminates these other trade distortions, the U.S. trade deficit and job losses will continue to grow rapidly in the future. While the overall U.S. trade deficit improved slightly in 2008—largely as a result of collapse in world trade associated with the onset of the great recession of 2008-09—the U.S. deficit with China increased $8.3 billion, mostly because China engaged in currency manipulation designed to suppress the value of the yuan. The increase in the U.S.-China trade deficit declined from $26.6 billion in 2007 to $8.3 billion in 2008, reflecting the collapse in demand in the United States.

Beginning in 2002, the dollar declined more than 30% against several major currencies such as the Euro and the Canadian dollar. However, yuan appreciation was largely delayed until late 2007 and 2008—too little and too late to be of any help in slowing the current U.S.-China trade gap to date.[3] Furthermore, the appreciation of the yuan has had little effect on the prices of U.S. imports from China, which rose only 2.5% between July 2005 (when the yuan was first adjusted) and May 2008, much less than the 19% appreciation of the yuan in that period (Congressional Budget Office 2008, 2). While Chinese exporters were able to absorb the impact of a higher yuan by lowering profit margins, at least through mid-2008, further appreciation is likely to be reflected in higher prices.[4]

China's currency manipulation has compelled other countries to follow similar policies in order to protect their relative competitiveness and to promote their own exports. Widespread currency manipulation has also contributed to the growth of very large, global current account imbalances. Cline and Williamson (2010) call for a substantial realignment of the dollar against currencies from five Asian countries that are undervalued relative to the dollar, in order to rebalance global current account flows: China, Hong Kong, Malaysia, Taiwan, and Singapore. They call for reducing the U.S. current account deficit to 2.8% of GDP in 2012 (from a projected 5.6% if currencies are not realigned). They estimate that the yuan needs to rise 41% against the U.S. dollar, and the other countries listed by 25% to 32%. Cline and Williamson project that global currency realignment would result in a 5.6% fall in the trade-weighted value of the U.S. dollar across all currencies. Reducing the U.S. current account to a lower level, such as 1% of GDP, would require proportionately greater rebalancing of currencies, especially those of Asian countries.

Undervaluation of the yuan has forced other countries to bear the burden of global current account realignment pressures. As a result, the currencies of many other countries, including Australia, New Zealand, South Africa, and Brazil, as well as the United States, have become overvalued on a trade-weighted basis.

As a result of China's currency manipulation and other trade distorting practices, including extensive subsidies, legal and illegal barriers to imports, dumping and suppression of wages and labor rights, China's share of the U.S. trade surplus has soared, especially in 2009. Between 2008 and 2009, the U.S. goods trade deficit declined 38.5%, while the U.S.-China trade deficit fell only 15.4%. China's share of the total, U.S. non-oil trade deficit jumped from 68.6% in 2008 to 80.2% in 2009 (Scott 2010).

China's entry into the WTO was supposed to bring it into compliance with an enforceable, rules-based regime that would require that it open its markets to imports from the United States and other nations. The United States also negotiated a series of special safeguard measures designed to limit the disruptive effects of surging Chinese imports on domestic producers. However, the core of the agreement failed to include any protections to maintain or improve labor or environmental standards and, prior to 2007, the administration rejected all requests for special safeguards protection. In September 2009, the Obama administration announced that it would take action to restrict imports of Chinese tires for three years under the special safeguard measures, the first time since 2001 that these measures had been utilized.

China's entry into the WTO has further tilted the international economic playing field against domestic workers and firms and in favor of multinational companies from the United States and other countries as well as state- and privately owned exporters in China. This shift has increased the global "race to the bottom" in wages and environmental quality and closed thousands of U.S. factories, decimating employment in a wide range of communities, states, and entire regions of the United States. U.S. national interests have suffered while U.S. multinationals have enjoyed record profits on their foreign direct investments (Scott 2008).

Failed expectations

Proponents of China's entry into the WTO frequently claimed that it would create jobs in the United States, increase U.S. exports, and improve the trade deficit with China. President Clinton claimed that the agreement allowing China into the WTO, which was negotiated during his administration, "creates a win-win result for both countries" (Clinton 2000, 9). He argued that exports to China "now support hundreds of thousands of American jobs" and that "these figures can grow substantially with the new access to the Chinese market the WTO agreement creates" (Clinton 2000, 10). Others in the White House, such as Kenneth Liberthal, the special advisor to the president and senior director for Asia affairs at the National Security Council, echoed Clinton's assessment:

> Let's be clear as to why a trade deficit might decrease in the short term. China exports far more to the U.S. than it imports [from] the U.S.…It will not grow as much as it would have grown without this agreement and over time clearly it will shrink with this agreement.[5]

Promises about jobs and exports misrepresented the real effects of trade on the U.S. economy: trade both creates and destroys jobs. Increases in U.S. exports tend to create jobs in the United States, but increases in imports will lead to job loss—by destroying existing jobs and preventing new job creation—as imports displace goods that otherwise would have been made in the United States by domestic workers.

The impact of trade changes on employment is estimated here by calculating the labor content of changes in the trade balance—the difference between exports and imports. Each $1 billion in computer exports to China from the United States supports American jobs. However, each $1 billion in computer imports *from* China displaces the American workers who would have been employed making them in the United States. On balance, the net employment effect of trade flows depends on the growth in the trade *deficit*, not just exports.

Another critically important promise made by the promoters of liberalized U.S.-China trade was that the United States would benefit because of increased exports to a large and growing consumer market in China. However, despite widespread reports of the rapid growth of the Chinese middle class, this growth has not resulted in a significant increase in U.S. consumer exports to China. The most rapidly growing exports to China are bulk commodities such as grains, scrap, and chemicals; intermediate products such as semiconductors; and producer durables such as aircraft (see Table 3 below). Furthermore, the increase in U.S. exports to China since 2001 has been overwhelmed by the growth of U.S. imports, as shown below.

Growing trade deficits and job losses

The U.S. trade deficit with China has risen from $84 billion in 2001 to $270 billion in 2008, an increase of $186 billion, as shown in Table 1. Since China entered the WTO in 2001, this deficit has increased by $26.6 billion per year, on average, or 18% per year.

While it is true that exports support jobs in the United States, it is equally true that imports displace them. The net effect of trade flows on employment is determined by changes in the *trade balance*.[6] The employment impacts of growing trade deficits are estimated in this paper using an input-output model that estimates the direct and indirect labor requirements of producing output in a given domestic industry. The model includes 201 U.S. industries, 84 of which are in the manufacturing sector.[7]

The model estimates the amount of labor (number of jobs) required to produce a given volume of exports and the labor displaced when a given volume of imports is substituted for domestic output.[8] The net of these two numbers is essentially the jobs displaced by growing trade deficits, holding all else equal.

Jobs displaced by the growing China trade deficit are a net drain on employment in trade-related industries, especially those in the manufacturing sector. Even if increases in demand in other sectors absorb all the workers displaced by trade (an unlikely event), it is likely that job quality will suffer, as many non-traded industries such as retail trade and home health care pay lower wages and have less-comprehensive benefits than traded-goods industries.

U.S. exports to China in 2001 supported 166,200 jobs, but U.S. imports displaced production that would have supported 1,188,200 jobs, as shown in the bottom half of Table 1. Therefore, the $84 billion trade deficit in 2001 displaced 1,022,000 jobs in that year. Job displacement rose to 3,349,300 jobs in 2007 and 3,440,700 jobs in 2008.

Since China's entry into the WTO in 2001 through 2008, the increase in U.S.-China trade deficits eliminated or displaced 2,418,800 U.S. jobs, as shown in the bottom half of Table 1. In 2008 alone 91,400 jobs were lost, either by the elimination of existing jobs or by the prevention of new job creation. On average, 345,500 jobs per year have been lost or displaced since China's entry into the WTO.

Trade and jobs, industry details

The composition of imports from China is changing in fundamental ways, with serious implications for certain kinds of high-skill, high-wage jobs once thought to be the hallmark of the U.S. economy. China is moving rapidly "upscale," from low-tech, low-skilled, labor-intensive industries such as apparel, footwear, and basic electronics to more capital- and skills- intensive sectors such as computers, electrical machinery, and motor vehicles; it has

TABLE 2

Trade with China by industry, 2001-08 (millions of dollars)*

	2001			2008			Change in trade, 2001-08		
	Imports	*Exports*	*Net exports*	*Imports*	*Exports*	*Net exports*	*Imports*	*Exports*	*Net exports*
Agriculture, forestry, fisheries	$749	$1,345	$596	$2,411	$10,222	$7,811	$1,662	$8,877	$7,215
Mining	250	80	-171	694	848	154	444	769	325
Oil and gas	89	8	-81	387	2	-385	298	-6	-304
Minerals and ores	161	71	-90	307	846	539	146	775	629
Manufacturing	100,866	15,383	-85,483	333,879	48,300	-285,579	233,014	32,918	-200,096
Non-durable goods	23,412	975	-22,436	58,214	3,323	-54,891	34,802	2,348	-32,454
Food and kindred products	591	763	173	3,000	2,616	-384	2,410	1,853	-557
Beverage and tobacco products	30	4	-26	30	36	5	0	31	31
Textiles and fabrics	328	74	-254	1,301	382	-920	973	307	-666
Textile mill products	1,854	13	-1,840	7,297	62	-7,235	5,443	49	-5,394
Apparel and accessories	8,597	30	-8,567	26,153	27	-26,126	17,556	-3	-17,559
Leather and allied products	12,012	90	-11,922	20,431	200	-20,231	8,419	110	-8,309
Industrial supplies	9,571	3,239	-6,332	33,071	11,775	-21,295	23,500	8,537	-14,963
Wood products	887	25	-862	2,765	69	-2,696	1,878	44	-1,834
Paper	706	501	-205	2,813	1,355	-1,459	2,107	854	-1,253
Printed matter and related products	730	44	-686	2,295	155	-2,139	1,564	111	-1,453
Petroleum and coal products	237	88	-149	393	375	-18	156	287	131
Chemicals	1,810	2,180	369	9,697	8,566	-1,130	7,886	6,387	-1,500
Plastics and rubber products	2,707	201	-2,506	10,011	752	-9,259	7,304	551	-6,752
Nonmetallic mineral products	2,493	201	-2,292	5,097	503	-4,594	2,604	302	-2,302
Durable goods	67,883	11,169	-56,714	242,595	33,202	-209,393	174,712	22,033	-152,678
Primary metal	794	236	-558	10,601	2,925	-7,675	9,807	2,690	-7,117
Fabricated metal products	3,862	291	-3,571	14,838	1,304	-13,534	10,976	1,013	-9,962
Not specified metal industries			0			0	0	0	0
Machinery, except electrical	4,518	2,430	-2,088	17,569	7,218	-10,352	13,052	4,788	-8,264
Computer and electronic parts	24,304	4,446	-19,858	110,991	11,074	-99,917	86,687	6,628	-80,059
Computer and peripheral equipment	8,174	1,182	-6,991	46,035	1,321	-44,714	37,862	139	-37,723
Communications, audio and video equipment	9,395	836	-8,559	46,798	908	-45,890	37,403	72	-37,331
Navigational, measuring, electromedical, and control instruments	1,237	822	-415	4,402	2,703	-1,699	3,165	1,881	-1,284
Semiconductor and other electronic components & magnetic and optical media production	5,499	1,606	-3,893	13,755	6,141	-7,614	8,256	4,535	-3,721
Electrical equipment, appliances, and component	8,997	457	-8,540	22,156	1,648	-20,508	13,159	1,191	-11,968

cont. on page 7

TABLE 2 (CONT.)

Trade with China by industry, 2001-08 (millions of dollars)*

	2001			2008			Change in trade, 2001-08		
	Imports	*Exports*	*Net exports*	*Imports*	*Exports*	*Net exports*	*Imports*	*Exports*	*Net exports*
Transportation equipment	1,816	2,837	1,020	8,066	7,478	-588	6,250	4,642	-1,608
Motor vehicles and parts	1,046	264	-782	6,039	1,815	-4,224	4,993	1,551	-3,443
Aerospace product and parts	88	2,555	2,467	387	5,429	5,042	299	2,874	2,575
Railroad, ship, and other transportation equipment	682	17	-665	1,639	234	-1,405	957	217	-740
Furniture and fixtures	4,942	20	-4,922	14,520	91	-14,429	9,579	72	-9,507
Miscellaneous manufactured commodities	18,650	453	-18,197	43,854	1,464	-42,390	25,204	1,011	-24,193
Information	6	0	-6	2	23	21	-4	23	28
Scrap and non-comparable imports	194	1,079	884	449	7,541	7,092	255	6,462	6,208
TOTAL	102,066	17,886	-84,180	337,435	66,935	-270,500	235,369	49,049	-186,320

* Totals vary slightly due to rounding.

SOURCE: EPI analysis of Census Bureau, ITC, and BLS data.

also developed a rapidly growing trade surplus in high technology products.

U.S. trade with China in 2001 and 2008 is summarized in **Table 2**. Trade flows increased dramatically in this period, especially imports, which rose from $102 billion in 2001 to $337 billion in 2008.[9] Manufactured goods were 99% of total imports and included a wide array of commodities. Computer and electronic products were responsible for one-third of total imports, including computer equipment ($46 billion, or 13.6%) and communications, audio, and video equipment ($47 billion, 13.9%). Other major importing sectors included apparel ($26 billion, 7.8%) and miscellaneous manufactured products ($44 billion, 13.0%).

U.S. exports rose rapidly in this period, but from a much smaller base, from $18 billion in 2001 to $67 billion in 2008. Manufacturing was the top industry exporting to China—72% of exports to China in 2008 were manufactured goods. Scrap and second-hand goods industries (that support no jobs in the BLS models) made up 11.3% ($7.5 billion) of the total. Within manufacturing, key export sectors included chemicals ($8.6 billion, or 12.8% of total exports), aerospace products and parts ($5.4 billion, 8.1%), machinery ($7.2 billion, 10.8%), and semiconductors and components ($6.1 billion, 9.2%). However, the scale of U.S. exports is dwarfed by imports, which exceeded the value of exports by more than 5 to 1.

The data in Table 2 show that China is rapidly diversifying its export base and expanding into higher value-added commodities such as computer and electronic products, aircraft, and auto parts and machinery. The United States has had a trade deficit with China in advanced technology products (ATP) throughout this period, but it increased more than six-fold, from $11.8 billion in 2002 to $74.0 billion in 2008.

The United States had a deficit in its ATP trade with the rest of the world in 2002. However, rapid growth of U.S. ATP exports to the rest of the world, which increased 7.1% per year between 2002 and 2008, generated a $13 billion surplus in 2008. This sector is enjoying some trade success at the moment. However, this small surplus was completely overwhelmed by the U.S. ATP deficit with China in 2008. As a result, the United States ran an overall deficit in ATP products in 2008, as is has in every year since 2002. The U.S. global ATP trade deficit was $61.1 billion in 2008.

TABLE 3

Change in net jobs created or displaced by industry, 2001-08

	Industry total*	Share of total
Agriculture, forestry, fisheries	27,300	-1.1%
Mining	-5,300	0.2
Oil and gas	-1,300	0.1
Minerals and ores	-4,000	0.2
Utilities	-6,800	0.3
Construction	-13,700	0.6
Manufacturing	-1,616,300	66.9
Non-durable goods	-301,000	12.5
Food and kindred products	-7,900	0.3
Beverage and tobacco products	-200	0.0
Textiles and fabrics	-55,100	2.3
Textile mill products	-33,100	1.4
Apparel and accessories	-150,200	6.2
Leather and allied products	-54,400	2.3
Industrial supplies	-177,600	7.4
Wood products	-20,900	0.9
Paper	-23,100	1.0
Printed matter and related products	-31,100	1.3
Petroleum and coal products	-1,400	0.1
Chemicals	-21,900	0.9
Plastics and rubber products	-59,200	2.4
Nonmetallic mineral products	-20,100	0.8
Durable goods	-1,137,700	47.1
Primary metal	-40,000	1.7
Fabricated metal products	-108,700	4.5
Not specified metal industries	0	0.0
Machinery, except electrical	-54,200	2.2
Computer and electronic parts	-627,700	26.0
Computer and peripheral equipment	-330,200	13.7
Communications, audio and video equipment	-148,600	6.2
Navigational, measuring, electromedical, and control instruments	-11,500	0.5
Semiconductor and other electronic components & magnetic and optical media production	-137,400	5.7
Electrical equipment, appliances, and component	-63,900	2.6
Transportation equipment	-22,100	0.9
Motor vehicles and parts	-25,100	1.0
Aerospace product and parts	6,000	-0.2
Railroad, ship, and other transportation equipment	-2,900	0.1

cont. on page 9

TABLE 3 (CONT.)

Change in net jobs created or displaced by industry, 2001-08

	Industry total*	Share of total
Furniture and fixtures	-84,300	3.5 %
Miscellaneous manufactured commodities	-136,900	5.7
Other not specified	0	0.0
Wholesale trade	0	0.0
Retail trade	0	0.0
Transportation	-103,000	4.3
Information	-98,100	4.1
Finance and insurance	-52,500	2.2
Real estate and rental and leasing	-22,900	0.9
Professional, scientific, and technical services	-139,000	5.8
Management of companies and enterprises	-72,700	3.0
Administrative and support and waste mgmt. and remediation svs.	-153,300	6.3
Education services	-5,600	0.2
Health care and social assistance	-900	0.0
Arts, entertainment and recreation	-14,300	0.6
Accomodation and food services	-52,300	2.2
Other services	-26,700	1.1
Government	-58,600	2.4
Scrap and non-comparable imports	0	0.0
Total jobs created or displaced	**-2,414,900**	**100.0**

* Totals vary slightly due to rounding.

SOURCE: EPI analysis of Census Bureau, ITC, and BLS data.

Trade deficits are highly correlated with job losses by industry, as shown in **Table 3**. Growing trade deficits with China eliminated 1,616,300 manufacturing jobs between 2001 and 2008, more than two-thirds (66.9%) of the total. By far the largest job losses occurred in the computer and electronic products sectors, which lost nearly 627,700 jobs (26.0% of the 2.4 million jobs lost overall). This sector included computer and peripheral equipment (330,200 jobs, 13.7%) and semiconductors and components (137,400 jobs, 5.7%). Other hard-hit sectors included apparel and accessories (150,200 jobs, 6.2%), fabricated metal products (108,700 jobs, 4.5%), and miscellaneous manufacturing (136,900 jobs, 5.7%). Several service industries, which provide key inputs to traded-goods production, experienced large job losses, including administrative and support services (153,300 jobs, 6.3%) and professional, scientific, and technical services (139,000 jobs, 5.8%).

Trade, jobs, and the states

Growth in trade deficits with China has reduced demand for goods produced in every region of the United States and has led to job displacement in all 50 states and the District of Columbia, as shown in **Table 4a**. Jobs displaced due to growing deficits with China exceeded 1.95% of total employment in states such as New Hampshire, North Carolina, Massachusetts, California, Oregon, Minnesota, Rhode Island, Alabama, Idaho, and South Carolina, as

TABLE 4A

Net job loss due to growing trade deficits with China 2001-08, ranked by share of state employment

	Net jobs lost	Total employment*	Share of total state employment
New Hampshire	16,300	694,200	2.35%
North Carolina	95,100	4,133,000	2.30
Massachusetts	72,800	3,241,300	2.25
California	370,000	16,565,000	2.23
Oregon	38,600	1,764,400	2.19
Minnesota	58,800	2,713,700	2.17
Rhode Island	10,600	526,500	2.01
Alabama	39,300	1,995,900	1.97
Idaho	13,500	685,800	1.97
South Carolina	38,400	1,950,800	1.97
Vermont	6,200	329,700	1.88
Colorado	45,200	2,424,500	1.86
Tennessee	51,400	2,778,500	1.85
Wisconsin	52,300	2,849,100	1.84
Indiana	54,900	3,000,700	1.83
Texas	193,700	10,602,400	1.83
Georgia	78,100	4,310,000	1.81
Illinois	105,500	6,087,800	1.73
Kentucky	32,200	1,863,500	1.73
Ohio	91,800	5,412,100	1.70
Puerto Rico	20,000	1,199,900	1.67
Pennsylvania	95,700	5,825,400	1.64
New Jersey	69,100	4,212,200	1.64
Mississippi	19,400	1,201,700	1.61
Arkansas	19,800	1,237,400	1.60
New York	140,500	8,954,600	1.57
Connecticut	27,300	1,742,300	1.57
Utah	19,200	1,228,900	1.56
Michigan	68,300	4,552,700	1.50
Arizona	40,200	2,756,400	1.46
Washington	44,300	3,051,500	1.45
Maine	9,400	656,400	1.43
Missouri	38,700	2,774,000	1.40
Virginia	51,700	3,739,700	1.38
Iowa	20,900	1,530,400	1.37
Maryland	36,600	2,827,400	1.29

cont. on page 11

TABLE 4A (CONT.)

Net job loss due to growing trade deficits with China 2001-08, ranked by share of state employment

	Net jobs lost	Total employment*	Share of total state employment
South Dakota	5,200	407,600	1.28%
Oklahoma	20,700	1,626,900	1.27
Kansas	17,400	1,380,000	1.26
Florida	101,600	8,204,700	1.24
Delaware	5,000	407,900	1.23
New Mexico	10,600	868,100	1.22
Nebraska	10,800	916,600	1.18
Nevada	13,400	1,206,800	1.11
District of Columbia	3,100	286,400	1.08
West Virginia	8,000	753,200	1.06
Louisiana	17,400	1,872,100	0.93
North Dakota	3,100	336,900	0.92
Hawaii	5,000	605,800	0.83
Montana	3,600	464,900	0.77
Alaska	2,400	322,300	0.74
Wyoming	2,000	268,800	0.74
National plus Puerto Rico total**	**2,414,900**	**141,348,700**	

* Average employment in 2005-07.
** Totals vary slightly due to rounding.

SOURCE: EPI analysis of Census Bureau, ITC, and BLS data.

shown in Table 4a and **Figure A**. More than 300,000 jobs were lost in California and more than 100,000 each in Texas, New York, Illinois, and Florida, as shown in **Table 4b**. An alphabetical list of job losses by state is shown in **Table 4c**.

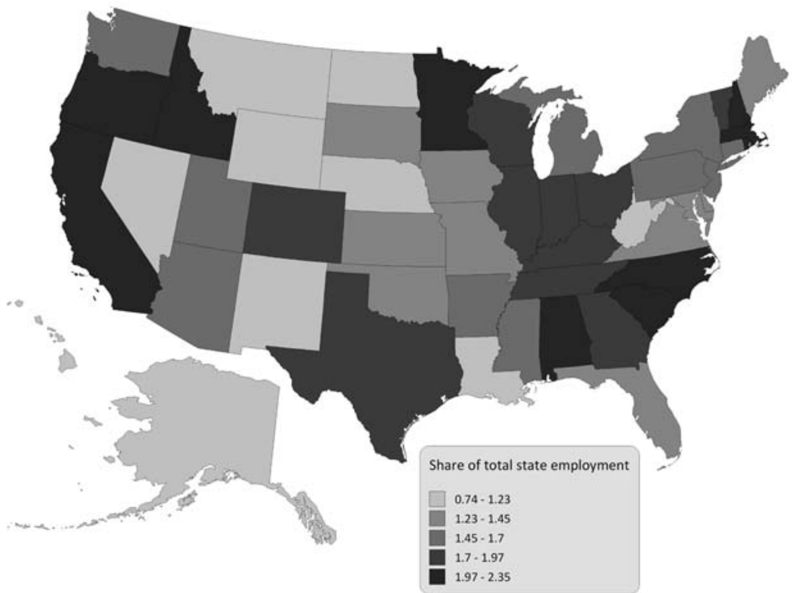
The state job loss map shows that the effects of growing trade deficits with China have been felt widely across the United States and that no area has been exempt from their impact. Job losses have been concentrated in states, with high-tech industries such as Massachusetts, California, and Oregon, and in a variety of manufacturing states, including New Hampshire, North Carolina, Minnesota, Alabama, and Rhode Island. Traditional manufacturing states, such as Wisconsin, Tennessee, Indiana, Illinois, and the Carolinas, were also hard hit.

Growing trade deficits with China have clearly reduced domestic employment in traded goods industries, especially in the manufacturing sector, which has been hard hit by plant closings and job losses. Workers displaced by trade from the manufacturing sector have had particular difficulty in securing comparable employment elsewhere in the economy. More than one-third of workers displaced from manufacturing dropped out of the labor force (Kletzer 2001, 101, Table D2), and average wages of those who found new jobs fell 11% to 13%.

Some economists have argued that job loss numbers extrapolated from trade flows are uninformative because *aggregate* employment levels in the United States are set by a broad range of macroeconomic influences, not just by trade flows. However, while the trade balance is but

FIGURE A

Job loss as share of total state employment, 2001-08



SOURCE: EPI analysis of Census Bureau, ITC, and BLS data.

one of many variables affecting aggregate job creation, the employment impacts of trade identified in this paper can be interpreted as the "all else equal" effect of trade on domestic employment. The Federal Reserve, for example, may decide to cut interest rates to make up for job loss stemming from deteriorating trade balances (or any other economic influence), leaving net employment unchanged. This, however, does not change the fact that trade deficits by *themselves* are a net drain on employment.

Further, even in the best-case scenario in which other jobs rise up one-for-one to replace those displaced by trade flows, the job numbers in this paper are a (conservative) measure of the *involuntary* job displacement caused by growing trade deficits and a potent indicator of imbalance in the U.S. labor market and wider economy. Economists may label it a wash when the loss of a hundred manufacturing jobs in Ohio or Pennsylvania is offset by the hiring of a hundred construction workers in Phoenix, but in the real world these displacements often result in large income losses and even permanent damage to workers' earning power (Bivens 2008b).

Lastly, many of the mechanisms that help push back against employment losses from growing trade deficits are not operating in the current recession (or jobless

TABLE 4B

Net job loss due to growing trade deficits with China 2001-08, ranked by number of jobs displaced

	Net jobs lost
California	370,000
Texas	193,700
New York	140,500
Illinois	105,500
Florida	101,600
Pennsylvania	95,700
North Carolina	95,100
Ohio	91,800
Georgia	78,100
Massachusetts	72,800
New Jersey	69,100
Michigan	68,300
Minnesota	58,800
Indiana	54,900
Wisconsin	52,300
Virginia	51,700
Tennessee	51,400
Colorado	45,200
Washington	44,300
Arizona	40,200
Alabama	39,300
Missouri	38,700
Oregon	38,600
South Carolina	38,400
Maryland	36,600
Kentucky	32,200
Connecticut	27,300
Iowa	20,900
Oklahoma	20,700
Puerto Rico	20,000
Arkansas	19,800
Mississippi	19,400
Utah	19,200
Kansas	17,400
Louisiana	17,400
New Hampshire	16,300

cont. on page 14

TABLE 4B (CONT.)

Net job loss due to growing trade deficits with China 2001-08, ranked by number of jobs displaced

	Net jobs lost
Idaho	13,500
Nevada	13,400
Nebraska	10,800
Rhode Island	10,600
New Mexico	10,600
Maine	9,400
West Virginia	8,000
Vermont	6,200
South Dakota	5,200
Delaware	5,000
Hawaii	5,000
Montana	3,600
District of Columbia	3,100
North Dakota	3,100
Alaska	2,400
Wyoming	2,000
National plus Puerto Rico total*	2,414,900

* Totals vary slightly due to rounding.

SOURCE: EPI analysis of Census Bureau, ITC, and BLS data.

recovery). The Federal Reserve cannot cut interest rates any lower than it already has, and interest-sensitive industries like residential construction are not seeing employment gains from lower rates. In short, in today's economy with high rates of unemployment, jobs displaced due to trade deficits with China are much more likely to be actual net, economy-wide losses, not just job reallocations.

Job loss by Congressional district

This study also reports, for the first time, on results of a new model which shows that growing trade deficits cost jobs in every Congressional district, including the District of Columbia and Puerto Rico.[10] Because the computer, electronic equipment, and parts industries experienced the largest growth in trade deficits with China, the hardest-hit Congressional districts were located in California and Texas, where remaining jobs in that industry are concentrated, and also in North Carolina, which was hard hit by job displacement in a variety of manufacturing industries.

The top 50 hardest-hit Congressional districts are shown in **Table 5**. The greatest concentrations of these districts are in California (15), Texas (5), North Carolina (5), Massachusetts (4), Minnesota (3), South Carolina (3), Colorado (2), and Illinois (2). These distributions reflect both the size of some states (e.g., California and Texas) and also the concentration of the industries hardest hit such as electronics, furniture, and other manufactured products.

The Congressional district job model is based on new data from the Census Bureau's American Community Survey (ACS). Prior studies in this series (such as Scott 2008) used state and demographic data drawn from the

TABLE 4C

Net job loss due to growing trade deficits with China 2001-08, alphabetically sorted

	Net jobs lost
Alabama	39,300
Alaska	2,400
Arizona	40,200
Arkansas	19,800
California	370,000
Colorado	45,200
Connecticut	27,300
Delaware	5,000
District of Columbia	3,100
Florida	101,600
Georgia	78,100
Hawaii	5,000
Idaho	13,500
Illinois	105,500
Indiana	54,900
Iowa	20,900
Kansas	17,400
Kentucky	32,200
Louisiana	17,400
Maine	9,400
Maryland	36,600
Massachusetts	72,800
Michigan	68,300
Minnesota	58,800
Mississippi	19,400
Missouri	38,700
Montana	3,600
Nebraska	10,800
Nevada	13,400
New Hampshire	16,300
New Jersey	69,100
New Mexico	10,600
New York	140,500
North Carolina	95,100
North Dakota	3,100
Ohio	91,800

cont. on page 16

TABLE 4C (CONT.)

Net job loss due to growing trade deficits with China 2001-08, alphabetically sorted

	Net jobs lost
Oklahoma	20,700
Oregon	38,600
Pennsylvania	95,700
Puerto Rico	20,000
Rhode Island	10,600
South Carolina	38,400
South Dakota	5,200
Tennessee	51,400
Texas	193,700
Utah	19,200
Vermont	6,200
Virginia	51,700
Washington	44,300
West Virginia	8,000
Wisconsin	52,300
Wyoming	2,000
National plus Puerto Rico total*	2,414,900

* Totals vary slightly due to rounding.

SOURCE: EPI analysis of Census Bureau, ITC, and BLS data.

Census Bureau's Current Population Survey (CPS). The Current Population Survey (CPS) provides labor force estimates for various demographic groups at the national and state levels. It is a monthly survey of about 50,000 housing units that is conducted by the U.S. Bureau of Census (BOC) for the U.S. Bureau of Labor Statistics (BLS). According to the Census Bureau,

> The American Community Survey (ACS) is a new program that is meant to collect census "long form" type data giving basic population characteristics continuously throughout the decade. Starting in 2003, the ACS will use a rolling sample of about 250,000 different housing units per month, spread evenly throughout the country, based on a continuously updated address list. Both the regular availability of "census" type data and the updated address list provide opportunities and additional flexibility for the CPS design and estimates.
>
> The greatest potential benefit to BLS from the ACS, because of its large sample size of 3,000,000 addresses per year, lies in enhancements of the models for labor force estimates at the state and sub-state levels.[11]

The ACS thus provides a much richer dataset for analyzing the effects of trade on employment in the states and, for the first time, provides information that was used to estimate the distribution of employment by industry at the Congressional district level.

TABLE 5

Net job loss due to growing trade deficits with China, 2001-08: Top 50 Congressional districts

State	Congressional district	Net jobs lost	Total employment*	Share of total employment
California	15	26,900	324,600	8.29%
California	14	20,300	320,700	6.33
California	16	18,200	303,700	5.99
Texas	31	14,900	338,200	4.41
California	13	13,400	313,900	4.27
California	31	11,400	291,600	3.91
Massachusetts	5	12,200	317,400	3.84
Texas	10	16,500	436,900	3.78
Oregon	1	14,600	388,100	3.76
California	34	9,600	262,800	3.65
North Carolina	10	10,700	301,100	3.55
Massachusetts	3	10,800	322,800	3.35
North Carolina	6	10,700	332,100	3.22
Georgia	9	11,100	352,100	3.15
North Carolina	4	11,700	384,800	3.04
California	50	10,100	344,500	2.93
California	47	8,300	285,900	2.90
North Carolina	5	9,300	321,700	2.89
Texas	3	12,000	418,300	2.87
Alabama	5	8,600	302,400	2.84
California	35	7,900	281,600	2.81
Minnesota	2	10,900	389,200	2.80
California	32	7,800	281,600	2.77
California	38	7,700	282,400	2.73
Texas	25	10,300	377,800	2.73
Minnesota	1	9,000	334,100	2.69
Illinois	8	10,200	379,000	2.69
Colorado	4	9,300	352,500	2.64
South Carolina	5	8,200	311,100	2.64
Mississippi	1	8,500	325,000	2.62
Minnesota	3	9,100	350,300	2.60
California	39	7,500	289,300	2.59
Alabama	4	7,000	274,300	2.55
North Carolina	13	8,800	344,900	2.55
Massachusetts	2	8,100	318,600	2.54
South Carolina	4	8,500	336,400	2.53

cont. on page 18

TABLE 5 (CONT.)

Net job loss due to growing trade deficits with China, 2001-08: Top 50 Congresssional districts

State	Congressional district	Net jobs lost	Total Employment*	Share of total employment
California	11	8,800	349,500	2.52%
California	48	8,800	351,200	2.51
Indiana	3	8,600	346,800	2.48
Alabama	3	6,800	274,800	2.47
Colorado	2	9,400	380,500	2.47
Idaho	1	8,800	359,700	2.45
New Hampshire	2	8,300	344,100	2.41
South Carolina	3	7,300	305,200	2.39
Massachusetts	4	7,700	326,500	2.36
Kentucky	6	8,400	357,200	2.35
California	40	7,500	320,600	2.34
New Hampshire	1	8,000	350,100	2.29
Illinois	6	7,900	346,100	2.28
Texas	16	6,000	262,900	2.28

* Average employment in 2005-07.

SOURCE: EPI analysis of Census Bureau, ITC, and BLS data.

The CPS data suffered from small sample sizes in some smaller states with lower industrial densities, which may have resulted in some underestimates of employment by state. More important, the ACS sample used for this survey contained pooled data for the 2005-07 period. The large number (approximately 9 million) of observations in this dataset allowed for the generation of reliable estimates of job displacement by Congressional district.

Conclusion

The growing U.S. trade deficit with China has displaced huge numbers of jobs in the United States and has been a prime contributor to the crisis in manufacturing employment over the past seven years. Moreover, the United States is piling up foreign debt, losing export capacity, and facing a more fragile macroeconomic environment.

Is America's loss China's gain? The answer is most certainly no. China has become dependent on the U.S. consumer market for employment generation, suppressed the purchasing power of its own middle class with a weak currency, and, most important, held trillions of dollars in hard currency reserves instead of investing them in public goods that could benefit Chinese households. Its vast purchases of foreign exchange reserves have stimulated the overheating of its domestic economy, and inflation in China has accelerated rapidly in the past year. Its repression of labor rights has suppressed wages, thereby artificially subsidizing exports.

The U.S-China trade relationship needs a fundamental change. Addressing the exchange rate policies and labor standards issues in the Chinese economy are important first steps.

—The author thanks Algernon Austin, Josh Bivens, and John Irons for comments.

—This research was made possible by support from the Alliance for American Manufacturing.

APPENDIX

Methodology

The trade and employment analyses in this report are based on a detailed, industry-based study of the relationships between changes in trade flows and employment for each of approximately 201 individual industries of the U.S. economy, specially grouped into 56 custom sectors and using North American Industry Classification System (NAICS) data obtained from the U.S. International Trade Commission (USITC).

This study separates exports produced domestically from foreign exports—which are goods produced in other countries, exported to the United States, and then re-exported from the United States. However, because only domestically produced exports generate jobs in the United States, employment calculations here are based only on domestic exports. The measure of the net impact of trade used here to calculate the employment content of trade is the difference between domestic exports and consumption imports. This measure is referred to in this report as "net exports," to distinguish it from the more commonly reported gross trade balance. Both concepts are measures of net trade flows.

The number of jobs supported by $1million of exports or imports for each of 201 different U.S. industries is estimated using a labor requirements model derived from an input-output table developed by the U.S. Bureau of Labor Statistics. This model includes both the direct effects of changes in output (for example, the number of jobs supported by $1 million of auto assembly) and the indirect effects on industries that supply goods used in the manufacture of cars. The indirect impacts include jobs in auto parts, steel, and rubber, as well as service industries such as accounting, finance, and computer programming. This model estimates the labor content of trade using empirical estimates of labor content and trade flows between U.S. industries in a given base year (an input-output table for the year 2006 was used in this study) that were developed by the U.S. Department of Commerce and the Bureau of Labor Statistics. It is not a statistical survey of actual jobs gained or lost in individual companies, or the opening or closing of particular production facilities (Bronfenbrenner and Luce 2004 is one of the few studies based on news reports of individual plant closings).

Nominal trade data used in this analysis were converted to constant 2000 dollars using industry-specific deflators (see next section for further details). This was necessary because the labor requirements table was estimated using price levels in that year. Data on real trade flows were converted to constant 2000 dollars using export and import price deflators from the Bureau of Labor Statistics (2009a). Use of constant 2000 dollars was required for consistency with the other BLS models used in this study.

Estimation and data sources

Data requirements

Step 1. U.S.-China trade data were obtained from the USITC DataWeb (2009) in four-digit, three-digit, and two-digit NAICS format. Consumption imports and domestic exports are downloaded for each year.

Step 2. To conform to the BLS Employment Requirements tables (BLS 2009b), trade data must be converted into the BLS industry classifications system. For NAICS-based data, there are 201 BLS industries. The data are then mapped from NAICS classifications onto their respective BLS classification.

The trade data, which are in current dollars, are deflated into real 2000 dollars using published price deflators from the Bureau of Labor Statistics (2009a).

Step 3. BLS real domestic employment requirements tables are downloaded from the BLS. These matrices are input-output tables industry by industry that show the employment requirements for $1,000,000 in outputs in 2000 dollars. So, for the i-th industry, the a_{ij} entry is the employment indirectly supported in industry i by final sales in industry j and where i=j, the employment directly supported.

Analysis

Step 1. Job equivalents

BLS trade data is compiled into matrices. Let $[T_{2001}]$ be the 201x2 matrix made up of a column of imports and a column of exports. $[T_{2007}]$ is defined as the 201x2 matrix of 2007 trade data. Finally, $[T_{2008}]$ is defined as the 201x2 matrix of 2008 trade data. Define $[E_{2001}]$ as the 201x201 matrix consisting of the real 2006 domestic employment requirements tables. To estimate the jobs displaced by trade, perform the following matrix operations.

$$[J_{2001}]=[T_{2001}]\times[E_{2006}]$$
$$[J_{2007}]=[T_{2007}]\times[E_{2007}]$$
$$[J_{2008}]=[T_{2008}]\times[E_{2006}]$$

$[J_{2001}]$ is a 201x2 matrix of job displacement by imports and jobs supported by exports for each of 201 industries. Similarly, $[J_{2007}]$ and $[J_{2008}]$ are 201x2 matrices of job displaced or supported by imports and exports (respectively) for each of 201 industries.

The employment estimates for retail trade, wholesale trade, and advertising were set to zero for this analysis. We assume that goods must be sold and advertised whether they are produced in the United States or imported for consumption.

To estimate jobs created/lost over certain time periods, we perform the following operations:

$$[J_{nx01\text{-}08}]=[J_{2008}]-[J_{2001}]$$
$$[J_{nx01\text{-}07}]=[J_{2007}]-[J_{2001}]$$
$$[J_{nx07\text{-}08}]=[J_{2008}]-[J_{2007}]$$

Step 2. State-by-state analysis

For states, employment by industry data is obtained for the ACS data from 2005-07 and is mapped into 56 custom sectors. We look at job displacement from 2001 to 2008, so from this point, we use $[J_{nx01\text{-}08}]$. In order to work with 56 sectors, we group the 201 BLS industries into a new matrix, defined as $[Jnew_{01\text{-}08}]$, a 56x2 matrix of job displacement numbers. Define $[St_{05\text{-}07}]$ as the 56x52 matrix of state employment shares (with the addition of the District of Columbia and Puerto Rico) of employment in each industry. Calculate:

$$[Stj_{nx01\text{-}08}]=[St_{05\text{-}07}]^T\,[Jnew_{01\text{-}08}]$$

Where $[Stj_{nx01\text{-}08}]$ is the 56x52 matrix of job displacement/support by state by industry. To get state total job displacement, we add up the subsectors in each state.

Step 3. Congressional district analysis

Employment by congressional district by industry by state is obtained from the ACS data from 2005-2007. In order to calculate job displacement in each Congressional district, we use each column in $[Stj_{nx01\text{-}08}]$ which represent individual state job displacement by industry numbers, and define them as $[Stj_{01}]$, $[Stj_{02}]$, $[Stj_i]\ldots[Stj_{52}]$, with i representing the state number and each matrix being 56x1.

Each state has Y congressional districts, so $[Cd_i]$ is defined as the 56xY matrix of Congressional district employment shares for each state. Congressional district shares are calculated thus:

$$[Cdj_{01}]=[Stj_{01}]^T\,[Cd_{01}]$$
$$[Cdj_i]=[Stj_i]^T\,[Cd_i]$$
$$[Cdj_{52}]=[Stj_{52}]^T\,Cd_{52}]$$

Where $[Cdj_i]$ is defined as the 56xY job displacement in state i by congressional district by industry.

To get Congressional district total job displacement, we add up the subsectors in each Congressional district in each state.

Endnotes

1. These purchases were sufficient to finance the entire U.S. current account deficit in 2009 (the broadest measure of all U.S. trade and income flows) of $420 billion. Without these purchases, the reduced demand would have put significant downward pressure on the U.S. dollar. A substantial depreciation in the dollar would begin to improve the U.S. trade deficit within a few years.

2. The official name of the Chinese currency is the renminbi (RMB). The RMB is convertible for current account transactions but not for capital account flows. "Unlike the United States and many other countries, China uses a different word—yuan—for the unit in which product prices, exchange rates, and other such values are denominated from the word used for its currency" (Congressional Budget Office 2008, note 3). Here after, the word yuan will be used when referring to the Chinese exchange rate.

3. The trade balance usually responds to a fall in the dollar with a substantial lag of at least one to two years, due to "J-curve" effects. The major initial impact of a depreciation is usually to raise the price and total value of imports, and hence the trade deficit. In the medium- and long-term, the trade flows usually respond to the increase in the relative competitiveness of domestic products as the rate of growth of imports slows or imports decrease, and the rate of growth of exports accelerates, ultimately leading to an improvement in the trade balance for large currency adjustments. Most of the dollar adjustment against major currencies occurred between February 2002 and December 2004. For example, the dollar fell 36.4% against the euro in this period, and then fell only 4.0% between December 2004 and December 2007.

4. If maintained, price suppression (in response to recent appreciation of the yuan) is likely to result in an increase in unfair trade complaints. In fact, a number of successful anti-dumping cases were filed against Chinese makers of steel pipe in 2008 and 2009, including Oil Country Tubular Goods.

5. *NewsHour with Jim Lehrer* transcript. 1999. "Online NewsHour: Opening Trade - November 15, 1999." <http://www.pbs.org/newshour/bb/asia/july-dec99/wto_11-15.html >

6. Output (gross domestic product or GDP) is the sum of consumption, investment, government spending, and the trade balance. The trade balance is the sum of exports less imports. A declining trade balance lowers GDP. The growth of the U.S. trade deficit with China has therefore reduced U.S. GDP and the demand for labor. Holding all other sources of demand constant, growing trade deficits therefore reduce the demand for labor in the United States.

7. See the Appendix for a technical presentation and details on data sources used. This model has been completely updated and expanded for this study using new data on employment by state, industry, and Congressional District from the American Community Survey, and employment requirements tables for 2006 and related economic data from the Bureau of Labor Statistics (2009a, 2009b). Trade data collected by the U.S. Census Bureau were downloaded from the U.S. International Trade Commission (2009).

8. For the purposes of this report it is necessary to distinguish between exports produced domestically and re-exports—which are goods produced in other countries, imported into the United States, and then re-exported to other countries, in this case to China. Since re-exports are not produced domestically, their production does not support domestic employment and they are excluded from the model used here. See Table 1 for information about the levels of U.S. re-exports to China in 2008.

9. Table 2 reports U.S. imports for consumption and domestic exports to China. These flows were chosen to emphasize goods produced and consumed in the United States. News reports from the Census Bureau and Commerce Department usually emphasize general imports and total exports. Total exports as reported by the Census Bureau include re-exports, i.e., goods produced in other countries and shipped through the United States. For 2007, the Census Bureau reported general imports from China of $337.8 billion, total exports of $71.5 billion, and a trade balance of -$266.3 billion.

10. Data for 437 districts total are shown in companion tables available with the posting of this report at www.EPI.org.

11. http://www.fcsm.gov/99papers/acsasa.html

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Ms. SÁNCHEZ. Thank you. And in my limited time, I want to ask Mr. Prestowitz: In your written testimony, you conclude that tax holidays, capital grants, and other incentives used to bribe global corporations with regard to the location of their plants, labs, and headquarters have to be subject to common WTO and IMF discipline.

And I was wondering if you could elaborate a little bit more on that.

One set of countries is playing a game that I would call dirty free trade. The markets are pretty open. I mean, our market is pretty open. It is not fully open, but it is pretty open. And they are playing in terms of market outcomes being acceptable, legitimate outcomes.

Another set of countries is playing the strategic, export-led catch-up game. It is like having two teams. One is playing football and one is playing baseball. But the premise of this discussion is everybody is playing baseball.

The truth is, everybody is not playing baseball. And we have an incompatibility between these two systems. It manifests itself in the currency. It manifests itself in the current account imbalances. And it is driven not just by—it is driven by a whole set of factors.

It is driven by one set of countries has strong incentive to save. The other set of countries tends to be high consumption. One set of countries manages its currency, provides export subsidies, offers aggressive investment incentives in order to attract investment, to attract technology flows, manages limits, restricts/guides entrance into its own market. The other set of countries allows pretty free entry.

And we are having a clash of those two systems. And part of that clash needs to be addressed, in my view, through the currency problem, as we have discussed today. But the currency issue won't solve the whole clash.

Intel, for example—if there is one product in which the United States has a classic competitive advantage, it has to be Intel's microprocessors. They make 85 percent of the world's computer microprocessors, and they make 80 percent of them in the United States. So we have a competitive advantage.

Intel has just announced a major factory in China. Now, is the production cost of those microprocessors going to be less in China? Not really. It is not labor-intensive. It is capital-intensive. And Intel is getting a huge tax and capital package in order to induce a location of that factory.

And that is not the only reason that Intel put the factory there, but it is an important one. And it is something that we have not been addressing. And yet if we do all the things that we think need to be done in terms of currency adjustment, that factor alone, that strong financial incentive, will continue to tend to draw competitive production facilities out of the U.S. into China and into other countries that pursue the same——

Ms. SÁNCHEZ. Resulting in job losses here in the United States. With respect to—and I love the phrase that you used, dirty free trade, because I think that says it all. Do you think that the same might also be true for labor and environmental laws, i.e. countries that have much more lax laws can lure global companies to locate there at the cost of those who actually have decent labor standards and environmental standards?

Mr. PRESTOWITZ. Yes. Certainly. That is a serious concern, yes.

Ms. SÁNCHEZ. And doesn't that then pretty much create this race to the bottom of, you know, companies moving to the place with the least amount of——

Mr. PRESTOWITZ. That is certainly a consideration in some of the shifts that are made in production locations, moreso in some industries than in other industries.

Ms. SÁNCHEZ. So, I mean, in essence, if you follow that line of reasoning to its logical conclusion, it is not really workers that end up benefitting or end up, you know, doing better or having increased opportunities over the long run. You have people who have the ability to move capital and facilities that continue to profit off of——

And the difficulty is that in the relationship between us and China and a number of other developing countries, we are playing as if we have deep integration, but we don't have the rules and the institutions to facilitate it.

So if I could just pose one last question? An additional 15 seconds? It is a yes or no question, so it should be——

Mr. CAMP. She has been given double the time any other member has gotten.

Ms. SÁNCHEZ. All right. I will submit in writing, and I will yield back.

Chairman LEVIN. All right. Well, she was last and the most patient, so I thought she might have a few extra moments.

Mr. CAMP. And she did receive them.

Chairman LEVIN. So thank you very, very much. This has been especially illuminating, really. I think you have been able to outline what the challenges are, and to outline some alternatives, and to help us evaluate them.

So I think, Mr. Camp, you join in thanking this particular—if you want to say a few words?

Mr. CAMP. Yes. I just want to thank the panel for their testimony. It was a very good hearing. And I want to thank the chairman for holding it.

Chairman LEVIN. We stand adjourned. We beat the bell. Thank you.

[Whereupon, at 12:13 p.m., the committee was adjourned.]

[Submissions for the Record follow:]

**U.S. House of Representatives, Committee on Ways and Means
Hearing on China's Exchange Rate Policy, Wednesday, March 24, 2010**

**Written Submission of
Terence P. Stewart, Esq., Managing Partner,
Elizabeth J. Drake, Esq., Associate,
Law Offices of Stewart and Stewart[1]**

These comments are submitted in response to the House Ways and Means Committee's announcement of a Hearing on China's Exchange Rate Policy, dated March 15, 2010. The announcement invited written comments on, among other things, steps that could be taken to address "the immediate and long-term impact of China's exchange rate policy on the U.S. and global economic recoveries and, more specifically, on U.S. job creation." The primary objective of these comments is to explain steps that could be taken to address China's exchange rate policy within the U.S. and international legal framework governing exchange actions and their impact on trade. In particular, the comments demonstrate that the United States does not need to await a formal determination from the IMF that China is manipulating its currency before it can pursue viable claims against China's trade-distorting exchange rate policies at the WTO.

I. Introduction

Economists are in broad agreement that China's exchange rate is substantially overvalued, by as much as 40% according to some estimates. Yet there is equally broad disagreement about what tools, if any, may be available to the United States to address this overvaluation and the severe economic costs it imposes on U.S. firms and workers, as well as the risks it poses to the global economy as a whole. These comments outline legal approaches the United States may wish to consider to achieve a revaluation of the Chinese yuan, consistent with the WTO and IMF obligations of both China and the U.S.

These comments focus on options available for WTO claims regarding the trade effects of China's exchange rate policies. As a preliminary matter, it must be noted that WTO claims provide only one possible avenue for redressing the harmful trade impacts of China's currency practices. The antidumping and countervailing duty laws also provide the U.S. Department of Commerce the authority to remedy exchange rate practices that injure the domestic industry. Stewart and Stewart is co-counsel in a pending countervailing duty investigation before the Department of Commerce where we are urging the department to investigate exchange rate management as a countervailable subsidy to the coated paper industry in China.[2] The trade remedy laws, when enforced

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[1] The Law Offices of Stewart and Stewart has more than fifty years of experience advocating for U.S. industries, farmers, ranchers, and workers in the field of international trade. The firm has extensive expertise on GATT and WTO law, as well as China's role in the international trading system, and the firm's professionals have authored numerous publications and testified frequently on these topics. These comments are submitted in the authors' personal capacity and not on behalf of any individual client.

[2] The Department decided not to initiate on the original subsidy allegation relating to China's exchange rate management, but petitioners have submitted additional information and argument in a new subsidy

effectively, provide a powerful tool for redressing unfair trade practices such as China's currency practices. Because we believe this tool is already available and the Department of Commerce has been specifically asked to investigate the countervailability of China's practices, these comments instead focus on other tools for addressing the trade effects of China's currency practices.

There is a common perception that the IMF must first formally determine that China is manipulating its currency in violation of Article IV:1(iii) of the IMF Articles of Agreement before a viable WTO claim may be brought regarding the trade effects of China's exchange rate policy. While a number of analysts have argued that China's exchange rate policies meet the legal definition of currency manipulation in Article IV:1(iii),[3] the IMF has been hesitant to make such a formal finding itself and is viewed as being constrained by its political structure from doing so. A closer review of WTO and IMF rules reveals that viable WTO claims against China's trade-distorting exchange rate policies are available even if the IMF refuses to formally determine that China is manipulating its currency in violation of the Fund's Articles of Agreement. In short, there is no need for the U.S. to relinquish its rights at the WTO due to a lack of effective action by the IMF.

II. The Relationship Between IMF and WTO Rights and Obligations

Both China and the U.S. are members of the IMF and WTO, and they thus enjoy certain rights and obligations under both the IMF Articles of Agreement and the WTO Agreements. IMF and WTO members (and GATT Contracting Parties before the WTO was established) have worked to ensure that membership in both organizations does not impose inconsistent obligations.[4] In particular, both organizations have established mutually reinforcing rules addressing the relationship between exchange rate policies and trade.

Under Article IV:1(iii) of the IMF's Articles of Agreement, "… each member shall … avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members."

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allegation to Commerce. The Department has not yet determined whether to initiate an investigation based on the new allegation. *See Certain Coated Paper Suitable For High–Quality Print Graphics Using Sheet–Fed Presses from the People's Republic of China: Preliminary Affirmative Countervailing Duty Determination and Alignment of Final Countervailing Duty Determination with Final Antidumping Duty Determination*, 75 Fed. Reg. 10,774, 10,775.

[3] *See*, *e.g.*, Michael Mussa, "IMF Surveillance over China's Exchange Rate Policy," Paper presented at the Conference on China's Exchange Rate Policy, Peterson Institute for International Economics (Oct. 19, 2007) for a detailed argument that China is in violation of Article IV:1(iii).

[4] *See*, *e.g.*, Deborah E. Seigel, *Legal Aspects of the IMF/WTO Relationship: The Fund's Articles of Agreement and the WTO Agreements*, 96 AM. J. INT'L L. 561 (2002); Jan Wouters and Dominic Coppens, *International Economic Policy-Making: Exploring the Legal Linkages Between the World Trade Organization and the Bretton Woods Institutions*, 3 INT'L ORG. L. REV. 267 (2006).

Article II:3 of the GATT 1994 prohibits a Member from altering its method of converting currencies "so as to impair the value of any of the concessions" it has made in its schedule of concessions. In addition, the WTO Agreement on Subsidies and Countervailing Measures includes in its illustrative list of prohibited export subsidies "Currency retention schemes or any similar practices which involve a bonus on exports." *Ad Note* 2 to Article VI:2 and 3 of GATT 1994 further states:

> Multiple currency practices can in certain circumstances constitute a subsidy to exports which may be met by countervailing duties under paragraph 3 or can constitute a form of dumping by means of a partial depreciation of a country's currency which may be met by action under paragraph 2. By 'multiple currency practices' is meant practices by governments or sanctioned by governments.

In addition, Article XV:4 of the GATT 1994 states: "Contracting parties shall not, by exchange action, frustrate the intent of the provisions of this Agreement, nor, by trade action, the intent of the provisions of the Articles of Agreement of the International Monetary Fund."[5] Article XV:5 also requires the WTO to report to the Fund if it considers that "exchange restrictions on payments and transfers in connection with imports" being applied by a Member are in violation of GATT rules on quantitative restrictions.[6]

WTO rules also require the WTO to defer to the IMF regarding certain matters within the IMF's jurisdiction. Article XV:2 of the GATT 1994 requires the WTO to, *inter alia*, "accept all findings of statistical and other facts presented by the Fund relating to foreign exchange, monetary reserves and balances of payments," and "accept the determination of the Fund as to whether action by a contracting party in exchange matters is in accordance with the Articles of Agreement of the International Monetary Fund." The application of these requirements to WTO dispute settlement panels is further discussed

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[5] The *Ad Note* to Article XV:4 states as follows:

> The word "frustrate" is intended to indicate, for example, that infringements of the letter of any Article of this Agreement by exchange action shall not be regarded as a violation of that Article if, in practice, there is no appreciable departure from the intent of the Article. Thus, a contracting party which, as part of its exchange control operated in accordance with the Articles of Agreement of the International Monetary Fund, requires payment to be received for its exports in its own currency or in the currency of one or more members of the International Monetary Fund will not thereby be deemed to contravene Article XI or Article XIII. Another example would be that of a contracting party which specifies on an import licence the country from which the goods may be imported, for the purpose not of introducing any additional element of discrimination in its import licensing system but of enforcing permissible exchange controls.

[6] Apparently the WTO and GATT before it have never reported to the Fund on a Member's exchange measures under this provision. *See* GENERAL AGREEMENT ON TARIFFS AND TRADE, ANALYTICAL INDEX 403 (6th ed. 1994); WORLD TRADE ORGANIZATION ANALYTICAL INDEX 226 (2nd ed. 2007).

in Section IV, below. Finally, Article XV:9(a) of the GATT 1994 provides: "Nothing in this Agreement shall preclude … the use by a contracting party of exchange controls or exchange restrictions in accordance with the Articles of Agreement of the International Monetary Fund …."

While both institutions seek coherence in international rules governing trade and exchange rate policies, the two institutions have markedly different systems for enforcing these rules. The IMF has no member-to-member dispute settlement system, and enforcement actions must be undertaken by IMF's Executive Board. Due to political constraints on the Board, the IMF generally relies upon dialogue and persuasion to encourage compliance with its obligations rather than outright findings of violation. Indeed, in the more than thirty years since Article IV of the IMF Articles of Agreement was ratified, the IMF Executive Board has never concluded that a member was in violation of the exchange rate policy obligations of the article.[7] In 2007, the IMF Executive Board adopted a new Decision on Bilateral Surveillance of Members' Policies under Article IV, which reaffirmed that "Dialogue and persuasion are key pillars of effective surveillance."[8] Moreover, when assessing whether exchange rates have been manipulated "in order to" prevent balance of payments adjustment or gain an unfair competitive advantage, any representation by a member regarding the purpose of its exchange rate policies will "be given the benefit of any reasonable doubt."[9]

By contrast, a WTO Member may initiate a dispute if it believes another Member is violating its WTO obligations or nullifying or impairing a benefit accruing to the complaining Member. If the dispute is not resolved through consultations, it will be heard by an independent dispute settlement panel and, if appealed from the panel, by the WTO's Appellate Body. If a Member is found to have acted inconsistently with its obligations, the complaining party may be authorized to withdraw concessions if the violation is not remedied. If a Member is found to have nullified or impaired a benefit, the WTO may recommend that the Member concerned "make a mutually satisfactory adjustment," which may include compensation to the complaining Member.[10] The WTO dispute settlement system is designed to operate with less interference from the various political pressures that have hampered more aggressive enforcement action by the IMF.

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[7] *See* Michael Mussa, "IMF Surveillance over China's Exchange Rate Policy," Paper presented at the Conference on China's Exchange Rate Policy, Peterson Institute for International Economics (Oct. 19, 2007) at 40.

[8] *See* International Monetary Fund, Decision on Bilateral Surveillance over Members' Policies (adopted June 15, 2007) at Part I(B)(8). Available on-line at http://www.imf.org/external/np/sec/pn/2007/pm0769.htm .

[9] *Id*. at Annex, para. 3.

[10] *See* Article 26 of the Dispute Settlement Understanding.

III. Defending Exchange Rate Actions from WTO Challenge under Article XV:9(a) of GATT 1994

The U.S. may have several claims that China's exchange rate policies violate WTO rules. If China has altered the method by which it converts its currency in a manner which impairs the value of the tariff concessions contained in its schedule, the measure may violate Article II:3 of the GATT 1994.[11] In addition, the government provision of yuan to exporters in exchange for dollars at an artificially undervalued exchange rate may constitute a prohibited export subsidy under Article 3 of the Agreement on Subsidies and Countervailing Measures. Cases against prohibited export subsidies are relatively straightforward and do not require a showing of the injury or adverse effects of such subsidies. If China is found to maintain a prohibited export subsidy, it would also violate Article 3.2 of the Agreement on Agriculture and China's Protocol of Accession. Certain currency practices that are not contingent on export may nonetheless be actionable at the WTO if it can be established that they are "specific" under Article 2 of the Agreement on Subsidies and Countervailing Measures and cause adverse effects under Articles 5 and 6 of the Agreement.

Alternatively, even if a direct violation of a WTO provision cannot be established, China's exchange rate policies may be subject to a claim under Article XV:4 of the GATT 1994 if they "frustrate" provisions of the WTO agreements, such as the schedule of tariff concessions agreed to by China and enforceable under Article II of the GATT 1994 or the non-discrimination provisions of Articles I and III of the GATT 1994.[12] Finally, even if China's exchange rate policies are found not to directly violate any WTO provisions, they may nullify and impair benefits accruing to the U.S. under the agreements and thus be subject to a dispute settlement claim under Article XXIII of the GATT 1994 and Article 26 of the Dispute Settlement Understanding.[13]

A comprehensive evaluation of the viability of such claims is beyond the scope of these comments. Instead, these comments focus on the potential defenses to such claims, and the procedures the WTO and IMF have established for evaluating such defenses. Any such claims must first be evaluated under Article XV:9(a) of the GATT, which states,

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[11] The provision has been invoked where a country has revalued its currency and thus adjusted bound specific duties so as not to impair the value of its concessions or "afford protection in excess of the amount of protection provided for in the Schedule" of concessions. *See* GENERAL AGREEMENT ON TARIFFS AND TRADE, ANALYTICAL INDEX 83-84 (6th ed. 1994).

[12] *See*, *e.g.*, Panel of Complaints, *Report on The Special Import Taxes Instituted by the Greek Government*, GATT Doc. G/25 (Oct. 31, 1952) at para. 8 ("Even if it were found that the tax did not fall within the ambit of Article III, the further question might arise under Article XV(4) whether the action of the Greek Government constituted frustration by exchange action of the intent of the provisions of Article III of the General Agreement.")

[13] For example, a 1979 GATT Working Party on Specific Duties noted that a claim that a Member who appreciated its currency should be required to reduce duties to preserve the value of its concessions would be available to Members under Article XXIII. *Report of the Working Party on Specific Duties*, GATT Doc. L/4858 (Nov. 2, 1979) at para. 14.

"Nothing in this Agreement shall preclude … the use by a contracting party of exchange controls or exchange restrictions in accordance with the Articles of Agreement of the International Monetary Fund …." As demonstrated below, this provision in no way establishes an absolute bar to all WTO claims regarding exchange actions merely because the IMF has not, at the time of the filing of the dispute, formally declared that such actions violate the IMF Articles of Agreement.

First, it appears clear that Article XV:9(a) may operate as a defense to a claim that an exchange restriction or control that the IMF has approved of under the Articles of Agreement is in direct violation of another WTO provision.[14] However, there is some ambiguity as to the relationship between Article XV:9(a) and the "frustration" claim available under Article XV:4 in the absence of a direct violation of another WTO provision. Some have argued that Article XV:9(a) trumps Article XV:4, and thus that any exchange action that is in accordance with the IMF Articles of Agreement not only cannot be found to directly violate GATT provisions but also cannot be found to "frustrate" any of those provisions under Article XV:4.[15] This view is supported by the negotiating history of Article XV:9(a), as drafters agreed to delete the phrase "Subject to paragraph 4 of this Article" from the beginning of the language now in Article XV:9(a) at the Havana Conference.[16]

The issue was specifically addressed by a Special Group on GATT-IMF relations formed as part of the GATT Review Working Party on Quantitative Restrictions in 1954. The United Kingdom proposed that an interpretative note be added to Article XV:9(a) clarifying that: 1) Article XV:9(a) safeguarded the rights of Members to take IMF-consistent exchange actions "without prejudice" to Article XV:4; 2) Article XV:9(a) should not be interpreted to prevent Members from inviting another Member to discuss the trade aspects of its exchange actions with reference to its GATT obligations; 3) Article XV:9(a) did not prevent parties from reporting exchange restrictions or controls to the IMF under Article XV:5; and 4) Article XV:9(a) did not preclude a party from invoking the nullification and impairment provisions of Article XXIII with regard to another party's exchange actions.[17]

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[14] This appears to be the case whether a violation of a GATT provision or a provision of another WTO Agreement is claimed. For example, the dispute settlement panel in *Dominican Republic – Cigarettes* examined whether the Dominican Republic had a Article XV:9(a) defense to a GATT Article II claim. A 1994 Ministerial Declaration on the Relationship of the World Trade organization with the International Monetary Fund appears to provide that the exception in Article XV:9(a) also applies to other WTO Agreements in addition to the GATT, unless those agreements explicitly provide otherwise. *See* Siegel, *supra* note 2, at 594.

[15] *See id*. at 591.

[16] *See* GENERAL AGREEMENT ON TARIFFS AND TRADE, ANALYTICAL INDEX 407-408 (6th ed. 1994).

[17] *See Review Working Party I on Quantitative Restrictions: Report of the Special Group on GATT-Fund Relations*, GATT Doc. W.9/234 (Mar. 1, 1955) at Annex II.

The Special Group declined to adopt the interpretative note.[18] As to the first part of the UK proposal, the Special Group "agreed that it would be preferable not to try to lay down general principles about the relationship between paragraphs 4 and 9 but to leave this question over for empirical consideration if and when particular points arose which had a bearing on it."[19] Thus, they declined to resolve one way or the other the question of whether an exchange action consistent with the IMF Articles of Agreement may frustrate a GATT provision under Article XV:4 even if it could not directly violate a GATT provision under Article XV:9(a). However, the Special Group did agree with the position put forward in the second and third parts of the UK proposal, stating its view that nothing in Article XV:9(a) prevented Members from discussing the trade effects of an exchange action with another Member or reporting such actions to the Fund.[20] Finally, the Special Group stated that an interpretative note clarifying that nothing in Article XV:9(a) prevented Members from resorting to nullification and impairment provisions with regard to exchange actions "was unnecessary."[21] Thus, it appears the Special Group agreed that an exchange action in accordance with the IMF Articles of Agreement could be found to nullify or impair benefits accruing to a Member and be subject to the procedures for such non-violative measures provided in Article XXIII.[22]

In sum, it appears that whether a WTO Member may be able to raise Article XV:9(a) as a defense depends on the nature of the WTO claim being brought against it. First, if a claim of a direct violation of a WTO agreement is brought, Article XV:9(a) is available as an affirmative defense if the measure is an "exchange restriction" or "exchange control" that is "in accordance with" the IMF Articles of Agreement. Second, if a "frustration" claim is brought under Article XV:4, it is unresolved whether Article XV:9(a) may be available as a defense, though negotiating history seems to indicate that it should be available. Third, if a nullification or impairment claim is brought against a non-violative measure under Article XXIII, it appears that Article XV:9(a) is likely not available as a defense.

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18 to *See id*. at para. 8.

19 *Id*. Subsequent GATT reports on the topic have cited this determination and not departed from it. *See, e.g.*, Committee on Balance-of-Payments Restrictions, Background Paper by the Secretariat, *Consultation with Italy (Deposit Requirement for Purchases of Foreign Currency)*, GATT Doc. BOP/W/51 (Sept. 25, 1981) at paras. 12-13.

20 *Id*.

21 *Id*.

22 *See also* Committee on Balance-of-Payments Restrictions, Background Paper by the Secretariat, *Consultation with Italy (Deposit Requirement for Purchases of Foreign Currency)*, GATT Doc. BOP/W/51 (Sept. 25, 1981) at para. 13 (characterizing the Special Group as agreeing "that the exemption { in Article XV:9(a) } did not preclude a contracting party from invoking, in relation to an exchange measure, the provisions of Article XXIII on nullification and impairment."). At least one author arguing for a strong reading of Article XV:9(a) nonetheless appears to agree that the exception would not preclude a nullification or impairment claim. *See* Seigel, *supra* note 2, at n. 136.

IV. Determining Consistency with the IMF Articles of Agreement under Article XV:9(a) of GATT 1994

If Article XV:9(a) is raised as a defense in a WTO dispute settlement claim, there are relatively clear rules and procedures regarding how a panel should evaluate the defense. Article XV:2 states that the WTO "shall accept the determination of the Fund as to whether action by a contracting party in exchange matters is in accordance with the Articles of Agreement of the International Monetary Fund." In addition, the Agreement between the International Monetary Fund and World Trade Organization concluded in 1994 states, at paragraph 8, "The Fund shall inform in writing the relevant WTO body (including dispute settlement panels) considering exchange measures within the Fund's jurisdiction whether such measures are consistent with the Articles of Agreement of the Fund."

These procedures were employed by the dispute settlement panel in *Dominican Republic – Cigarettes*. There, the Dominican Republic sought to defend a foreign exchange fee imposed on imported cigarettes under Article XV:9(a).[23] The Panel first noted that any party raising Article XV:9(a) as a defense bore the burden of demonstrating, first, that the challenged measure was an exchange control or exchange restriction, and, second, that the measure was "in accordance with" the IMF Articles of Agreement.[24] The panel further found that it should respect IMF criteria prescribed by the IMF for determining consistency with its Articles of Agreement and apply them in its evaluation.[25] In addition, the panel determined that "it needed to consult with the IMF based on paragraph 2 of Article XV to verify { the Dominican Republic's } argument for a determination by the Panel on whether the measure is justified under Article XV:9(a) of the GATT."[26] The panel requested the views of the Fund, and the IMF replied that the challenged measure did not constitute an "exchange restriction," and thus the issue of its consistency did not arise under paragraph 8 of the Fund-WTO Agreement.[27]

The panel agreed with the IMF, finding that the measure was not an "exchange restriction."[28] The panel then conducted its own analysis of the consistency of the measure with the IMF Articles of Agreement, since the IMF did not consider it to be a measure within the scope of Article XV:9(a) or subject to the agreement to provide a

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[23] *See* Panel Report, *Dominican Republic – Measures Affecting the Importation and Internal Sale of Cigarettes*, WT/DS302/R (Nov. 26, 2004) at para. 7.123.

[24] *Id*. at para. 7.131.

[25] *Id*. at para. 7.132.

[26] *Id*. at para. 7.139.

[27] *See id*. at paras. 7.142 – 7.144, 7.150. The IMF concluded that, because the measure was not an "exchange restriction," it was also not an "exchange control." *See id*.

[28] *See id*. at para. 7.145.

legal determination to the panel.[29] The panel found that the provision of an IMF press release stating that the Dominican Republic had been granted a "waiver" for the measure, absent a copy of the formal waiver decision by the IMF or any clear legal basis for such waiver, was insufficient to establish that the measure was in accordance with the IMF Articles of Agreement.[30] The panel thus found that the measure could not be justified under Article XV:9(a).[31] These findings were not appealed to the Appellate Body.

If a WTO dispute were brought challenging China's exchange rate policies and China sought to justify them under Article XV:9(a), and if the approach of the IMF and the WTO panel were similar to that taken in *Dominican Republic – Cigarettes*, one would expect the IMF and WTO panel to proceed on the following basis:

1) China bears the burden to justify the challenged measures under Article XV:9(a);

2) China must establish both that its challenged exchange rate measures constitute an "exchange restriction" or "exchange control" and that the measures are "in accordance with" the IMF Articles of Agreement;

3) the panel should follow IMF-prescribed criteria in making its evaluation of the measures;

4) the panel must request a determination from the IMF regarding whether the measures fall within the exception in Article XV:9(a);

5) the IMF is required to provide the requested determination to the panel in writing under paragraph 8 of the IMF-WTO Agreement; and

6) China will fail to demonstrate its measures are in accordance with the IMF Articles of Agreement in the absence of a formal IMF determination of consistency with the legal justification therefore under the Articles of Agreement.

V. Conclusion

In sum, the absence of a formal IMF Executive Board decision determining that China has manipulated its currency in violation of Article IV:1(iii) of the IMF Articles of Agreement should not prevent the United States from evaluating whether it has viable WTO claims against China regarding the trade effects of its exchange rate policies. Some claims – such as a nullification and impairment claim, and, arguably, an Article XV:4 claim – may not be subject to the defense in Article XV:9(a) of the GATT 1994. Other claims of direct WTO violations – such as Article II of the GATT 1994 and the

[29] *See id*. at paras. 7.151 – 7.154.

[30] *See id*.

[31] *See id*. at para. 7.155.

prohibited and actionable subsidy provisions of the Agreement on Subsidies and Countervailable Measures – may be subject to a claim by China that is has a defense under Article XV:9(a). However, even if a claim is subject to an Article XV:9(a) defense, China would bear the burden in maintaining the defense, the Fund would be required to provide a legal determination to a WTO panel on the issue, and the absence of a clear and legally justifiable determination that China's policies are in accordance with the Articles of Agreement should cause China's defense to fail.

Economists are in broad agreement that China's exchange rate policies substantially undervalue the yuan, and this undervaluation artificially increases the cost of U.S. exports and decreases the cost of Chinese goods imported into the United States. The result is a massive and persistent U.S. trade deficit with China, elimination of important export opportunities, harsh competition for domestic producers from unfairly low-priced imports, and the loss of production, income, and employment in the United States.

The U.S. has the authority to remedy the harm caused by these practices under its domestic unfair trade laws, and the Department of Commerce should effectively enforce those rules by investigating allegations that currency management constitutes a countervailable subsidy. In addition, the U.S. should actively explore affirmative WTO claims regarding China's exchange rate policies. The WTO and IMF were designed to create a coherent, rules-based system to prevent and redress exactly the type of trade-distorting currency practices that China is currently engaged in. Those rules can and should be employed to their fullest extent to achieve effective relief for U.S. industries, farmers, workers, and communities.

BEFORE THE COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

WRITTEN STATEMENT OF
THE COMMITTEE TO SUPPORT U.S. TRADE LAWS

FOLLOWING THE HEARING ON MARCH 24, 2010,
REGARDING CHINA'S EXCHANGE RATE POLICY
(April 7, 2010)

The Committee to Support U.S. Trade Laws ("CSUSTL") is an organization of companies, trade associations, labor unions, workers, and individuals committed to preserving and enhancing U.S. trade laws. CSUSTL's members span all sectors, including manufacturing, technology, agriculture, mining and energy, and services. CSUSTL is dedicated to ensuring that the unfair trade laws are enforced and not weakened through legislation or policy decisions in Washington, in international negotiations, or through dispute settlements at the World Trade Organization ("WTO") and elsewhere. CSUSTL appreciates the opportunity to submit this written statement on China's exchange-rate policy.

I. National and International Regulation of Exchange Rates

Control over a country's currency in the first instance is the responsibility of that country's government and a function of national sovereignty. At the same time, since the competitive currency depreciation that played a large role in contributing to the Great Depression globally in the 1930s, there has been a general recognition that countries' exchange-rate policies can have undesirable international consequences. As a result, certain rights and obligations have arisen in public international law – primarily in agreements overseen by the International Monetary Fund ("IMF") and the World Trade Organization ("WTO") – that are meant to prevent, or at least to curtail, disruptive imbalances in international trade and investment attributable to inappropriate exchange-rate arrangements. These agreements constitute a significant ceding of national sovereignty by the member states of the IMF and the WTO over currency matters.

Thus, Article IV of the IMF's Articles of Agreement states that each member of the IMF shall avoid manipulating exchange rates or the international monetary system in order to prevent effective balance-of-payments adjustment or to gain an unfair competitive advantage over other members. In 2007, the IMF updated its guidance to members under Article IV by adding a principle recommending countries avoid exchange-rate policies – undertaken for whatever reason – that cause external instability.

Similarly, Article VI of the WTO's General Agreement on Tariffs and Trade ("the GATT"), as augmented by the WTO's Agreement on Subsidies and Countervailing Measures ("SCM Agreement") and the WTO's Antidumping Agreement, recognizes that multiple currency practices by governments can in certain circumstances constitute a subsidy to exports or a form of dumping through partial depreciation and can be offset by countervailing or antidumping duties. Article XV of the GATT also provides that member states of the WTO shall not, by exchange action, frustrate the intent of the GATT's Articles and shall not, by trade action, frustrate the intent of the IMF's Articles of Agreement. Article XV further sets forth guidelines on how the IMF and the WTO are to work in tandem on issues generated by the intersection of international trade and exchange rates.

This dual jurisdiction of the IMF and the WTO reflects the hybrid nature of exchange rates as a monetary measure with far-reaching repercussions for international trade and investment. Also of importance is that the governmental intent that is a criterion for a finding of currency manipulation under Article IV of the IMF's Articles of Agreement is not a prerequisite for imposing countervailing or antidumping duties under the WTO's provisions, which only focus upon the subsidization or dumping, the subsidy's export-contingency, and injurious effects caused by the unfair pricing.

II. Addressing on a Multilateral Basis the Fundamental Misalignment of China's Renminbi and Other Countries' Currencies

A. China's Fundamentally Undervalued Renminbi Is a Highly Protectionist and Destabilizing Measure Contrary to China's International Legal Obligations

China, as a member state of both the IMF and the WTO, is bound by public international law to abide by those institutions' requirements. In connection with its accession to the World Trade Organization in December 2001, China noted that it had had since 1994 a single and managed floating exchange-rate regime based upon supply and demand and underscored that it would abide by its obligations with respect to foreign-exchange matters in accordance with the provisions of the WTO Agreement and related declarations and decisions of the WTO that concern the IMF.[1]

China, however, does not have a floating exchange-rate regime and has fallen far short of honoring these commitments. For nearly sixteen years, China has engaged in enforced undervaluation of its currency, the renminbi. This fundamental misalignment has been achieved by means of the Chinese government's pegging of the renminbi to the U.S. dollar and extensive currency controls and massive and protracted intervention in exchange markets. There is broad consensus that the renminbi is undervalued, and the Peterson Institute estimates that the renminbi is misaligned by about 40 percent relative to the U.S. dollar. China's intervention in the exchange markets is now approximately $30 - $40 billion per month.

China's fundamental misalignment of its currency is a classic protectionist measure. The renminbi's undervaluation acts as a deterrent to imports into China and facilitates exports from China, while fostering jobs and foreign direct investment in China at the expense of the United States and other countries. The Economic Policy Institute recently has issued a report that the

[1] See "Report of the Working Party on the Accession of China," WT/ACC/CHN/49, at paras. 31 and 35 (Oct. 1, 2001).

renminbi's substantial undervaluation has been a major reason for the United States' imbalanced trade with China, the loss of 2.4 million manufacturing jobs in the United States between 2001 and 2008, and depressed and lower wages for many more millions of U.S. workers.[2] From 2002 to 2009, the United States ran a cumulative trade deficit of nearly $5.4 trillion for All Merchandise, including a deficit of almost $1.6 trillion with China. China's share of the U.S. trade deficit in All Merchandise rose from 22 percent in 2002 to 45.3 percent in 2009.[3]

Perhaps the clearest yardstick of how damaging and extensive the renminbi's under-valuation has been can be seen in the enormous foreign reserves that China has been gaining at a rapid rate. This growing accumulation of foreign reserves persisted even during the time when China loosened the renminbi's peg to the U.S. dollar for a while. In July 2005, China allowed a revaluation of the renminbi, from 8.28 renminbi/$1 to 8.11 renminbi/$1. From then until July 2008 when China reinstituted the peg, China permitted the renminbi to strengthen further to 6.82 renminbi/$1, a nominal appreciation in total of approximately 17.5 percent. Nevertheless, during these three years China's foreign reserves (exclusive of the foreign reserves held by Hong Kong and Macao) rose from $711 billion to $1.8 trillion. By the end of 2009, China's foreign reserves (again apart from the foreign reserves of Hong Kong and Macao) were typically cited as having risen further to about $2.4 trillion, but could well be closer to $3 trillion, even as China has continued to invest in a wide range of assets around the world.[4]

In summary, the renminbi's fundamental misalignment undercuts and prevents a sustainable flow of trade across national boundaries. As Harry Dexter White, the chief negotiator of the United States at Bretton Woods, observed at the time of the IMF's founding in 1944, "A depreciation in exchange rates is an alternative method of increasing tariff rates; and exchange restriction is an alternative method of applying import quotas."[5] By the same token, as Chairman Bernanke noted in a speech in Beijing on December 15, 2006, "Greater scope for market forces to determine the value of the RMB would also reduce an important distortion in the Chinese economy, namely, the effective subsidy that an undervalued currency provides for Chinese firms that focus on exporting rather than producing for the domestic market." In a forum sponsored by the Economic Policy Institute on March 12, 2010, Nobel Laureate Paul Krugman echoed Chairman Bernanke by calling the renminbi's fundamental misalignment a measure that should be treated as a countervailable subsidy.

B. Multilateral and Bilateral Efforts to Date Have Not Resolved the Issue

China's exchange rate with the United States today continues to be 6.82 renminbi/$1, and the adverse effects of the renminbi's and other foreign currencies' undervaluation relative to the

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[2] Robert E. Scott, "Unfair China Trade Costs Local Jobs" (Economic Policy Institute, Mar. 23, 2010).

[3] See Fair Currency Coalition, "Fact of the Week – RMB Peg Fuels China Trade Surpluses, Undercuts U.S. Recovery" (Feb. 23, 2010), available at, www.faircurrency.org.

[4] See Fair Currency Coalition, "Fact of the Week – China's Record Reserves" (Jan. 26, 2010), available at, www.faircurrency.org.

[5] H.D. White, "The Monetary Fund: Some Criticisms Examined," 23 Foreign Affairs 195, 208 (1944-45).

U.S. dollar threaten the recovery of the U.S. and global economies. Despite this predicament, and despite the broad consensus that the undervaluation of the renminbi and other currencies is considerable, the IMF has been able only to draw attention to this situation, because the agency is not empowered to do more and certainly cannot compel revaluation. The IMF's position is so circumscribed under its Articles of Agreement that China has been able to block publication of the IMF's 2007, 2008, and 2009 annual surveillance reports under Article IV.[6]

Similarly, there appears to have been little or no coordination between the IMF and the WTO on this situation even though, as mentioned earlier, Article XV of the General Agreement on Tariffs and Trade speaks to the respective roles of these two international organizations in matters pertaining to issues that have monetary and trade aspects. In addition, while the WTO has its various agreements, including its Understanding on the Settlement of Disputes, the WTO has not acted on this problem, and no member state has opted for dispute settlement thus far.

Lastly in this regard, discussions on this subject by the G-20 finance ministers, in the U.S.-China Strategic and Economic Dialogue, and during other bilateral meetings between senior officials of China and the United States at the highest levels have not persuaded China thus far to modify its mercantilist behavior.

C. The Imperative for Meaningful Multilateral Action Without Delay

It is evident from the foregoing that China's unwillingness to revalue the renminbi is deep-seated. China's political leaders regularly cite "stability" as justification for fixing the renminbi's value within a narrow range. While that term can be variously interpreted, Chinese authorities in the past have stressed (a) the need for China's economy to generate 20-25 million new jobs each year[7] and (b) low profit margins on many Chinese exported goods of less than 2 percent[8] as reasons to avoid large changes in the renminbi's value. China's undervaluation of the renminbi also has been spurring (a) the huge foreign reserves noted earlier that have enabled China to purchase assets around the world to ensure a steady supply of raw materials and strengthen China's economy and national security, (b) large trade surpluses, and (c) foreign direct investment in China. From China's narrow perspective, these factors apparently are seen as conducive to "stability."

The problem, however, is that China's policy is one of protectionism at the expense of other nations and actually is creating instability by way of increasingly dangerous economic and monetary imbalances on an unprecedented scale. These imbalances are undesirable for the United States, for China's other trading partners, and ultimately for China as well. Neither the United States nor any other country can run extensive and debilitating trade deficits on an open-

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[6] See Fair Currency Coalition, "Fact of the Week – The International Monetary Fund (IMF) Record on Currency Manipulation" (Feb. 2, 2010), available at, www.faircurrency.org.

[7] International Monetary Fund, Country Report No. 04/351, "People's Republic of China: 2004 Article IV Consultation – Staff Report" at 12-13 (Nov. 2004).

[8] The Wall Street Journal, Asia News, "China Official Warns of Currency Risks" (Mar. 18, 2010) (statement by Vice Commerce Minister Zhong Shan that further appreciation of the renminbi risks driving Chinese exporters out of business).

ended basis. In the end, China's best chance of stimulating jobs and achieving "stability" without excess production and inflation in China will be through balanced and sustainable growth. Increased flexibility in the renminbi's exchange rate will be critically important in the realization of this goal and orderly resolution of global imbalances. A greater reliance by China on exchange rates that reflect market fundamentals is also vital for the United States to bolster its manufacturing base and economy.[9]

D. A Proposal

At this stage, after so many years without a constructive resolution of this worsening situation, the international community should feel a compelling urgency to address competitive currency depreciation effectively before conditions deteriorate further. Even now, unfortunately, it is questionable whether China is prepared unilaterally to shift from its contradictory policy of "stability" via rigid exchange rates and to revalue the renminbi sufficiently and quickly enough. Morgan Stanley has said that it expects China will permit the renminbi to appreciate to 6.54 renminbi/\$1 by the end of 2010 and to 6.17 renminbi/\$1 by the end of 2011.[10] Yet that nominal appreciation from the current rate of 6.82 renminbi/\$1 would be only 9.5 percent, about the same pace over the next 21 months that China set between July 2005 and July 2008. If that previous experience is any guide, that movement would probably be inadequate and would not stem the current imbalances in such areas as foreign reserves and trade from becoming more extreme. From the standpoint of the United States, further losses of jobs and increases in debt could be expected. Nor is it likely that the IMF under its current rules would have any real success in encouraging China to revalue the renminbi. The initial and fragile recovery from the global recession could very easily be undermined.

Stronger multilateral provisions are required to hold in check and to offset competitive currency depreciation by countries. The Bretton Woods system and the GATT took essential, first steps in the mid- and late 1940s (a) by formally recognizing that fundamentally misaligned exchange rates undo efforts to liberalize international trade and (b) by putting in place a framework under public international law by which members of the IMF and the GATT (now WTO) relinquished some sovereignty over exchange rates. It would have been ideal had this progress been solidified in the 1970s when the Bretton Woods' par-value mechanism was replaced with the present rules of the IMF, but that did not happen, and so the task of improving the international mechanism for the enforcement of orderly exchange rates remains.

As the present circumstances described above set forth, it is the negative and disruptive impact on balanced trade and investment across national boundaries that suffers when a country acts in a protectionist manner by seriously misaligning its currency's exchange rates over a

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9 International Monetary Fund, Country Report No. 04/351, "People's Republic of China: 2004 Article IV Consultation – Staff Report" at 12-13 (Nov. 2004); and Secretary of the Treasury Timothy Geithner, "The United States and China, Cooperating for Recovery and Growth," Speech at Peking University – Beijing, China (June 1, 2009).

10 Morgan Stanley, "China Economics – Renminbi Exit from USD Peg: Whether, Why, When, How," at 1 (Apr. 5, 2010).

prolonged period of time. It consequently makes sense to rely upon anti-protectionist, multilateral trade remedies as part of the solution to remedy that damage.

As a way of punctuating, therefore, that fundamental misalignment of a currency is not acceptable under public international law, CSUSTL supports H.R. 2378, The Currency Reform for Fair Trade Act, bipartisan legislation that would treat fundamental misalignment of a foreign currency as a prohibited countervailable export subsidy and authorize the imposition of either countervailing or antidumping duties on injurious imports into the United States from any country that fundamentally undervalues its currency.

This action is appropriate and necessary. First, this bill is a reasonable implementation in U.S. domestic law of the WTO's SCM Agreement and Antidumping Agreement. If China or any other country wanted to do so, it could contest the WTO-consistency of this legislation in dispute settlement at the WTO. Whether successful or not, such a challenge would draw attention to the critical need for enforceable, effective recourse in place under public international law to counter injury caused by fundamentally undervalued currencies.

Second, this bill is very much needed in the short term. Its passage would extend to materially injured U.S. companies and workers an immediate means to neutralize the unfair price advantage of imports that benefit from any other country's enforced currency depreciation. Over the longer term, the availability of this relief could serve as a deterrent to the practice of currency depreciation. This remedy would not be unilateral and protectionist, but instead would be multilateral and anti-protectionist under the current provisions of the WTO and the IMF.

BEFORE THE COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

WRITTEN STATEMENT OF
THE FAIR CURRENCY COALITION

FOR THE HEARING ON
CHINA'S EXCHANGE RATE POLICY
(March 24, 2010)

The Fair Currency Coalition ("FCC") consists of manufacturing, agricultural and labor groups seeking an effective, lasting solution to the growing problem of currency misalignment. A list of the FCC's members is attached.

The FCC appreciates this occasion to be heard on the critical subject of China's exchange rate policy. China is not the only country to pursue a mercantilist currency policy, of course, but it is the most prominent one and the one that is sometimes hailed as a model for developing countries. As our views on the nature of the problem and its impact on American industries and workers are well known,[1] this statement focuses primarily on the issue of whether and how a solution might be found in the "multilateral approach" to the problem of currency manipulation that is often invoked as an alternative to the use of national trade remedies.

The United States Has Pursued A Multilateral Solution for Years to No Avail

Continuing calls for a "multilateral solution" obscure the plain fact that the United States has tried for years to use every multilateral means to persuade China, in particular, to adopt a more market-based currency regime. The past two administrations have repeatedly raised the issue in meetings of the G-7, the G-8, the G-20, the World Bank, and the International Monetary Fund --- all to no avail.

The G-20 considers itself "the premier forum for our international economic cooperation."[2] On September 24-25, 2009 in Pittsburgh, the G-20 agreed, among other things, "to launch a framework that lays out the policies and the way we act together to generate strong, sustainable and balanced global growth" and "to reform the global architecture to meet the needs of the 21st century." As Treasury Secretary Tim Geithner has made clear, a change in the value of the renminbi is one critically important step to achieve "strong, sustainable and balanced growth."[3] So, at least from the perspective of the United States, the G-20 formula implicitly recognizes the need for a currency realignment.

[1] For more information, consult our website: http://www.faircurrency.org.

[2] Leaders' Statement: The Pittsburgh, September 24-25, 2009, at para. 19.

[3] See, for example, his speech at Peking University, June 1, 2009.

On March 29, President Obama and four other leaders wrote a letter to the rest of the G-20 regarding the agenda for the next G-20 summit to be held in Toronto on June 26-27, 2010. Nine months after the Pittsburgh meeting, the five leaders wrote:

> We all understand that ongoing trade, fiscal and structural imbalances cannot lead to strong and sustainable growth. Without cooperative action to make the necessary adjustments to achieve that outcome, the risk of future crises and low growth will remain. All G20 countries must move quickly to implement the first steps of the new Framework agreed to in Pittsburgh – to report robustly on what each of us can do to contribute to strong, sustainable and balanced growth.

Even at a time of financial and economic crisis, the multilateral process moves slowly. Seven months after the Pittsburgh meeting, the G-20 leaders must exhort the group to "*move quickly to implement the first steps*" of the new Framework. Note, too, that divisive issues are not referred to directly. There is no mention of currency issues in the Pittsburgh statement or in the March 29 letter. Of necessity, multilateral diplomacy consists of endless talk and the extensive use of coded words and phrases. Differences tend to be papered over, not resolved.

Multilateral diplomacy has been tried repeatedly by the current and the previous U.S. administrations and has consistently failed to produce any concrete result in terms of more realistic, market-based exchange rates. We do not argue that multilateral diplomacy should be abandoned. Instead, we are convinced that a new approach is needed. As Martin Wolf wrote in the Financial Times, "The US was right to give talking a chance. But talk must lead to action."[4]

The rest of this statement assesses the limitations arising from existing multilateral rules and institutions in dealing with currency misalignment and proposes a new strategy based on the use of national trade laws consistent with our rights and obligations under multilateral agreements.

Relevant IMF Rules Are Too Weak to be Effective

At the conclusion of World War II, a new international monetary system was created and the International Monetary Fund was established to oversee it. A principal responsibility of the IMF is surveillance of member countries' exchange rates.

The rules governing undervalued currencies are contained in Section 1 of Article IV of the IMF's Articles of Agreement:

> **Section 1. General obligations of members**
> Recognizing that the essential purpose of the international monetary system is to provide a framework that facilitates the exchange of goods, services, and capital among countries, and that sustains sound economic growth, and that a principal objective is the continuing development of the orderly underlying conditions that are necessary for financial and economic stability, each member undertakes to collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates. In particular, each member shall:

[4] "Evaluating the renminbi manipulation," Financial Times, April 7, 2010.

(i) endeavor to direct its economic and financial policies toward the objective of fostering orderly economic growth with reasonable price stability, with due regard to its circumstances;

(ii) seek to promote stability by fostering orderly underlying economic and financial conditions and a monetary system that does not tend to produce erratic disruptions;

(iii) avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members; and

(iv) follow exchange policies compatible with the undertakings under this Section.

Subsection (iii) is the heart of the matter: all 186 IMF member countries are obligated to "avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members." The language used is "*shall avoid* ….," making clear that there is a legal obligation not to manipulate one's exchange rates. It is also clear that the objective is not rigid, unchanging exchange rates, as Chinese representatives sometimes imply. Rather, the overarching objectives are economic and financial stability and sustained, sound economic growth on a global basis, aims that are echoed in the recent G-20 statements. The obligation of IMF members is to allow exchange rates to respond to market forces as necessary to correct imbalances in payments and avoid the creation of an unfair competitive advantage.

Despite the apparent clarity of the IMF obligations, China has effectively held down the value of its currency, the renminbi ("RMB") or yuan, against the U.S. dollar for 16 years. For all but three years (July 2005 – July 2008), the RMB has been tightly pegged to the dollar. The results of China's policy are startling. In just the past eight years, China has amassed a cumulative trade surplus in manufactured good of $1.6 trillion dollars, while its official reserves have skyrocketed to $2.4 trillion.

Over the past decade, the IMF has proved impotent to address the problem despite its mandate to exercise "firm surveillance over the exchange rate policies of members."[5] The IMF holds annual bilateral consultations with China and every other member of the IMF on exchange issues under Article IV. The Fund has recommended repeatedly that China adopt a "more flexible" exchange rate regime. Its advice has gone unheeded.

Consistent with its mandate to "adopt specific principles for the guidance of all members with respect to those [exchange rate] policies," the Fund has also issued several policy guidelines since 1997. The latest additional guideline, approved in June 2007, refines the concept of "currency manipulation" by adding the principle that IMF members should avoid "exchange rate policies that result in external instability." In other words, each IMF member is instructed to consider the effects its currency policies have on trading partners and the system as a whole.

China's response has been to ignore the IMF's guidelines as well as its recommendations. For the past three years – that is, every year since 2006 -- China has gone farther, successfully blocking the release of the 2007, 2008, and 2009 reports on completed annual Article IV consultations. China's 3.65 percent voting share is not large enough to veto any formal decision

[5] IMF Article IV, Section 3(b).

of the IMF.[6] Instead, China is able to block reports it doesn't like, apparently merely by saying "no" to their public release.

The lesson that can be drawn from this history of futility is: even when backed by the IMF's legal obligations and policy guidelines, moral suasion has proved inadequate to convince a large, unwilling member to reform its currency policy. Attempts at moral suasion by groups that lack *any* legal powers – the G-8 and the G-20, for example – are even less likely to convince such a country.

Existing WTO Rules Are Too Weak and Untested to Be Effective

The General Agreement on Tariffs and Trade, the basic trade contract on which the post-war trading system is based, gives some attention to currency issues. One such provision lies in Article XV, Section 4:

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

Some observers see in this broad language the possibility of action by the WTO, the successor to the GATT. It should be possible, for example, to build a legal case on the argument that currency misalignment constitutes an export subsidy, a practice prohibited on manufactured goods by GATT Article VI. In addition, it might be possible to argue that misalignment constitutes a de facto additional levy on imports, nullifying and impairing the tariff bindings under GATT Article II that have been the chief bulwark against a resurgence of 1930's-style protectionism.

While there is little question that an undervalued currency has those deleterious effects on key elements of the basic trade contract among WTO members, it is far less clear what action the WTO might take in response to a complaint brought by the United States or a group of countries.

Novel issues pose substantial problems for the WTO's ad hoc dispute settlement panels and the standing Appellate Body. Panelists are drawn from the trade policy establishment around the world. Their knowledge and experience vary, of course, but few of them have any grounding in monetary affairs. As a consequence, it is difficult to know in advance how they would analyze, much less resolve, disputes centering on IMF standards and concepts.

Moreover, the WTO arguably lacks a clear mandate to deal with these issues on its own. Instead, GATT Article XV, paragraph 2 requires the WTO to "consult fully with the International Monetary Fund" in cases dealing with "monetary reserves, balances of payments or foreign exchange arrangements." Worse yet, the WTO is obligated by that same paragraph of Art. XV to "accept the determination of the Fund as to whether action by a contracting party in exchange matters is in accordance with the Articles of Agreement of the International Monetary Fund."

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[6] Only the United States, with 16.74 percent, has sufficient voting power to block a decision.

In other words, the same IMF that cannot find a way to issue its own consultation reports or to enforce its own policy guidelines is supposed to supply the definitive determination on which WTO action would hinge. This institutional arrangement seems unworkable, calling into question any hope for timely, effective action under Article XV.

An Intelligent Approach to a Multilateral Solution

In the final analysis, only multilateral action can be expected to remedy the deficiencies in multilateral rules and institutions. One direct approach, advocated by Arvind Subramanian of the Peterson Institute for International Economics and Aaditya Mattoo of the World Bank, would be to amend the WTO rules expressly to prohibit currency undervaluation. They choose the WTO over the IMF because undervaluation has clear trade effects and because the IMF has no enforcement powers, especially when it comes to large creditor nations – just the ones who might benefit from an undervalued currency. Theoretically, it would be possible to amend the GATT or to add this issue to the long-stalled Doha Round negotiations. Either process looks to be endless.

The issue before the Obama administration, the Congress and the world is how best to achieve a fair, effective and durable solution under the international rules – a solution that resolves not just the immediate case of China but also establishes effective legal norms to prevent future cases from growing so large. The most sensible, pragmatic and legally defensible strategy would be:

- as a matter of policy, to direct the Department of Commerce to begin enforcing the U.S. antidumping and countervailing duty remedies to offset currency subsidies in a manner consistent with our WTO obligations;
- as a matter of prudence, to enact the Currency Reform for Fair Trade Act (H.R. 2378) to establish as clearly as possible for U.S. courts the intent of the Congress that the law be applied to remedy currency subsidies;
- to prepare for a WTO challenge against our use of the anti-subsidy remedies available under national law; and
- to open broader multilateral discussions on how best to address the deficiencies in the current international system of rules and disciplines.

By acting decisively on our legitimate interests and doing so within the existing framework of international rights and obligations we would have the best chance of driving a multilateral process to a useful conclusion. By acting first, we help to ensure that we can defend our actions rather than carry the heavy burden of proof that someone else's practices, which often lack transparency, violate provisions that have rarely if ever been enforced by the IMF or the WTO, even in the face of egregious violations. Our example of using existing countervailing duty remedies would encourage other trading partners to act in a similar way. Only by acting first, can the United States lead in securing a lasting multilateral solution to the problem of currency misalignment.

Attachment

FAIR CURRENCY COALITION: MEMBERS
(As of February 19, 2010)

1. Allegheny Technologies Incorporated
2. American Corn Growers Association (ACGA)
3. American Cotton Shippers Association
4. American Federation of Labor Industrial Union Council
5. American Foundry Society
6. American Iron and Steel Institute
7. American Manufacturing Trade Action Coalition
8. American Mold Builders Association
9. Bakery, Confectionary, Tobacco Workers and Grain Millers International Union (BCTGM)
10. Coalition for a Prosperous America
11. Communication Workers of America (CWA)
12. F & L Metal Finishes, Inc.
13. The Copper & Brass Fabricators Council, Inc.
14. International Association of Machinists and Aerospace Workers (IAM)
15. International Brotherhood of Boilermakers (IBB)
16. International Brotherhood of Electrical Workers (IBEW)
17. International Federation of Professional Employees (IFPTE)
18. Lapham-Hickey Steel Corporation
19. Manufacturers Association of Central New York (MACNY)
20. Metals Service Center Institute
21. National Council of Textile Organizations
22. National Textile Association
23. National Tooling and Machining Association
24. North American Die Casting Association
25. Nucor Corporation
26. Organization for Competitive Markets
27. Penn United Technologies, Inc.
28. Precision Machined Products Association
29. Precision Metalforming Association
30. Sheet Metal Workers International Association (SMWIA)
31. Specialty Steel Industry of North America
32. Spring Manufacturers Institute
33. Steel Dynamics, Inc.
34. Steel Manufacturers Association
35. Tooling & Manufacturing Association
36. Tooling, Manufacturing, and Technologies Association
37. United Automobile Workers (UAW)
38. Universal Electric Corporation
39. United Mineworkers of America (UMWA)
40. United States Business & Industry Council
41. United Steelworkers of America (USW)
42. US Industrial Fabrics Institute
43. Wisconsin Paper Council
44. Wood Machinery Manufacturers of America (WMMA)
45. Vanadium Producers & Reclaimers Association
46. Xcel Mold and Machine, Inc.

Rep. Peter J. Visclosky
Chairman, Congressional Steel Caucus
Submission for the Record
Hearing on China's Exchange Rate Policy
April 1, 2010

I would like to thank Chairman Levin, Ranking Member Camp, and all Members of the Ways and Means Committee for holding this very timely and important hearing on China's exchange rate policy. In the past, I have testified in person before this Committee on this critical issue, and I thank you for allowing me the opportunity to submit this statement for the record today.

I write in my capacity as the Chairman of the Congressional Steel Caucus, and I would like to bring to your attention the sentiment of the steel industry that was expressed in a hearing I held last week on the state of the domestic steel industry. The Caucus heard testimony from executives of various steel companies and a representative from the United Steelworkers. All expressed a profound concern towards Chinese trading policies, including their currency manipulation.

In the world of steel, China is of paramount concern. In 2009, China produced 47 percent of the world's total output of steel, which is 567.8 million tons of steel. This is more than double the amount that China produced in 2003. Multiple factors contributed to this unprecedented increase in production, including illegal government subsidies and currency manipulation. By comparison, last year the United States produced around 60 million tons of steel, compared with around 100 million tons in 2003. Chinese currency manipulation is perpetuating this destructive trade imbalance and costing American jobs. Therefore, I implore you to advance H.R. 2378, the Currency Reform and Fair Trade Act, which would remedy this situation.

Two quotes from the Steel Caucus hearing are particularly poignant on this issue. Mr. Tom Conway, International Vice President for the United Steelworkers, stated, "We must also get tough on trade to ensure that we do not continue to hemorrhage jobs and capacity due to unfair trade practices like currency manipulation." And Mr. Mario Longhi, CEO of Gerdau Ameristeel, stated, "We must ensure the U.S. is still a competitive place for manufacturing investment. This requires the U.S. to reverse the unsustainable imbalance that has allowed other nations to adopt policies supporting excessive exports of manufactured goods to the U.S., while we export debt and manufacturing jobs."

I also would like to bring your attention to a report recently published by Robert Scott, Senior International Economist and Director of International Programs at the Economic Policy Institute, entitled *Unfair China Trade Costs Local Jobs*. This report states that because of our trade imbalance with China, 2.4 million jobs were lost in the United States between 2001 and 2008, including 4,900 jobs from the First Congressional District of Indiana. The report highlights how Chinese currency manipulation has furthered this trade imbalance and American job loss, and how China has aggressively acquired U.S. dollars to further depress the value of its own currency. Specifically, China currently has about $2.4 trillion in foreign exchange reserves, of which about 70 percent are in U.S. dollars.

Mr. Chairman, I believe that we are at a turning point in the discussion of this issue, and I applaud you for having this hearing with these prominent economists, which highlights the seriousness of the issue and the momentum that is growing for change. I again thank you for the opportunity to submit testimony and commend you and your Committee on your steadfast work.

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March 22, 2010

Written Testimony

of Jack Davis, President

a **Witness**

on behalf of I Squared R Element Co., Inc. and its employees

Before The

Ways and Means Committee Chairman, Sander M. Levin, hearing on the exchange rate policy of the Government of the People's Republic of China, and its impact on the U.S. and global economies.

I have been invited by my Congressman, Chris Lee, to make a written statement to the Ways and Means Committee Chairman, Sander M. Levin, on China's manipulation of currency. I want to thank Congressman, Chris Lee, and Chairman, Sander Levin, for this opportunity.

In 1994, in a brilliant move to create jobs and industries, China cut the value of the Yuan by forty percent and locked its value against the U.S. dollar. China was then a much poorer country.

They knew to create wealth they had to grow, dig, or manufacture. Their stated industrial policy was to make China the world's largest manufacturer. To grow their manufacturing industries they needed capital, modern technology, plants, machinery, and export markets.

They opened their home markets, with restrictions, to banks, insurance companies and brokerage houses. This provided the capital for industrial expansion.

They also opened their manufacturing industries, with restrictions. China had approximately three hundred million unemployed or under-employed workers (this is about the total population of the U.S.) willing to work for twenty cents an hour. To entice U.S. manufacturing companies they offered cheap labor, cheap land and cheap plants, low taxes and a market of one billion three hundred million people.

The decrease in the value of the Yuan immediately made all Chinese exports 40% cheaper. In the short term the U.S. consumer enjoyed the benefits of cheaper products. In the long term this has caused the greatest transfer of wealth and technology the world has ever seen. By 2008, it had created an economic crisis in the U.S., worse than the Japanese surprise attack on Pearl Harbor.

It has also caused a worldwide recession in every country except China. China's Gross National Product is still expanding at 9% a year.

The Peoples Bank of China now holds over 2 trillion U.S. dollars and U.S. debt. A totalitarian country is now our country's banker.

The main reason China was so successful and that it was such an economic disaster for the U.S. was that the majority of Congress, the Executive Branch and Academia are Free Traders.

This group has failed to understand that both countries must be free traders.

If one country (China) has a predatory trade policy and the other a free trade policy (no taxes at borders) the free trade country loses jobs, looses industries and looses wealth.

Also, the original free trade theory only works when products are traded (e.g. wool from Britain for wine from Spain). It was never intended and will not work when one country trades products for the other country's currency.

If you manufacture heating elements, automobiles, machinery, flat screen TV's or any other products and have a selling price of 1000 US dollars, the same product made in China is only 600 U.S. dollars, i.e. 40% cheaper. No U.S. business can compete with the Chinese government's manipulated currency.

We are in the worst economic recession since the 1930's depression.

There are seventeen million workers unemployed or under employed and the numbers are still increasing. Companies continue to downsize, offshore and go out of business.

Our accumulative trade deficit, yearly budget deficit and national debt continues to increase.

Tax receipts in village towns, cities, counties and states are down causing huge deficits. My business is down 20%, we have people on lay-off, and work 3, 4, or 5 days a week due to lost U.S. businesses.

Many would agree that entrepreneurs and small businesses were the job creators that drove our once great economy.

I am an entrepreneur and owner founder of a small business. I have been creating jobs for over 45 years. Before I will spend my money or borrow money to rent or buy a building, acquire fixtures, computers, manufacturing equipment, raw materials, finished inventory and hire people, I first consider the risk of whether I will make or lose money. If I determine a foreign competitor can sell an equivalent product at a lower price I will not make the investment and hire people. Most entrepreneurs think as I do.

We cannot make China do something they don't want to do. They have it just the way they want it now. The Chinese government has too many ways to cheat and too few cultural or moral taboos against cheating. Their government can not be trusted.

The Chinese government by locking the devalued Yuan to the U.S. Dollar has destroyed millions of jobs and thousands of companies.

Congress must do its duty and level the playing field.

I whole heartily agree with Paul Krugman's article "Taking On China", he recommends placing a surcharge of 25% on all of Chinese products shipped into the U.S.

Our Constitution, Article 1, Section 8 states Congress shall have the power to regulate commerce with foreign nations. In my opinion, Congress has been negligent in the performance of its duties and should immediately place a surcharge on all Chinese products shipped into the United States.

Thank you.
Jack Davis
President

Statement for the Record
Congressman Christopher J. Lee (NY-26)
Ways & Means Committee Hearing on China's Exchange Rate Policy
March 24, 2010

Thank you Mr. Chairman for the opportunity to submit comments on this important issue.

A study released just this week by the Economic Policy Institute reported that since China joined the World Trade Organization (WTO) in 2001, 2.4 million jobs have been lost or displaced in the U.S.

China's currency manipulation is a significant factor in our U.S. trade deficit, and a broad range of economists believe that China's currency is deliberately undervalued by at least 40 percent. As the Committee well knows, the practical effect of China intentionally lowering its currency's value is to make its goods cheaper. So when Chinese manufacturers export a product, they effectively receive a 40 percent subsidy on their exports, a nearly insurmountable advantage over U.S. producers. This market-distorting policy artificially raises the price of our exports to China and gives Chinese goods a competitive edge in our market.

Before being elected to Congress, I ran a manufacturing company. I have seen firsthand how China's currency manipulation has harmed America's manufacturing base. America's workers are the best in the world, and given a level playing field, we can compete and win in a global economy. But the playing field vis-à-vis China is not level, and China has gained an unfair advantage over U.S. manufacturers.

Currency manipulation creates an unfair trade advantage, which ultimately harms American manufacturers and adds to the growing U.S. trade imbalance.

Last fall, I joined more than 40 of our colleagues in sending a letter to President Obama expressing our disagreement over the Treasury Department's decision to not name China as a currency manipulator in its October 15, 2009, report to Congress. It's important the Treasury Department joins the work being done in Congress and denounce China's illegal and unfair trade practices.

In the letter, we also expressed our support for H.R. 2378, the Currency Reform for Fair Trade Act, which would target exchange rate misalignment between the U.S. Dollar, Chinese Yuan, and other major trading partners, in order to reduce the unfair comparative advantages that command economies can use against market economies. I'm hopeful this Committee will move this important legislation forward so we can begin to seriously address the inequity.

I appreciate the Committee receiving written testimony from my constituent, Jack Davis, who also has a firsthand view of how China's currency manipulation has had a negative effect on the economy in Western New York.

The longer we allow China to manipulate their currency without repercussions the longer our domestic manufacturing industry will continue to suffer. I appreciate the opportunity to submit this testimony to the Committee and look forward to working with you to strengthen our manufacturing sector and level the playing field for American businesses and workers.

CARNEGIE ENDOWMENT
FOR INTERNATIONAL PEACE

Congressional Testimony

THE RMB: MYTHS AND TOUGHER-TO-DEAL-WITH REALITIES

Submission for the Record by:
Pieter Bottelier, Nonresident Scholar
Uri Dadush, Senior Associate
Carnegie Endowment for International Peace

House Committee on Ways and Means
Washington, D.C.
March 24, 2010

WASHINGTON DC ▪ MOSCOW ▪ BEIJING ▪ BEIRUT ▪ BRUSSELS

China fever will again grip Washington as the U.S. Treasury nears its mid-April deadline for pronouncing whether China manipulates its currency. Dangerous myths about the RMB will again be propagated, feeding China bashers and protectionist lobbies. Meanwhile, more important and politically tougher reforms in both the United States and China will be conveniently overlooked.

Most economists would agree that the RMB is undervalued and that it is in China's interest to allow appreciation. By pegging its exchange rate to the dollar, China abdicates a large measure of control over its monetary policy. In addition, an undervalued currency increases prices for Chinese consumers, and contributes to inflationary pressures and excessive accumulation of low-yielding reserves.

However, the benefits of RMB appreciation for the United States are mixed at best and—whether net positive or negative—are certainly exaggerated. U.S. policy makers should prioritize maintaining a collaborative relationship with China, now the world's largest trading nation, over staging another fruitless debate on the RMB.

The Myths

China's growth has depended primarily on exports

While integration into world markets has been vital for China's development, domestic demand has always been the country's primary growth driver. During the decade before the crisis, net-exports accounted for only about 1 percentage point of China's 9.5 percent average annual growth, as imports grew almost as fast as exports.

China did not contribute enough to global demand during the crisis

Chinese demand was integral to Asia's early emergence from the recession, and the rest of the world benefited as well. In 2008, China accounted for over 50 percent of world growth; last year, China expanded rapidly while the world economy contracted.

Domestic demand in China expanded 12.3 percent in 2009, while domestic demand in the United States and industrialized countries contracted 2.6 percent and 2.7 percent, respectively. China's output was able to grow nearly 9 percent even as exports plummeted 16 percent. Imports held up much better than exports, and China's current account surplus declined from 9.6 percent of GDP in 2008 to 5.8 percent in 2009. Data to February this year suggests that the surplus is still shrinking.

Furthermore, during the most acute phase of the crisis—the fourth quarter of 2008 to the first quarter of 2009, when the dollar appreciated against nearly all currencies—China maintained the RMB's peg to the dollar. This helped other countries weather the demand collapse.

China's consumption is not growing fast enough

Private consumption in China grew by an average of about 7.5 percent over the ten years prior to the crisis, faster than in any other large economy. In the United States, private consumption grew at an annual rate of 3.6 percent over the same period. Nonetheless, consumption's share of China's national income fell over that period as investment grew even faster. In 2009, however, consumption's share rose, another hopeful sign that the economy may be rebalancing toward domestic demand at the expense of exports.

The United States depends on China to buy its government debt

At the end of 2009, China held only about 7 percent of U.S. federal government debt outstanding. Sold at a high price (low yield), U.S. government debt is a popular security. At the same time, the United States is benefiting China: China has few good alternatives to hold its reserves and U.S. firms are large investors and employers in China. In the investment arena, as in others, the United States and China are mutually dependent.

China has been manipulating its currency to get an unfair advantage in trade for years

About 60 countries peg their exchange rates to the dollar today, and they are not all currency manipulators. The real question is whether a country systematically pegs its currency at an artificially low rate in order to gain competitive advantage—a violation of IMF and WTO rules.

The evidence against the RMB is mixed at best. China pegged the RMB to the dollar at the end of 1997, in the midst of the Asian crisis. At that time, the United States and other countries applauded the peg as a generous act that promoted stability in the region. Serious complaints did not emerge until 2003, when China's trade surplus and America's trade deficit (with the world and with China) began to rise sharply.

However, the RMB/dollar rate, which had not changed, was not the primary reason for the growing imbalance. Rather, in the United States, the fiscal surpluses of the final Clinton years had shifted to large deficits and the Greenspan Fed was pursuing very loose monetary policies while the financial sector generated additional liquidity as a result of inadequate oversight and regulation. In China, aggressive domestic reforms had prompted exceptional productivity growth in manufacturing, while the government promoted both exports and import substitution.

Recognizing these shifts, China adopted a policy of gradual RMB appreciation in July 2005. Three years later, the RMB had risen 21 percent against the dollar. Because of the sharp, crisis-induced drop in export orders, however, China suspended the policy. China's central bank governor recently confirmed that the suspension is a special, crisis-related measure, implying that gradual appreciation will resume as the crisis abates.

Revaluation of the RMB will help the U.S. economy

The immediate effect of RMB appreciation would be to raise prices for U.S. consumers. A 25 percent revaluation of the RMB, which some economists have said is needed, would—if not offset by a reduction in China's prices—add $75 billion to the U.S. import bill. Since the United States imports three times as much from China as it exports there, higher U.S. exports to China would not nearly offset the welfare loss to U.S. consumers from higher

Chinese prices. It would take years for adjustment to a higher RMB to occur, but in the end, though some U.S. firms would gain and some export jobs would be created, the U.S. consumer would be the loser, and the net welfare effect on U.S. workers would probably be negative.

Revaluation of the RMB is critical for reducing global trade imbalances

A revaluation of the RMB by itself would do little to redress global imbalances, and could, as mentioned, initially lead to a wider U.S.–China trade deficit. Most likely, unless U.S. domestic demand falls for other reasons, the overall U.S. trade deficit would hardly budge in the end as the United States would simply import more from other countries that would resist following China's lead in allowing currency appreciation.

The (Tougher-to-Deal-With) Realities

China's policies artificially promote investment, exports, and import substitution at the expense of consumption

Many leaders in China acknowledge the need to address the country's pervasive export and import-substitution policies, as well as the suppressed interest rates, which lower the cost of capital for Chinese firms. However, tough internal policy battles lie ahead as powerful vested interests resist change. International pressure on these issues would strengthen the hand of reformers.

China needs to improve its safety nets

Although budget outlays for health and education have increased significantly in recent years, much more needs to be done. Further improvements would probably prompt households to reduce savings and increase consumption. However, the impact on China's trade balance would depend on how the safety nets were financed. If social security contributions to the de-facto pay-as-you-go system were simply raised, national savings would change little. If on the other hand, these outlays increased government deficits and borrowing, national savings and China's trade surplus might decline.

Overwhelmingly, U.S. external deficits are determined by U.S. policies

All fair-minded economists recognize that measures to reduce the U.S. fiscal deficit and encourage household savings will do infinitely more to correct U.S. current account deficits than any conceivable policy change in China. Though the needed measures are well-known, and include raising consumption and energy taxes, increasing competition and efficiency in healthcare, and establishing a needs-tested social security system, these changes are politically complicated to say the least.

Conclusion

China's economy has become so large and globally integrated that its exchange rate policy is a matter of international concern. But, more than an international issue, it is crucial for

China. Given the realities outlined above, it makes little sense for the United States to point to China's exchange rate as a major bilateral issue. Designating China a currency "manipulator" will only impair a crucial relationship. In addition, the debate diverts attention from the politically difficult, but much more significant, domestic reforms that are needed in both the United States and China.

Pieter Bottelier, former chief of the World Bank's resident mission in Beijing, is a nonresident scholar in Carnegie's International Economics Program and senior adjunct professor of China studies at the School of Advanced International Studies (SAIS) at Johns Hopkins University. Uri Dadush is a senior associate in and the director of Carnegie's International Economics Program.

**WRITTEN TESTIMONY OF
COALITION FOR A PROSPEROUS AMERICA**

**BEFORE THE UNITED STATES HOUSE OF REPRESENTATIVES
COMMITTEE ON WAYS AND MEANS**

HEARING ON THE EXCHANGE RATE POLICY OF THE GOVERNMENT OF THE PEOPLE'S REPUBLIC OF CHINA, AND ITS IMPACT ON THE U. S. AND GLOBAL ECONOMIES

HEARING DATE MARCH 24, 2010

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Thank you Chairman Levin, and members of the House Committee on Ways and Means, for allowing the Coalition for a Prosperous America to present this written testimony to you. We respectfully request that this written testimony be accepted into the written record for this hearing.

SUMMARY OF TESTIMONY:

The Coalition for a Prosperous America, and its members, support neutralizing the persistent undervaluation of the Chinese renminbi countervailing duties, and/or anti-dumping duties. This can best be accomplished through passage of the Currency Reform for Fair Trade Act of 2009 (H.R. 2378). There is wide agreement that China persistently undervalues its currency and that the impact is a mercantilist one, not a free-trade result. The quantity of undervaluation is anywhere from 25 to 50 percent, a range that is agreed upon widely. This currency manipulation has in large part been an underlying cause of the Great Recession. The volume of manufacturing and jobs off shored because of this unfair trade tactic has been devastating. As Treasury Secretary Geithner has argued, we cannot grow GDP without correcting this problem. Diplomacy and negotiation have been tried for several years, reached the upper levels with President Obama's November 2009 visit to China, and failed. Enforcement of international norms, which disallow such undervaluation, is necessary. The U.S. House should pass the Currency Reform for Fair Trade Act for 2009 (HR 2378) to neutralize this currency advantage and return to free and fair trade. Passage of HR 2378 is the most significant jobs creation and economic growth action that this body can take.

BACKGROUND OF CPA:

The Coalition for a Prosperous America (CPA) is a national, nonpartisan organization representing the interests of 2.7 million citizens through its farmer, rancher, manufacturing and organized labor association and company members. Our members include industry sectors such as farming, ranching, steel, aluminum, tooling and machining, electronics, textiles, service industries, cattle production, crop production and many other sectors. We advocate only on issues in which all sectors agree. Our members unanimously agree, and place a top priority upon, neutralizing the currency undervaluation caused by China and other countries.

THE GDP PROBLEM CAUSED BY THE TRADE DEFICIT:

Our recent recession was, by definition, the result of a contraction of gross domestic product (GDP). GDP is a mathematical calculation including four factors: (1) Consumption; (2) Investment; (3) Government Procurement; and (4) Net Exports (exports minus imports).

In recent years, the U. S. has experienced record Net Imports, not Net Exports. Net Imports means our trade balance directly and mathematically depressed GDP. (The Administration has a new goal to double exports in 5 years, but the issue is not absolute exports, but Net Exports.) Production and jobs were off-shored, so we imported and consumed products rather than produced them.

Because such a high volume of production and jobs was off-shored, Investment followed that production elsewhere. Investment that would have occurred here occurred elsewhere. Therefore, in the last ten years, net Investment has been zero in the United States. GDP was not assisted at all by Investment.

The result is that GDP has been supported by Consumption and Government Procurement only. Investment contributed nothing. And Net Imports depressed GDP.

We cannot build an economy on Consumption and Government Procurement alone. We have to produce, invest and export more than we import in order to stop foreign borrowing and begin to pay down our massive international debt. The solution is to fix trade policy, rebalance our current account deficit, and produce more here. Doing so will negate the Net Import problem; cause substantial Investment; add millions of jobs; and grow GDP.

FREE TRADE CANNOT EXIST WITH MANIPULATED CURRENCIES:

Classic free trade permits little or no government intervention in terms of tariffs, subsidies, or nontariff/nonsubsidy barriers and market distortions. There is debate as to whether classical free trade can truly exist among diverse economies, but we will assume it can for purposes of this testimony.

Free trade cannot exist unless respective national currency values reflect their true market value. In other words, if currency values do not adjust to changing market conditions (whether by a repeg or a float), then free trade cannot exist. That is because changes in currency valuation will occur in the free market to counter persistent trade deficits or trade surpluses. Persistent trade deficits or trade surpluses are destabilizing to the global economy and to national economies.

The manner in which currency valuation changes remedy persistent trade deficits or trade surpluses is as follows. When Country A has persistent net exports, its economy grows, and its currency should appreciate in value. With appreciation, Country A's exports become more expensive, less attractive on the world market in relation to competitors, and exports thus decline while imports rise. Country B may have persistent trade deficits (net imports). County B's economy thus slows its growth (or contracts). Its currency valuation should decline. Its export offerings become cheaper on global markets, thus more attractive to buyers, while imports become more expensive, and Country B's net trade rebalances to a more positive level.

China (and other Asian countries such as South Korea, Japan, Taiwan and Singapore) manipulate their currency values at the expense of countries with free-floating currencies. This trade strategy is both protectionist (protecting against import competition) and mercantilist (facilitating exports unfairly). China is the most egregious and noteworthy currency manipulator because of the size of its economy, the brazenness of its efforts, and its percentage share of the U.S. trade deficit. We believe its currency is at least 35 percent undervalued, making Chinese exports 35 percent cheaper than it would otherwise be (an export subsidy) and making U. S. sales to China 35 percent more expensive than they would otherwise be (a tariff).

CHINA'S LABOR COST ADVANTAGE IN THE CONTEXT OF CURRENCY MANIPULATION.

China is sometimes assumed to be a low cost manufacturing country, in large part because of cheap labor. However, China is a high-cost manufacturing country because of low productivity, immature infrastructure, and the artificially high cost of imported energy and components, among other factors. While labor costs are a local market, capital and raw materials costs are more often priced in international markets. Thus China can only have an advantage on labor, but not necessarily raw materials and capital costs.

The labor cost differential is largely irrelevant to trade where currency manipulation exists. There are few major U. S. production sectors, if any, wherein labor makes up 35 percent or more of the cost of production. Let's assume an industry sector in which labor is 10 percent of the cost of production. Let's further assume that we could, by government fiat, cause the labor input portion of costs to be **zero**. If that occurred, China would still have a 25 percent advantage due to currency alone.

U.S. producers of food and goods have to reduce their costs by an astounding 35 percent to become competitive with the Chinese due to their currency intervention. (We ignore, for purposes of this testimony, other Chinese government subsidies.) U.S. competitiveness internationally is not a serious topic unless we address this unfairness.

Free trade cannot exist unless the currency undervaluation problem is neutralized as a tariff and subsidy.

REMEDY:

Enforcement of international trade norms must be a priority if the U.S. is to be a successful economic country. If rules are not enforced, international trade breaks down and produces harm instead of benefit. Neutralizing the Chinese currency advantage through countervailing duties, anti-dumping duties, or carefully calibrated tariffs is essential.

H.R. 2378 should be approved by this Committee, and passed on the House floor. Persistent currency undervaluation is a violation of the IMF Charter. The IMF has an agreed-upon method to quantify the level of persistent currency undervaluation. U. S. trade laws are set up to neutralize wrongful foreign subsidies. Persistent currency undervaluation is a subsidy. H.R. 2378 will categorize persistent currency undervaluation by trade rivals as an unlawful subsidy. Existing enforcement mechanisms of U.S. trade law can make a major dent in the problem. In other words, HR 2378 creates no new substantive law. Rather it takes existing international norms and creates a remedy for them under U. S. trade laws.

SUMMARY:

America cannot recover from the Great Recession with job growth and production growth without remedying the currency problem. This issue is mature and has been deliberated. Diplomacy has failed. China has a far stronger incentive to continue its undervaluation than to revalue. Enforcement is the sensible approach, and cannot be determined a radical approach. Those opposing enforcement are protecting the protectionism of others.

It is worth noting as well that, unlike other approaches to stimulating the recovery and restructuring of the American economy, passage of H.R. 2378 would not require new government spending.

We encourage this committee to mark up HR 2378, approve it, and move that bill to the floor of the House for a full vote.

Respectfully submitted,

Brian O'Shaughnessy, Chief Co-Chair and Manufacturing Co-Chair of CPA
(Chairman, Revere Copper Products)

Joe Logan, Agricultural Co-Chair of CPA

(Director, Agricultural Programs, Ohio Environmental Council)

Bob Baugh, Labor Co-Chair of CPA
(Executive Director, AFL-CIO Industrial Union Council)

Fighting for the U.S. Cattle Producer!

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March 24, 2010

The Honorable Sander M. Levin
Chairman
Committee on Ways & Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington D.C. 20515

Re: **R-CALF USA's Written Submission Regarding Hearing on China's Exchange Rate Policy Scheduled for March 24, 2010**

Dear Chairman Levin:

The Ranchers-Cattlemen Action Legal Fund, United Stockgrowers of America (R-CALF USA) appreciates the opportunity to make this written submission for the record of the *Hearing on China's Exchange Rate Policy* scheduled for March 24, 2010.

R-CALF USA is a national, non-profit organization dedicated to ensuring the continued profitability and viability of the U.S. cattle industry and represents thousands of U.S. farmers and ranchers, whose businesses involve the raising and selling of live cattle, on domestic and international trade and marketing issues. R-CALF USA's membership consists primarily of cow-calf operators, cattle backgrounders, and feedlot owners. Its members are located in 46 states, and the organization has numerous local and state association affiliates, from both cattle and farm organizations. Various main-street businesses are associate members of R-CALF USA.

The distortions that persist in global beef and cattle trade have contributed significantly to the long-term contraction of the U.S. cattle industry. Since 1980, U.S. Department of Agriculture (USDA) data show that the U.S. has lost over 40 percent of its U.S. cattle farms and ranches that raise beef-type cattle, representing an exodus of over half a million U.S. cattle businesses from all across the United States.[1] Data from USDA also show the U.S. cattle industry has been shrinking the size of its cattle herd, which now consists of nine million fewer cattle than were in

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[1] *See* Number of Operations with Cattle and Milk Cows, 1979-1980, Cattle, U.S. Department of Agriculture (USDA), Economic Research Service (ERS) (Jan. 30, 1981), at 16 (There were 1,272,950 beef cattle operations in the U.S. in 1980), available at http://usda.mannlib.cornell.edu/usda/nass/Catt//1980s/1981/Catt-01-30-1981.pdf; *see also* Cattle and Calves: Number of Operations and Percent of Inventory by Size Group, United States, 2008-2009, Farms, Land in Farms, and Livestock Operations 2009 Summary, USDA, National Agricultural Statistics Service (NASS) (February 2010), at 20 (There were 753,000 remaining beef cattle operations in the U.S. in 2009.), available at http://usda.mannlib.cornell.edu/usda/current/FarmLandIn/FarmLandIn-02-12-2010_new_format.pdf.

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the domestic production chain in 1996.[2] Ironically, other major cattle-producing countries increased their respective herd sizes while the U.S. herd was shrinking.[3] Brazil is just one notable example of this phenomena, as is the growth in the collective herd size of the 17 countries with which the U.S. currently has free trade agreements.[4]

China is viewed by many in the U.S. as a potential customer of U.S. beef. But, the distortion created by China's undervaluation of its currency likely would price U.S. beef beyond the reach of even China's middle-income population. In 2009, the U.S. cattle producer received less than 43 percent of the value of Choice beef sold at retail.[5] Thus, in order for U.S. cattle producers to at least maintain the economic returns realized in 2009, they would need to continue receiving approximately $1.81 per pound retail weight from each carcass that actually sold at retail for $4.26 per pound in 2009.[6] However, with an estimated per-capita income of only $6,500 in 2009 dollars,[7] the Chinese population is not likely to consume significant volumes of U.S. beef at the price U.S. cattle producers must receive to maintain economic par with 2009 (i.e., $1.81 per pound retail weight), let alone at the average 2009 retail price of $4.26 per pound, which *is* the retail price necessary for U.S. cattle farmers and ranchers to maintain the economic returns realized in 2009 under the current structures of the U.S. cattle and beef industries.

Before introducing the added effect of China's exchange rate policy, it should be noted that the United States, where per-capita income is estimated at $46,400[8] (which is more than seven times greater than in China), consumed more beef than it produced in 2009.[9] China,

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[2] *See* Cattle and Calves, Number by Class and Calf Crop, United States, January 1, 1995-1996, Cattle, USDA NASS (January 1997), at 3 (On Jan. 1, 1996, the number of U.S. cattle and calves in the U.S. was approximately 103.5 million head.), available at http://usda.mannlib.cornell.edu/usda/nass/Catt//1990s/1997/Catt-01-31-1997.pdf; *see also*, Cattle, USDA NASS (Jan. 29, 2010), at 1 (On Jan. 1, 2010, the number of U.S. cattle and calves in the U.S. was 93.7 million head.), available at http://usda.mannlib.cornell.edu/usda/current/Catt/Catt-01-29-2010.pdf.

[3] *See* FAOSTAT Production Database, Food and Agricultural Organization of the United Nations, available at http://faostat.fao.org/site/573/DesktopDefault.aspx?PageID=573#ancor.

[4] *See id.*

[5] *See* Choice Beef Values and Price Spreads and the All-Fresh Retail Value, USDA ERS, available at http://www.ers.usda.gov/Data/meatpricespreads/.

[6] *See id.* (These values reflect the 2009 average Choice beef retail value (retail beef price) and the 2009 average net farm value (the average price paid to U.S. cattle producers based on the retail beef price.).

[7] *See* The World Factbook: China, U.S. Central Intelligence Agency, available at https://www.cia.gov/library/publications/the-world-factbook/geos/ch.html.

[8] *See id.*, United States, available at https://www.cia.gov/library/publications/the-world-factbook/geos/us.html.

[9] *See* Beef and Veal Selected Countries, Livestock and Poultry: World Markets and Trade, U.S. Department of Agriculture, Foreign Agricultural Service (October 2009) (The U.S. consumed 12.3 million metric tons of beef but produced only 11.8 million metric tones, making the U.S. a net importer of beef and veal.), available at http://www.fas.usda.gov/psdonline/circulars/livestock_poultry.pdf.

however, produced more beef than it consumed in 2009.[10] Thus, China's prospects of soon becoming a significant purchaser of U.S. beef, particularly at prices necessary to sustain a U.S. cattle industry, do not appear promising.

China's currency undervaluation is an effective tariff on U.S. beef exports. When China's undervalued currency is factored into the consideration of China as a potential market for U.S. beef, the prospect of exporting beef to China at prices necessary to sustain the U.S. cattle industry at even the 2009 economic level (albeit a level that is insufficient to reverse the ongoing contraction of the domestic industry) is dismal. China's currency is undervalued between 30 and 50 percent. [11] The effect is that the $4.26 per pound Choice beef price in the U.S. (which, again, is the price necessary to sustain the economic condition of U.S. cattle producers at the 2009 level) becomes anywhere from $5.54 per pound to $6.39 per pound when sold to Chinese buyers because of the currency tariff. The effect is to price U.S. beef beyond the reach of the Chinese population, which already has limited purchasing power in a country that produces more beef than it consumes.

In addition, though China does not currently export beef to the United States, it has a cattle herd size of approximately 82.6 million cattle,[12] which is comparable to the United States' herd size of 93.7 million cattle.[13] Thus, China has the potential to significantly increase beef production, particularly if it attempts to emulate cattle production and beef processing practices in the United States. And, this appears to be China's intention. China's currency policy could facilitate this transformation by subsidizing exports and deterring imports of beef, just as it has already done for corn, apples and apple concentrate, and countless other products.

In 2001, China began a $200 million development project (backed by the World Bank) to build an infrastructure of feedlots and slaughterhouses and give assistance to small-scale cattle producers in east-central China to build a competitive beef production industry in the region.[14] In

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[10] *See* Beef and Veal Selected Countries, Livestock and Poultry: World Markets and Trade, U.S. Department of Agriculture, Foreign Agricultural Service (October 2009) (China produced 5.76 million tons of beef and veal and consumed 5.75 million tons of beef and veal, meaning that China likely is a net beef and veal exporter.), available at http://www.fas.usda.gov/psdonline/circulars/livestock_poultry.pdf.

[11] *See* Hearing Advisory, Web Site of Committee on Ways & Means, available at http://waysandmeans.house.gov/press/PRArticle.aspx?NewsID=11060.

[12] *See* FAOSTAT Production Database, Food and Agricultural Organization of the United Nations (estimate based on 2008 data.), available at http://faostat.fao.org/site/573/DesktopDefault.aspx?PageID=573#ancor.

[13] *See* January 1 Cattle Inventory Down 1 Percent, Cattle, U.S. Department of Agriculture, National Agricultural Statistics Service (Jan. 29, 2010), available at http://usda.mannlib.cornell.edu/usda/current/Catt/Catt-01-29-2010.pdf.

[14] *See* Subsidies Enforcement Annual Report to the Congress, Joint Report of the Office of the U.S. Trade Representative and the U.S. Department of Congress, February 2001.

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2003, China initiated a national strategic 'Beef Advantageous Development Area Program' that was intended to shift their marketing focus to higher quality beef production.[15]

In a more recent USDA Foreign Agricultural Service (FAS) report, the agency predicted that 2009 beef consumption was expected to fall in China due to the high price of beef compared to other meats.[16] The FAS report also indicated that beef production, likewise, was expected to decrease due to shrinking profits for Chinese cattle producers. The currency-devalued price of fed cattle in China in 2008 was approximately RMB 6,615 ($965.70 U.S.), and production costs were estimated at RMB 6,340 ($880.50 U.S.), which, according to the report, resulted in a per head profit of about $40 for Chinese cattle producers.[17] In comparison, the 2008 average market price for fed cattle in the U.S. was $1,162.63 per head[18] and the cost of production for U.S. cattle feeders was approximately $1,315.5 per head,[19] representing a per head loss to U.S. cattle feeders of approximately $153 per head that year.

Should China increase its domestic beef production and/or begin exporting beef to the U.S. while its currency undervaluation remains unaddressed, the likely effect would be an accelerated contraction of the U.S. cattle industry. China's currency undervaluation alone would enable it to sell beef in the U.S. market for between 30 percent and 50 percent less than the value of domestic beef, not to mention the effect on the price of beef due to other internal government subsidies that may significantly lower the market price of Chinese beef.

The adverse effect of China's undervalued currency becomes more apparent to the U.S. cattle industry when costs and prices for live cattle are considered. For example, using the 2008 production costs and prices for fed cattle discussed above, a hypothetical Chinese fed steer sold in the U.S. market would net the Chinese producer about $282 per head (U.S. price of $1,162.63 less Chinese production cost of $880.50). Thus, with China's subsidized currency, a hypothetical Chinese steer sold in the 2008 U.S. market would have given China a $435 per head advantage over U.S. cattle producers whom sold cattle in the U.S. that year (calculated by adding China's $282 profit to the United States' $153 per head loss).

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[15] *See* Subsidies Enforcement Annual Report to the Congress, Joint Report of the Office of the U.S. Trade Representative and the U.S. Department of Congress, February 2004, at 41.

[16] *See* China, Peoples Republic of, Livestock and Products, Semi-Annual Report, 2009, GAIN Report No. CH9017 (March 9, 2009) available at http://www.fas.usda.gov/gainfiles/200903/146327423.pdf.

[17] *See id.* (Note, however, that while the GAIN report estimates the profit at $40.00 per head, the numbers provided in the report to calculate production costs indicate the profit is about $85.00 per head.), available at http://www.fas.usda.gov/gainfiles/200903/146327423.pdf.

[18] *See* Choice Beef Values and Price Spreads and the All-Fresh Retail Value, USDA ERS (Estimate is based on the average 5 market steer price in 2008 and a 1,250 pound steer.), available at http://www.ers.usda.gov/Data/meatpricespreads/.

[19] *See* High Plains Cattle Feeding Simulator, USDA ERS (Estimate is based on the average monthly cost of producing a fed animal in 2008).

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The introduction of increased supplies of lower-cost beef resulting from China's undervalued currency would have a tremendous, negative impact on the viability of the U.S. cattle industry that is extremely price-sensitive to increased supplies due to the industry's farm elasticity of demand. The U.S. International Trade Commission has determined that the farm level elasticity of demand for slaughter cattle is such that "each 1 percent increase in fed cattle numbers would be expected to decrease fed cattle prices by 2 percent."[20] By extension, increases in the supply of beef that is derived from fed cattle likewise would depress fed cattle prices in the same manner.

In conclusion, if the goal of Congress and the Administration is to increase exports of beef and other U.S. agricultural products, then this tariff caused by China's currency undervaluation must be neutralized. R-CALF USA urges the U.S. House Ways and Means committee to take immediate and decisive action to correct the untenable trade distortions caused by China's persistent currency undervaluation.

Sincerely,

Bill Bullard
CEO

[20] U.S.-Australia Free Trade Agreement: Potential Economywide and Selected Sectoral Effects, United States International Trade Commission (Publication 3697; May 2004) at 44, fn 26, available at http://hotdocs.usitc.gov/docs/pubs/2104f/pub3697.pdf.

Appreciate This: Chinese Currency Rise will have a Negligible Effect on the Trade Deficit

by Daniel Ikenson
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Free Trade Bulletin No. 41 – March 24, 2010

Introduction

The Chinese currency issue has roared back to life with a vengeance and once again threatens U.S.-China relations and the global trading system. Official dialogue has descended into an exchange of finger-pointing and tongue-lashings. And Washington is abuzz with sanctions talk, as lawmakers from both major parties throw their support behind legislation intended to compel China to revalue the Renminbi (RMB).

The catalyst for this latest flare-up is the impending Treasury Department report to Congress on currency manipulation, which is due on April 15. Although Treasury has never branded China as a currency manipulator—which is a label that would spark negotiations on an "expedited basis" and open the door to "remedial" legislation—there is increasing speculation that a new precedent will be set with the forthcoming report.

The president has expressed concern that an undervalued RMB "artificially inflates the price of U.S. goods" and, by extension, undermines the goal of his just-unveiled National Export Initiative to double U.S. exports in five years. Reducing imports—the perennial goal of America's very vocal import-competing industries and unions—seems to be the primary motivation for Congress in the currency debate.

Before they do something rash, the administration and Congress should take deep breaths and consider whether RMB appreciation would even lead to the outcomes they desire—namely, more balanced trade. The evidence does not support their objective. They also should consider the likely consequences of taking the provocative actions under review. Although the short-term political benefits may be all that matter to some politicians, real economic costs will be borne without any economic benefits to show.

There are less provocative alternatives for encouraging China to recycle its accumulated foreign reserves, which is probably a worthy objective. Unfortunately, policymakers' fixation on the politically charged, but economically meaningless, bilateral trade account only spells trouble.

The Renminbi is Likely Undervalued

Many economists believe that the Renminbi is undervalued, but there is disagreement about the magnitude. Disagreement is to be expected. After all, nobody can know the true value of the RMB unless, and until, it is allowed to float freely and restrictions on China's capital account are removed.[1] Short of that, economists produce estimates of undervaluation—and those estimates vary widely. So that begs a practical question: How will we know when we are there?

That question is important because Congress is once again agitating to consider legislation to compel the Chinese to allow RMB appreciation under the threat of sanction. Of course, that approach assumes that China will respond more "favorably" to public condemnation and arm-twisting than it would if the issue were allowed to migrate to the back burner. But U.S. politics won't allow that.

Laser-like Focus on the Trade Deficit

For Congress, the issue is not that the currency is undervalued per se, but that the United States has a large bilateral trade deficit with China, which is popularly attributed to the undervalued RMB.[2] Currency revaluation for many policymakers is just a proxy for reducing the trade deficit to zero, or better still, turning it into a surplus. There should be little doubt that many will take the position that the RMB is undervalued as long as U.S. imports from China exceed U.S. exports to China.

Leaving aside the question of whether bilateral deficit reduction should even be an explicit objective of policymaking in the first place, there is reason to be skeptical that currency revaluation would have the "desired" effect. It is assumed that Americans will reduce their purchases of Chinese products and that the Chinese will increase their purchases of American products if the value of the RMB increases against the dollar. But whether those trends would work to reduce the U.S. deficit with China depends on the extent to which consumers in both countries are responsive to the relative price changes.

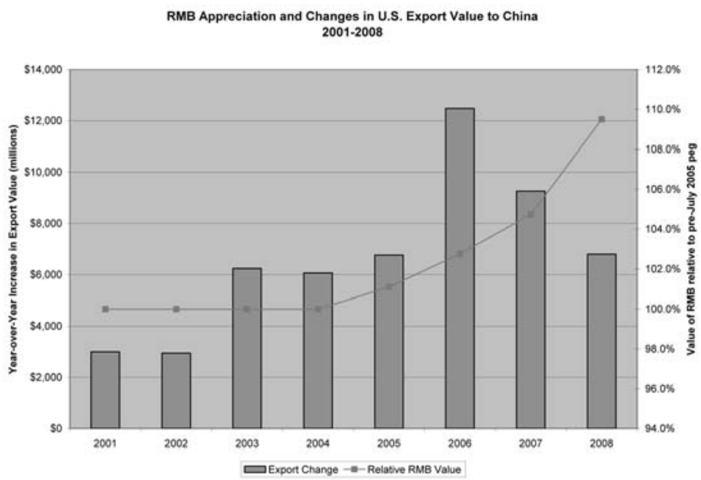
What matters for the trade account is *how much* Americans reduce their purchases of Chinese goods and *how much* the Chinese increase their purchases of U.S. goods. Import value equals price times quantity, so if the percent increase in price (appreciation of the RMB) exceeds the percent reduction in quantity of imports consumed (in absolute value), then import value will *increase*. For example, if the RMB appreciates by 25 percent and U.S. consumers reduce consumption of Chinese imports by only 10 percent, then the value of U.S. imports from China will be greater than before (*adding* to the trade deficit). The same 25 percent increase in RMB value, however, should lead to an unequivocal increase in U.S. exports to China because the dollar price charged (the price used to measure U.S. exports) remains the same, while the quantity sold to China increases because Chinese consumers, by virtue of RMB appreciation, face lower relative prices, and demand more goods. Thus, RMB appreciation should unambiguously increase U.S. export value, reducing the trade deficit. But its effect on U.S. import value *is* ambiguous.

Whether the aggregate change in U.S. import and export value results in a lower trade deficit depends on the relative responsiveness (price elasticity) of American and Chinese consumers to the price changes they face. If U.S. consumers are responsive (they reduce the quantity of their purchases *by a percentage greater than the price increase*), then the trade deficit will decline, regardless of the degree of Chinese responsiveness. If U.S. consumers are not responsive (they reduce the quantity of their purchases by a smaller percentage than the price increase), then import value will rise and Chinese consumers would have to increase their purchases of American goods by a large enough percentage to offset the increased U.S. import value, if the U.S. trade deficit is to be reduced.[3]

Weak Link between Currency Values and Trade Flows

Recent evidence suggests that RMB appreciation will not reduce the U.S. trade deficit and undermines the common political argument for compelling China to revalue. Between July 2005 and July 2008, the RMB appreciated by 21 percent against the dollar—from a value of \$.1208 to \$.1464.[4] During that same period (between the full year 2005 and the full year 2008), the U.S. trade deficit with China increased from \$202 to \$268 billion.

U.S. exports to China increased by \$28.4 billion, or 69.3 percent. But how much of that increase had to do with RMB appreciation is very much debatable. The chart below shows that U.S. exports to China were already on an upward trajectory, increasing by \$3 billion in 2001, \$3 billion in 2002, \$6.2 billion in 2003, and \$6.1 billion in 2004, when the exchange rate was consistently at 8.28 RMB per dollar. Natural sales growth from the confluence of market penetration and cultivation of Chinese demand was already evident.



In 2005—the first year in which there was a slight RMB appreciation—the value of exports increased by \$6.8 billion. Exports jumped another \$12.5 billion in 2006, a year in which the RMB appreciated by 2.8 percent. But in 2007, despite an even stronger 4.7 percent RMB appreciation, the increase in exports was only \$9.3 billion. And in 2008, the RMB appreciated by a substantial 9.5 percent, but the increase in exports fell to \$6.8 billion. If currency value were a strong determinant, then export growth should have been much more robust than it was in 2007, and in particular, 2008.

On the import side, recent experience is even more troubling for those who seek deficit reduction through currency revaluation. The evidence that an appreciating RMB deters the U.S. consumption of Chinese goods is not very compelling. During the period of a strengthening RMB from 2005 to 2008, U.S. imports from China increased by \$94.3 billion, or 38.7 percent.

Not only did Americans demonstrate strong price inelasticity, but they actually *increased* their purchases of Chinese imports, in seeming defiance of the law of demand. One reason for continued U.S. consumption of Chinese goods despite the relative price increase is that there may be a shortage of substitutes in the U.S. market for Chinese-made goods. In some cases, there are no domestically produced alternatives. Accordingly, U.S. consumers are faced with the choice of purchasing higher-priced items from China or foregoing consumption of the item altogether.

It is doubtful that members of Congress, who support action to compel Chinese currency appreciation, would proudly announce to their constituents that they intentionally reduced their real incomes. But that is the effect of relative dollar depreciation.

Globalization Mutes the Effect of Currency Changes

Something else is evident about the relationship from those 2005 to 2008 data. The fact that a 21 percent increase in the value of the RMB was met with a 38.7 percent increase in import value means that the quantity of Chinese imports demanded after the price change increased by nearly 15 percent.[5] Higher prices being met with greater demand would seem to defy the law of demand.

Chinese exporters must have lowered their RMB-denominated prices to keep their export prices steady. That would have been a completely rational response, enabled by the fact that RMB appreciation reduces the cost of production for Chinese exporters—particularly those who rely on imported raw materials and components. According to a growing body of research, somewhere between one-third and one-half of the value of U.S. imports from China is actually Chinese value-added.[6] The other half to two-thirds reflects costs of material, labor, and overhead from other countries. China's value-added operations still tend to be low-value manufacturing and assembly operations, thus most of the final value of Chinese exports was first imported into China.

RMB appreciation not only bolsters the buying power of Chinese consumers, but it makes Chinese-based producers and assemblers even more competitive because the relative prices of their imported inputs fall, reducing their costs of production. That reduction in cost can be passed on to foreign consumers in the form of lower export prices, which could mitigate entirely the intended effect of the currency adjustment, which is to reduce U.S. imports from China. That process might very well explain what happened between 2005 and 2008, and is probably a reasonable indication of what to expect going forward.

In a 2006 Cato paper on the topic of exchange rates and trade flows, this author found that despite considerable dollar depreciation between 2002 and 2005 against the Canadian dollar, the Euro, the Japanese yen, the Korean won, and the Brazilian real, the U.S. trade deficit expanded during that period with Canada, Europe, Japan, Korea, and Brazil.[7] Factors other than currency movements, such as income and the availability of substitutes, impact trade flows, particularly when exporters are willing to absorb the costs of those currency changes.

In a recently published paper from the U.S. International Trade Commission, economist Cathy L. Jabara observes a weak relationship between exchange rates and U.S. import prices, particularly with respect to imports from Asia. Exchange rate pass-through is quite low because exporters often "price to market" to absorb costs and maintain market share. She notes that the economic literature supports her findings of low exchange rate pass-through, particularly for consumer goods. Ironically, she also notes that economist Paul Krugman, who is among the most outspoken advocates of U.S. intervention on the currency issue, was one of the first to explore and describe the potential for exchange-rate pass-through to mitigate the impacts on trade flows.[8]

Congressional Action Would be Costly and Misplaced

Despite the evidence of a weak relationship between currency values and trade flows, Congress has been pushing the Commerce Department—and is now considering legislation—to treat currency manipulation as a subsidy to be remedied under the U.S. Countervailing Duty law. Of course there are many immediate practical problems with this idea, not the least of which is determining how to measure the alleged subsidy. If one takes note of the fact that the economists are in disagreement about the level of undervaluation—estimates from respectable sources range from 10–50 percent—one would conclude that there is more than one way to skin the cat. How would the Commerce Department justify its subsidy measurement methodology? Whatever method it chose would likely be subject to an immediate WTO challenge, inviting similar frivolity from China and undermining the credibility of the WTO at a time when the United States is planning to hold other members more accountable to their own commitments.

Less Provocative Alternatives

Another reason China may be loathe to see the RMB appreciate too rapidly is that it owns \$800 billion of U.S. debt. A 25 percent appreciation in the RMB would reduce the value of those holdings to approximately \$640 billion. That's a high price for China to pay, especially in light of the fact that U.S. inflation is expected to rise in the coming years, which will further deflate the value of those holdings (and ease the burden of repayment on U.S. taxpayers). Likewise, mass dumping of U.S. government debt by Chinese investors—the much ballyhooed "leverage" that China allegedly holds over U.S. policy—would precipitate a decline in the dollar as well, which also would depress the value of Chinese holdings. The assertion that China holds U.S. debt as a favor to America, and would withdraw that favor on a whim, is a bit far-fetched.

China, it seems, is guilty of a failure to heed the first law of investment: it failed to diversity its portfolio adequately. The overwhelming investment focus on U.S. public debt has left China exposed to heavy losses from dollar inflation and RMB appreciation. The fact that the inflation rate is in the hands of U.S. policymakers makes China even more reluctant to allow large-scale or, at least, precipitous, RMB appreciation.

As of the close of 2008, Chinese direct investment in the United States stood at just \$1.2 billion—a mere rounding error at about 0.05 percent of the \$2.3 trillion in total foreign direct investment in the United States. That figure comes nowhere close to the amount of U.S. direct investment held by foreigners in other big economies. U.S. direct investment in 2008 held in the United Kingdom was \$454 billion; \$260 billion in Japan; \$259 billion in the Netherlands; \$221 billion in Canada; \$211 billion in Germany; \$64 billion in Australia; \$16 billion in South Korea; and even \$1.7 billion in Russia.[9]

If it is desirable that China recycle some of its estimated \$2.4 trillion in accumulated foreign reserves, U.S. policy (and the policy of other governments) should be more welcoming of Chinese investment in the private sector. Indeed, some of China's past efforts to take equity positions or purchase U.S. companies or buy assets or land to build new production facilities have been viewed skeptically by U.S. policymakers—and scuttled—ostensibly over ill-defined security concerns.

A large inflow of investment from China would have a similar impact as a large increase in U.S. exports to China on the value of both countries' currencies, and on the level of China's foreign reserves. In light of China's large reserves and its need and desire to diversify, America's need for investment in the real economy, and the objective of creating jobs and achieving sustained economic growth, U.S. policy should be clarified so that the benchmarks and hurdles facing Chinese investors are better understood. Lowering those hurdles would encourage greater Chinese investment in the U.S. economy and a deepening of our mutual economic interests.

Conclusion

The world would be better off if the value of China's currency were truly market-determined, as it would lead to more optimal resource allocations. But compelling China to revalue under threat of sanction could produce adverse consequences—including reductions in Americans' real incomes and damaged relations with China—without even achieving the underlying, but misguided, policy objectives.

For now, it would be better to let the storm pass and allow China to appreciate its currency at its own pace.

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1. To float its currency and let markets determine the value, China would have to remove restrictions on its capital account, so that investment can flow in and out of the country freely. If China did this, it is not entirely clear that the value of the RMB would appreciate. It is possible that there would be more capital flight than inflow, as domestic savings are able to pursue investment options outside of China. This capital flight would have a depreciating effect on the value of the RMB.
2. Of course, there are many other important determinants of the trade account besides relative currency values.
3. There is also an "income effect" from the change in currency values. When the dollar declines in value, U.S. consumers experience a decline in real income, which affects their consumption choices. Even though Chinese imports might be relatively more expensive than they were before the currency rise, they may still be less expensive than the alternatives. Accordingly, U.S. consumers with lower real incomes might be inclined to purchase more Chinese imports.
4. Federal Reserve Board, Federal *Reserve Statistical Release G5.A, Foreign Exchange Rates (Annual)*, release dates January 4, 2010 and January 2, 2009. Since July 2008, the value of the Yuan against the dollar has not changed measurably.
5. Assume that the price of imports is $1 and the quantity demanded is one unit. The import value is then $1. If a 15.2 percent increase in price leads to a 38.7 percent increase in value, then quantity must increase by 20.4 percent because : (1.152 x price) * (1.204 x quantity) = 138.7.
6. Robert Koopman, Zhi Wang, and Shang-jin Wei, "How Much of Chinese Exports Is Really Made in China? Assessing Foreign and Domestic Value-Added in Gross Exports," U.S. International Trade Commission, Office of Economics, Working Paper no. 2008-03-B, March 2008.
7. Daniel J. Ikenson, "Currency Controversy: Surplus of Controversy, Deficit of Leadership," Cato Free Trade Bulletin no. 21, May 31, 2006.
8. Cathy L. Jabara, "How Do Exchange Rates Affect Import Prices? Recent Economic Literature and Data Analysis," U.S. International Trade Commission, Office of Industries Working Paper no. ID-21 (revised), October 2009.
9. Bureau of Economic Analysis, "Foreign Direct Investment in the United States: Selected Items by Detailed Industry of U.S. Affiliate," 2004–2008, http://www.bea.gov/international/xls/LongIndustry.xls.

BEFORE THE COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

WRITTEN STATEMENT OF
THE SPECIALTY STEEL INDUSTRY OF NORTH AMERICA

FOR THE HEARING ON
CHINA'S EXCHANGE RATE POLICY
(March 24, 2010)

The Specialty Steel Industry of North America ("SSINA") is a voluntary trade association that represents virtually all of the producers of specialty steel in North America. The SSINA's member companies produce stainless steel, superalloys, high-nickel materials, electrical steel, and other specialty steels in a variety of forms including bar, rod, wire, angles, plate, sheet, and strip. These products are used in a wide range of applications of central importance to the economy and national security of the United States. A list of the SSINA's members is attached. SSINA welcomes this occasion to be heard on the critical subject of China's exchange rate policy.

The Impact of China's Exchange Rate Policy

For the past sixteen years, China effectively has pegged the renminbi to the U.S. dollar. China's political leaders acknowledge that this policy is meant to protect Chinese jobs by means of exports and in this way to maintain social stability in China. According to this view, many Chinese exports have a slim profit margin of less than 2 percent, so that even a very modest revaluation of the renminbi relative to the dollar would mean the failure of companies and lost jobs in China on a large scale, but would not help the U.S. economy. Further from China's perspective, as Premier Wen Jiabao recently argued, the renminbi in any event is not undervalued, and China's exchange rate policy is a matter within China's sovereign rights.

China's rigid and protracted undervaluation of the renminbi has been accomplished by means of strict currency controls and massive intervention by the Chinese government in the exchange markets. That intervention, which the Peterson Institute estimates is now about $30 - $40 billion per month, has been generating huge imbalances, notably foreign reserves of at least $2.4 trillion and likely around $3 trillion or more for China and large annual trade surpluses by China with the United States and globally. Also importantly, foreign direct investment in China has significantly increased while foreign direct investment in the United States has declined. Research and technological advancement have been slowing here and accelerating in China. These trends are extremely worrisome.

From the standpoint of the United States, in other words, the situation looks quite differently than it does to China. In the first place, there is a broad consensus among economists that the renminbi is undervalued between 20 percent and 50 percent or more relative to the dollar. In order to keep pace with China, other countries also have been undervaluing their currencies. The extent of the renminbi's undervaluation especially is a formidable commercial disadvantage for U.S. companies to overcome, whether going head-to-head with Chinese products in the U.S. market, in China, or in third-country markets.

While not the only factor involved, the renminbi's undervaluation has certainly been playing a key role in reducing U.S. production, exports, income, investment, and jobs in the United States. The SSINA's member companies have been experiencing these adverse effects first-hand and have been seeing their customers injured as well. These circumstances are not sustainable either generally or for the United States particularly. There must be a rebalancing, and an important component of that rebalancing must be a commercially realistic revaluation of the renminbi vis-à-vis the dollar and other countries' currencies. Without this kind of revaluation, for example, it is extremely difficult to envision how the United States can possibly implement President Obama's plan for the United States to double exports in the next five years.

Addressing the Issue

In a speech delivered in Beijing on June 1, 2009, Secretary of the Treasury Geithner gave a far-reaching, thoughtful analysis of what the United States and China, respectively and together, need to do to lay the foundation for future growth. In one passage of his remarks Secretary Geithner stated,

> Our common challenge is to recognize that a more balanced and sustainable global recovery will require changes in the composition of growth in our two economies. Because of this, our policies have to be directed at very different outcomes.
>
> In the United States, saving rates will have to increase, and the purchases of U.S. consumers cannot be as dominant a driver of growth as they have been in the past.
>
> In China, as your leadership has recognized, growth that is sustainable growth will require a very substantial shift from external to domestic demand, from an investment and export intensive driven growth, to growth led by consumption. Strengthening domestic demand will also strengthen China's ability to weather fluctuations in global supply and demand.

Secretary Geithner's prescription remains timely today, as does his comment on China's task that

> {a}n important part of this strategy is the [Chinese] government's commitment to continue progress toward a more flexible exchange rate regime. Greater flexibility will help reinforce the shift in the composition of growth, encourage resource shifts to support domestic demand, and provide greater ability for monetary policy to achieve sustained growth with low inflation in the future.

As practical as Secretary Geithner's suggestions are, China's willingness to proceed on the path he eloquently described remains open to question. As noted above, exchange depreciation by way of governmentally-enforced undervaluation of the renminbi is integral to China's entrenched strategy of generating exports and attracting foreign direct investment. China has very deliberately designed this plan to support social stability. The outlook for China to modify this orientation is not encouraging.

Nor have reasoning with China to change course and multilateral initiatives fared well. Increasingly over the last five or six years, the United States has worked to persuade China that rigid exchange rates will lead to dangerous imbalances in global trade and investment and result in instability. Even though that prognosis unfortunately is proving accurate, China appears to be adamant that its monetary policy is its sovereign prerogative regardless of the consequences for other countries. At the same time, it has become evident that the International Monetary Fund ("IMF") is unable to do more than urge China to revalue the renminbi, and the World Trade Organization ("WTO") apparently has not been active on this issue, even though Article XV and other provisions of the General Agreement on Tariffs and Trade ("GATT") recognize the interrelationship between international trade and exchange rates and impose obligations on China that complement obligations that China has assumed under the IMF's Articles of Agreement.

Under these circumstances, and with the deterioration of the U.S. manufacturing base now at an alarming rate, the SSINA believes that the United States should act to enforce the trade laws by passing H.R. 2378, The Currency Reform for Fair Trade Act. As Chairman Bernanke of the Federal Reserve wrote in a paper dated December 15, 2006, and presented in Beijing,

> Greater scope for market forces to determine the value of the RMB would also reduce an important distortion in the Chinese economy, namely, the effective subsidy that an undervalued currency provides for Chinese firms that focus on exporting rather than producing for the domestic market. A decrease in this effective subsidy would induce more firms to gear production toward the home market, benefiting domestic consumers and firms. Reducing the implicit subsidy to exports could increase long-term financial stability as well: {sic} If China invests too heavily in export industries whose economic viability depends on undervaluation of the exchange rate, a future appreciation of the RMB could lead to excess capacity in those industries, resulting in low returns and an increase in nonperforming loans.

H.R. 2378 is bipartisan legislation that would treat fundamental misalignment of a foreign currency as a prohibited countervailable export subsidy. This measure is a reasonable implementation in U.S. domestic law of the WTO's Agreement on Subsidies and Countervailing Measures as well as Article VI of the GATT. H.R. 2378 would offset, by imposing countervailing duties on injurious imports, the unfair advantage that China or any other country gains by engaging in competitive currency depreciation on a protracted, large-scale basis. The U.S. economy needs this bolstering to rebuild and avoid a recessionary relapse.

H.R. 2378's remedy also would appropriately and firmly convey that all countries that are members of the IMF and the WTO, as China is, have certain obligations to the global community under public international law as far as exchange rates and international trade are concerned. Moreover, for the reasons that Secretary Geithner and Chairman Bernanke have articulated so well, the social stability that China seeks is more surely attainable and sustainable if China allows revaluation of the renminbi through market fundamentals and adjusts its focus to greater domestic production that will benefit consumers and companies in China. In a WTO- and IMF-consistent manner, H.R. 2378 underscores that a country's fundamental misalignment and undervaluation of its currency is a mercantilist, protectionist practice that causes dangerous imbalances and that consequently will not be tolerated.

Attachment

MEMBERS OF THE Specialty Steel Industry of North America

January 2010

Allegheny Ludlum
An Allegheny Technologies Company
Pittsburgh, Pennsylvania

ATI Allvac
An Allegheny Technologies Company
Monroe, North Carolina

Carpenter Technology Corporation
Reading, Pennsylvania

Electralloy
Oil City, Pennsylvania

Latrobe Specialty Steel Company
Latrobe, Pennsylvania

North American Stainless
Ghent, Kentucky

Outokumpu Stainless
Schaumburg, Illinois

Talley Metals Technology, Inc.
A Carpenter Company
Hartsville, South Carolina

Universal Stainless and Alloy Products
Bridgeville, Pennsylvania

Valbruna Slater Stainless Inc.
Fort Wayne, Indiana

BEFORE THE COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

WRITTEN STATEMENT OF
THE COPPER AND BRASS FABRICATORS COUNCIL, INC.

FOR THE HEARING ON
CHINA'S EXCHANGE RATE POLICY
(March 24, 2010)

The Copper and Brass Fabricators Council, Inc. ("Council"), is a non-profit membership trade association that dates from 1964. Membership is open to any person, firm, or corporation engaged in the fabrication or production in the United States of products made, in whole or in part, from copper or copper alloys. The Council's member companies generally are engaged in the production of copper and copper alloy sheet and strip, rod and bar, plumbing tubing, OEM or air-conditioning tubing, wire, extrusions, shapes and profiles, forgings, and fittings. These products are used chiefly in the automotive, construction and electrical/electronic industries. There are currently eighteen member companies that produce over 80 percent of all copper and brass mill products produced in the United States. The Council's list of members is attached. The Council appreciates the opportunity to submit this written statement on China's exchange rate policy, which is a subject of considerable importance to the Council's members.

China's Exchange Rate Policy Is Adversely Affecting U.S. Copper and Brass Mills

By intervening in the exchange markets on a protracted and massive scale, China has controlled the rate of exchange between the renminbi and the U.S. dollar for many years and especially so since the mid-1990s. According to the Peterson Institute, the extent of the renminbi's undervaluation can be conservatively estimated at 25 – 40 percent, and China's direct intervention now is $30 - $40 billion per month, a staggering amount at an unprecedented pace. China's present foreign reserves are acknowledged by Chinese authorities to be approximately $2.4 trillion, but it is quite likely that even this vast sum is understated. The magnitude of China's foreign reserves is all the more remarkable given the Chinese government's on-going program of investing around the globe in a wide range of assets, including copper mines.

This policy by China of undervaluing its currency is taking a serious toll on U.S. copper and brass mills. The renminbi's substantial undervaluation subsidizes Chinese exports to the United States and other countries and curtails U.S. exports. China's low-priced exports are not only of the sort of semi-fabricated, copper-based products that the Council's members produce, but also are of value-added, downstream products like those that U.S. customers of the Council's members make. Moreover, China's enormous foreign reserves of dollars enable China to purchase great volumes of copper-based scrap in the United States. This added demand from China has contributed to tightened supplies and higher prices for copper-based scrap.

With its relatively scarce supplies of indigenous copper, China should be at a comparative disadvantage vis-à-vis the United States, which has extensive quantities of copper. Instead, in large part due to the renminbi's substantial undervaluation, China has the upper hand. Copper and brass mills in the United States are seeing their share of the U.S. market and third-country markets erode and at the same time cannot export much to China. In addition, U.S. customers of the Council's members have been either going out of business or relocating abroad, often to China. Along with this shrinking of demand, the Council's members are paying more for copper-based scrap in competition with the Chinese government's excessive foreign reserves of dollars that are attributable to the renminbi's undervaluation. These vast reserves are providing various other subsidies as well that benefit China's copper and brass mills to the detriment of the Council's members. U.S. jobs suffer as a result.

Not surprisingly under these circumstances, with contracting demand for their products and rising costs for their raw materials, the Council's members view China's policy of undervaluing the renminbi as a severe impediment to the health of the U.S. copper and brass industry. The renminbi's fundamental misalignment is just one of a number of factors that the Council's members are facing, but a meaningful revaluation of the renminbi is the first and most important measure that needs to be accomplished.

Resolving the Issue

Competitive currency depreciation is a monetary measure with far-reaching implications for international trade. A consequence of this hybrid nature is that both the International Monetary Fund ("IMF") and the World Trade Organization ("WTO") share jurisdiction over this matter, much as the different congressional committees involved do. If possible, a multilateral solution to this problem would be preferable. At this juncture, however, the prospects for some internationally negotiated resolution appear to be very modest, particularly in light of statements made recently by China's leadership.

In the meantime, the adverse effects of the renminbi's and other foreign currencies' undervaluation worsen and threaten the recovery of the U.S. and global economies. There is a broad consensus that the undervaluation is substantial, and yet the IMF has been able only to state this conclusion and has no international legal authority to compel revaluation. Similarly, there appears to have been little or no coordination between the IMF and the WTO on this predicament, even though Article XV of the General Agreement on Tariffs and Trade speaks to the roles of these two international organizations in matters pertaining to issues with interrelated monetary and trade aspects. The WTO has its various agreements, including its Understanding on the Settlement of Disputes, but that route thus far has not been resorted to by anyone either.

At this juncture, from the Council's perspective and for the reasons cited above, it is vitally important for the United States to shore up its manufacturing base, not only for the sake of the U.S. economy and national security, but also in order to bolster a sustainable balance in international trade and investment. Integral to that effort will be exchange rates that reflect market fundamentals. As Harry Dexter White observed at the time of the IMF's founding, "A depreciation in exchange rates is an alternative method of increasing tariff rates; and exchange restriction is an alternative method of applying import quotas."[1] As he also noted,

> The world needs assurance that exchange depreciation will not be used as a device for obtaining competitive advantage in international trade; for such exchange depreciation is never a real remedy. It inevitably leads to counter measures, and the ultimate effect is to reduce the aggregate volume of trade. This is precisely what happened in the period of the 1930's when competitive exchange depreciation brought wider use of import quotas, exchange controls and similar restrictive devices.[2]

With these thoughts in mind, the Council urges favorable consideration of H.R. 2378, The Currency Reform for Fair Trade Act, bipartisan legislation that would treat fundamental misalignment of a foreign currency as a prohibited countervailable export subsidy. The Council supports this bill (1) as a reasonable implementation in U.S. domestic law of the WTO's Agreement on Subsidies and Countervailing Measures and (2) as a means to check material injury to U.S. domestic industry caused by imports from a country whose currency is fundamentally undervalued.

In connection with its becoming a member of the WTO in December 2001, China made a series of commitments, among which was its pledge to implement its obligations with respect to matters of foreign exchange in accordance with the WTO's agreements and related declarations and decisions of the WTO that concern the IMF.[3] By the same token, China is bound as a member of the IMF, as a matter of public international law, to observe the IMF's Articles of Agreement, including Article IV thereof, which commits members to avoid manipulating exchange rates in order to prevent effective balance-of-payments adjustment or to gain an unfair competitive advantage over other members.

China, in other words, has ceded some of its sovereignty over the management of its currency, just as the other members of the WTO and IMF have ceded some of their sovereignty over their currencies. It is submitted that H.R. 2378 is WTO-consistent as well as IMF-consistent and is called for under what have become urgent conditions.

Attachment

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[1] H.D. White, "The Monetary Fund: Some Criticisms Examined," 23 Foreign Affairs 195, 208 (1944-45).

[2] Id. at 199.

[3] "Report of the Working Party on the Accession of China," WT/ACC/CHN/49, at ¶ 35 (Oct. 1, 2001).

COPPER AND BRASS FABRICATORS COUNCIL, INC.
MEMBERSHIP LIST
March 24, 2010

BRUSH WELLMAN, INC.
Mayfield Heights, OH 44124

CAMBRIDGE-LEE INDUSTRIES, INC.
Reading, PA 19612

CERRO FLOW PRODUCTS, LLC
St. Louis, MO 63166-6800

CHASE BRASS & COPPER COMPANY, INC.
Montpelier, OH 43543

CHICAGO EXTRUDED METALS COMPANY
Cicero, IL 60804

DRAWN METAL TUBE COMPANY
Thomaston, CT 06787

HEYCO METALS, INC.
Reading, PA 19605

HUSSEY COPPER LTD.
Leetsdale, PA 15056-1099

KOBE WIELAND COPPER PRODUCTS, LLC
Pine Hall, NC 27042

LUVATA NORTH AMERICA, INC.
Buffalo, NY 14240-0981

METALS AMERICA
Shelby, NC 28150

THE MILLER COMPANY
Meriden, CT 06450-1010

MUELLER INDUSTRIES, INC.
Memphis, TN 38125

NATIONAL BRONZE & METALS, INC.
Houston, TX 77280

OLIN BRASS
East Alton, IL 62024-1174

PMX INDUSTRIES, INC.
Cedar Rapids, IA 52404-4303

REVERE COPPER PRODUCTS, INC.
Rome, NY 13440-5561

WIELAND METALS, INC.
Wheeling, IL 60090

National Retail Federation®
The Voice of Retail Worldwide

March 24, 2010

The Honorable Sander M. Levin
Chairman
Committee on Ways and Means
United States House of Representatives
1104 Longworth House Office Building
Washington, DC 20515

RE: Hearing: China's Exchange Rate Policy

Dear Chairman Levin:

On behalf of its members in the U.S. retail industry, the National Retail Federation (NRF) welcomes the opportunity to submit these comments to the Ways and Means Committee regarding China's exchange rate policy.

The **National Retail Federation** is the world's largest retail trade association, with membership that comprises all retail formats and channels of distribution including department, specialty, discount, catalog, Internet, independent stores, chain restaurants, drug stores and grocery stores as well as the industry's key trading partners of retail goods and services. NRF represents an industry with nearly 1.6 million U.S. retail establishments, 24 million employees - about one in five American workers - and 2009 sales of more than $4.1 trillion. As the industry umbrella group, NRF also represents over 100 state, national and international retail associations.

Retail Industry Profile

Retailing represents one of the largest industries in the United States in terms of the number of companies, employment, and contribution to gross domestic product. According to the most recent annual (2009) statistics:

- The U.S. retail industry comprises more than 1.1 million retail companies;
- Among American retail companies, the vast majority (98.5 percent) are small businesses located in every Congressional district in the country;
- The U.S. retail industry had annual sales more than $4.1 trillion;

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- Of the more than two-thirds of U.S. GDP generated from consumer spending, over 41 percent of that spending (*i.e.*, nearly 30 percent of U.S. GDP) occurs in retail establishments;
- With 24 million employees – nearly one in five American workers – the retail industry provides more jobs than any other U.S. industry;
- Retail employees averaged $16.77 per hour in total compensation (wages, salaries, and benefits).[1]

Like any other business, retailers face the daily challenge of creating value for their customers and shareholders, in an industry marked by cutthroat competition and an average profit margin of 2-3 percent. Currently, retailers are slowly climbing their way out of the worst economic environment for our industry in over 40 years. During the past 18 months, retailers suffered a huge number of bankruptcies, store closures, and over one fifth of all the job losses in the United States.

Retailing is also an extremely trade reliant industry that is directly impacted by the direction and operation of U.S. trade policy. Like other U.S. industries, including manufacturing and agriculture, every retailer, from the largest national chains to the smallest neighborhood shop, depends on a global supply chain to procure the products that its customers – the American consumer - need and want.

The commercial activity generated by global sourcing of consumer goods by American retailers supports good-paying, skilled blue and white collar jobs, many of them union jobs. These millions of American workers are employed not only in the retail industry, but also in many ancillary industries that support retail operations and supply chains – *e.g.*, manufacturing, farming, ports, rail, trucking, warehousing, air delivery, and logistics.[2]

As an industry engaged in importing, we would point out that, contrary to popular opinion, evidence shows that imports as a whole support millions of U.S. jobs, and help, not only retailers, but all U.S. companies involved in international commerce to enhance their productivity, competitiveness, and ability to expand employment. Research

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[1] Source, *Retail Industry Indicators*, Prepared for the NRF Foundation by The Trade Partnership.

[2] *See, Imports and America: The Rest of the Story*, prepared by The Trade Partnership for the National Retail Institute and the Council of the Americas, August 1998, and *Impact of Imports from China on U.S. Employment*, prepared by Trade Partnership Worldwide, LLC for the National Retail Federation, November 2005.

demonstrates that imports support more than 10 million American jobs, and that imports from China alone support nearly 1 million net jobs in the United States.[3]

U.S.-China Trade Relations

Much of the national economic anxiety over trade and globalization is focused on issues in the U.S.-China trade relationship as China has become an increasingly significant player in the global economy. In the unfolding debate on the U.S.-China trade relationship, few U.S. industries have more at stake than retailers. Consumer goods comprise nearly 80 percent of all U.S. imports from China, and China is a key supplier, and sometimes the dominant supplier, in every consumer goods category. Moreover, retailers have been adversely impacted by a recent increase in trade remedies investigations (antidumping, countervailing duty and safeguards) against imported consumer products mainly targeting China. Indeed, many of the proposed changes to the trade remedies laws currently under consideration before this committee are intended primarily to target imports from China.

The retail industry acknowledges that there are serious and legitimate issues with China that need to be effectively addressed, including inadequate protection of intellectual property rights, proliferating market access barriers, the need for a monetary system that allows for more flexible exchange rates and a fully-convertible currency, ensuring that China abides by its obligations under international trade rules, and dealing with the difficulties inherent in China's transformation from an isolated, centrally-planned, non-market economy to a market-economy country. In considering how best to address these issues, the retail industry urges prudence and thoughtfulness on the part of policy makers. Policy makers should support appropriate action through diplomatic efforts and the use of multilateral mechanisms to address issues in the U.S.-China relationship that can yield effective progress and are consistent with World Trade Organization (WTO) rules.

However, we continue to see descriptions of issues in the U.S.-China trade relationship presented in the most reckless, sweeping, facile, and grossly exaggerated terms – China "cheats"; China has "stolen" "millions" of American jobs; China exports goods made by "slave labor" working for "pennies a day"; the "devastating" impact of China's "enormous" subsidies and "massive" currency undervaluation; a "flood" of "unsafe and poisonous" Chinese products; etc.[4] Indeed, from the tone of many of these

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[3] *See, e.g., Imports and America, Ibid.*

[4] *See e.g.*, AFL-CIO website, www.aflcio.org; American Trade Action Coalition (AMTAC) website, www.amtacdc.org; National Council of Textile Organizations (NCTO) website, www.ncto.org; Public

and other statements, one might be led to think that China is responsible for the loss of every manufacturing job in the United States, is largely to blame for the current state of the U.S. economy, and that China's exchange rate policy is the main reason behind the U.S. bilateral trade deficit with China. These are absurd propositions on their face.

Too frequently, the intention behind this hyperbole is not to propose serious solutions to any of the issues the United States has with China. Rather the goal is to justify a protectionist agenda – blocking imports from China and punishing U.S. companies that do business in China all purportedly in the emotionally-charged, but largely meaningless name of "fairness." The U.S.-China trade relationship is simply too complex and important to be driven by such emotional rhetoric.

In looking at serious policy options to address issues in the U.S.-China trade relationship, NRF and the retail industry have consistently supported the Strategic and Economic Dialogue (SED) and recent actions by the U.S. Trade Representative's Office against China under the WTO dispute settlement mechanism over practices that violate WTO rules, and coordination at the multilateral level. We applaud statements by the Obama Administration and Chairman Levin emphasizing the use of all available diplomatic avenues and constructive dialogue with China to address issues such as currency policy and practices. By the same token, we believe it is appropriate for the United States to protect its rights by challenging China at the WTO where there are clear violations of international trade rules. Diplomatic avenues, such as the SED, and dispute settlement through the WTO may be slower processes than some may prefer, but are most likely to yield positive results while avoiding unintended consequences that could hurt the U.S. economy and jobs.

On the other hand, the Administration and Congress should reject unilateral, counterproductive, and WTO illegal restrictions on imports of Chinese goods as a policy tool to compel action by China. There is no evidence that these actions would be effective in addressing any of the issues in the U.S.-China trade relationship. Meanwhile, they would impose huge costs on the U.S. economy, seriously harm U.S. retailers, manufacturers, services providers and farmers that depend on trade with China and global supply chains, and adversely affect millions of American consumers.

Chinese Currency and Exchange Rate Policy

The subject of this hearing – Chinese currency policy and the value of the yuan – are central issues in the debate over U.S.-China trade relations. Some claim that the

Citizen website, www.citizen.org; Stand Up For Steel website, www.standupforsteel.org; UNITE-HERE! website, www.unitehere.org.

yuan is greatly undervalued vis-à-vis the dollar, and blame it as the driving factor behind the sizable bilateral trade deficit with China and the loss of U.S. manufacturing jobs.[5] Among their proposed remedies is to impose trade barriers to imports from China through various means, including changes to the U.S. antidumping and countervailing duty laws. They would also essentially force the U.S. Trade Representative to initiate dispute settlement proceedings at the World Trade Organization (WTO) against Chinese currency policy and the Secretary of the Treasury to determine that China is a currency manipulator. Not surprisingly, these proposals are strongly endorsed by certain domestic industries, such as steel and textiles, that for decades have relied on, and continue to seek new means to impose trade barriers against imports, particularly from China.

There is no real disagreement that China must move toward a more flexible currency regime. The only disagreements are the means to effect that change and how quickly it can reasonably be accomplished without creating further turmoil in the financial sector, and adversely impacting the U.S. economy. As a guiding principle, we oppose unilateral, counterproductive, and WTO illegal restrictions on imports of Chinese goods as a policy tool to compel action by China. By the same token, we are convinced that the best course of action is dialogue and negotiation through mechanisms such as the SED and the Joint Commission on Commerce and Trade (JCCT). A deft diplomatic and multilateral strategy by the United States will ultimately be a much more effective tool in identifying mutually-beneficial goals, and moving the Chinese Government in a more constructive direction, while strengthening, rather than undermining the important U.S.-China economic relationship.

By the same token, we will continue to oppose the use of trade remedies as a means to address China's currency policy for two reasons. First, many of the proposed changes to the trade remedies laws would violate WTO rules. Second, there may be widespread consensus among economists that the Chinese currency is undervalued, but there clearly is no agreement over the extent to which the yuan is undervalued. Thus, any attempt to quantify the degree to which the yuan may be undervalued, with

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[5] Evidence does not support the claim that China's exchange rate is a significant factor in the size of the U.S. trade deficit or in the loss of "millions" of U.S. manufacturing jobs. As the US-China Business Council correctly observed in its paper, *China and the US Economy: Advancing a Winning Trade Agenda* (Jan. 2009), much of what is imported from China had been imported from other Asian countries. Moreover, while transportation and labor costs, as well as inflation had a significant impact on the price of imports from China in the first half of 2008, there is little evidence of such an impact from the 20 percent appreciation in the Yuan, which had the offsetting effect of lowering the cost of imports into China. Accordingly, it is simply not credible that forcing China to appreciate its currency further will reverse the U.S. trade deficit. The economic crisis itself resulted in a huge drop in Chinese exports – 17.5 percent in January 2009 – which adversely impacted both the U.S. and Chinese economies.

the degree of specificity required in an antidumping or CVD case, will result in an entirely arbitrary and inaccurate calculation.

One proposal to address the currency issue through the use of the trade remedies laws that raises particularly troubling concerns is legislation that would redefine countervailable subsidies to include the undervaluation of a foreign currency through exchange rate manipulation or misalignment. NRF has argued in the past that this unilateral attempt by Congress to redefine what constitutes a countervailable subsidy would conflict with WTO rules and invite trade retaliation or reciprocal action to the detriment of U.S. companies and workers.

The WTO Subsidies Code[6] identifies three types of subsidies – prohibited; actionable (*i.e.*, subject to countervailing duties); and non-actionable (*i.e.*, permitted). Articles 1 and 2 of the Subsidies Code specify that to be countervailable, a subsidy must be: (1) a financial contribution from a government (2) that provides a benefit (3) to a specific industry or industries or enterprise or group of enterprises.

Because the "benefit" from currency valuation is generally available to all economic players in a country, the proposed legislative change would conflict with the specificity requirement under WTO rules. Because currency policy does not involve the transfer of anything of tangible value from the government, the proposed legislation would also conflict with the financial contribution requirement under WTO rules. Currency policy also cannot meet the WTO definition of a prohibited subsidy because its benefit is not contingent on exportation and does not require the use of domestic goods.

Moreover, some proposals would direct that currency misalignment be determined on the basis of a country's trade balance, amount of foreign direct investment, and foreign currency reserves. What these proposals fail to recognize is that these matters are influenced by many factors that may have nothing to do with a country's currency policy.

In the end, defining a countervailable subsidy in a way that violates WTO rules would undermine efforts to ensure that other countries abide by international trade rules, expose exports of U.S. goods and services to possible trade sanctions, and does nothing to address the underlying issue in an effective manner.

Another troubling proposal with respect to the currency issue would require adjustments to antidumping margins in investigations and reviews to offset the amount

[6] WTO Agreement on Subsidies and Countervailing Measures of the General Agreement on Tariffs and Trade 1994.

by which a country's currency may be undervalued or "misaligned." There is, however, no widely accepted benchmark for determining the extent to which a particular currency may be undervalued. In the case of China, it was claimed the Yuan was undervalued by 15 to 40 percent. That is a huge range that demonstrates the imprecision of the calculation. Thus, any calculation by the Commerce Department, that has no expertise on such matters, will be an entirely arbitrary exercise, and therefore subject to political influence.

However, the bigger threat from this proposal is the precedent it would set to allow any country to game the antidumping process by unilaterally setting an arbitrary value on another country's currency. The result will be to make the trade remedies system even more unpredictable for U.S. importers and exporters.

Another problem with this proposal is that it would violate Article 2.4.1 of the WTO Agreement on Antidumping (AD Agreement), which establishes the rule for currency conversion and adjustments by reference to the value set by currency markets:

> "When the comparison [between export price and normal value] requires a conversion of currencies, such conversion should be made <u>using the rate of exchange on the date of sale</u>, provided that when a <u>sale of foreign currency</u> on forward <u>markets</u> is directly linked to the export sale involved, the <u>rate of exchange</u> in the forward sale <u>shall be used</u>." (emphasis added)

No other provision of the AD Agreement would permit this type of adjustment. Notably, Article VI.2 of the General Agreement on Tariffs and Trade applies only to multiple currency practices, not "fundamentally misaligned currencies."

In addition, the surrogate country methodology used in AD investigations against imports from China and other non-market economy (NME) countries already addresses the effect of any currency undervaluation. In calculating an AD margin in NME cases, the Commerce Department uses market-based values from a surrogate country to determine the normal value of the subject imports, which it then compares to the U.S. export price. As a result, the AD calculation effectively offsets the effect of the currency undervaluation on price. Requiring an additional adjustment would violate WTO rules by capturing the effect of the undervaluation twice.

Thus, we are left with the question of what would be an effective approach to the currency issue. We agree with several points on this issue raised in an article in the opinion section of the Wall Street Journal on March 18, 2010.[7] In particular, moving China to a fully-convertible currency and loosening capital controls are more important reforms than a futile attempt to force China to revalue or float the yuan. As pointed out in the article, lack of full convertibility and excessive capital controls are two factors spurring the Chinese government to buy huge amounts of U.S. Treasury notes and hindering efforts at further liberalization of the Chinese financial sector.

In any event, as also noted in the article, there is no assurance that a revaluation or full float of the Chinese currency will have any appreciable impact on the U.S. bilateral trade deficit with China, especially if the Chinese economy is adversely affected through deflation and imports into China decline as a result as happened under similar circumstances with Japan in the late 1980s and early 1990s. Indeed, appreciation or float of the yuan will certainly have no impact on the overall merchandise trade deficit as any Chinese production adversely impacted by a higher valuation of the yuan will likely simply move to another foreign country.

In conclusion, before acting on any legislation targeting Chinese currency policy, Congress and the Administration need to ask three questions: (1) Does the legislation conform to WTO rules?; (2) Will the legislation be effective in achieving the stated goal?; (3) Will any benefits of the legislation outweigh the harm it may inflict on U.S. companies, workers, and the economy? If the answers to any one of these questions is no, then the entire exercise will be seen as merely protectionist political posturing.

NRF appreciates the opportunity to comment on China's exchange rate policy. Should you have any questions please contact me at (202) 626-8104 or by e-mail at autore@nrf.com.

Sincerely,

Erik O. Autor

Erik O. Autor
Vice President
International Trade Counsel

cc: The Honorable Dave Camp (R-MI), Ranking Member

[7] *The Wall Street Journal*, Opinion: The Yuan Scapegoat, The U.S. establishment flirts with a currency and trade war with China (Mar. 18, 2010).

The Honorable Xavier Becerra (D-CA)
The Honorable Shelley Berkley (D-NV)
The Honorable Earl Blumenauer (D-OR)
The Honorable Charles W. Boustany, Jr. (R-LA)
The Honorable Kevin Brady (R-TX)
The Honorable Ginny Brown-Waite (R-FL)
The Honorable Eric Cantor (R-VA)
The Honorable Joseph Crowley (D-NY)
The Honorable Artur Davis (D-AL)
The Honorable Danny K. Davis (D-IL)
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The Honorable Patrick Tiberi (R-OH)
The Honorable Chris Van Hollen (D-MD)
The Honorable John A. Yarmuth (D-KY)

Submission for the Record
Hearing on China's Exchange Rate Policy
Congressman Michael H. Michaud

Thank you for the opportunity to submit written testimony in conjunction with the Ways and Means Committee hearing on China's currency manipulation issue.

I am deeply concerned about the impact of China's undervaluation of the renminbi (RMB) on the economy of Maine and the country as a whole. I submit to your Committee today a case study of two companies from my state that have suffered severe losses from China's undervalued RMB. The examples of Sappi Fine Paper and NewPage Corporation demonstrate the tangible and irrevocable consequences of China's pegged currency on American manufacturers and American workers. Their losses also underscore the imperative need for urgent U.S. action to force China to stop manipulating the RMB. I ask your Committee to consider the impact on these Maine companies as you evaluate how to respond to China's currency undervaluation in Congress and in tandem with the Administration.

NewPage Corporation is the largest coated paper manufacturer in North America and has 10 paper mills in several states, including Maine, and in Nova Scotia, Canada. In the last several years, however, it has had to scale back its production, and – if China continues to undervalue its currency to the degree it does now – the company will likely have to downsize more. In 2008 at its Rumford, Maine facility, NewPage had to shut down a couple of paper machines and lay off workers as a result of foreign imports. The Department of Labor certified in 2009 that these workers were eligible for Trade Adjustment Assistance (TAA) "because the increased imports of coated freesheet and coated mechanical paper by customers of NewPage Corporation contributed importantly to the worker group separations and sales/production declines at NewPage Corporation." Chinese paper exports to the U.S. are the primary source of new competition that forced NewPage to reduce its paper output in Rumford, and the RMB undervaluation simply makes Chinese paper cheaper than the competing U.S. product.

Sappi Fine Paper has similarly been forced to scale back their coated paper business over the last several years as a result of the unfair competition from Chinese paper imports. The company still has three mills in the U.S., including two in Maine, but last year had to permanently close its paper mill in Muskegon, Michigan. DOL certified the Sappi Fine Paper workers who subsequently lost their jobs as being eligible for TAA. This reduction in production is nothing new for the company. In 2003, Sappi Fine Paper had to shutdown its paper machine in the Westbrook, Maine facility, laying off 170 employees in the process. In small town paper mill communities, the closure of a mill or a plant is often irrevocably devastating. If China continues to be able to export its coated paper at a subsidized price, I am very concerned that the two Sappi Fine Paper mills in Somerset and Westbrook, Maine will also close. This would result in nearly 1,200 workers losing their jobs and the economic devastation of these paper mill communities.

Facing this dramatic downsizing across their industry, on September 23, 2009 U.S. producers of coated paper filed a petition with the Commerce Department to investigate the Chinese government's subsidization of its paper industry. In that petition, U.S. producers alleged that China's intentional undervaluation of its currency provides a subsidy to Chinese exporters of coated paper. Although Commerce initiated an investigation on nearly all of the other subsidy allegations, it declined to initiate an investigation on currency undervaluation. Despite this setback, the U.S. paper producers refiled its allegation on January 13, 2010 that China is subsidizing exporters of coated paper by deliberately maintaining an undervalued currency. This submission provided additional support for the allegation, including an economic study showing that exporters benefit disproportionately from China's undervalued currency. On March 1st, the Department of Commerce issued its preliminary determination in the China coated paper countervailing duty investigation. In that decision, Commerce stated that it was still reviewing the currency allegation, but has not yet acted to initiate an investigation. Given the indisputable effects of China's currency manipulation, I am disappointed that the Department of Commerce has not decided to more aggressively address China's RMB undervaluation and hope that additional time to investigate this matter will lead them to agree with the U.S. producers' claims.

Finding in favor of the U.S. paper producers would be consistent with an International Trade Commission report from late last year. In November 2009 the ITC concluded that there is "reasonable indication that an industry in the United States is materially injured by reason of imports of certain coated paper from China." The examples of Sappi Fine Paper and NewPage demonstrate that the consequences of China's currency manipulation are material. The effects are very tangible in U.S. communities whose industries are struggling to stay afloat in the face of Chinese competition, communities such as the towns of Westbrook and Rumford, Maine. These Main Street consequences are the most compelling reason for the Administration, including the Departments of Treasury and Commerce to respond to the RMB undervaluation with all of their resources. Should these agencies not adequately protect American companies from China's unfair currency practices, Congress will have no option but to act itself.

Thank you for allowing me to submit this testimony, and I look forward to working with you to ensure that American workers and businesses are able to compete globally on a level playing field.

STRENTHENING INTERNATIONAL MONETARY ARRANGMENTS

Statement by
Robert Z. Aliber

Professor of International Economics and Finance Emeritus
Chicago Booth School of Business
University of Chicago

Before the Ways and Means Committee

United States House of Representatives

March 24, 2010

I am honored by the invitation to testify before this Committee and regret that I have a long standing commitment to be in Beijing on the date of these very important hearings.

First, my background. I have studied international financial issues for more than fifty years, including currency questions and the evolution of international monetary and banking arrangements. Much of my research and writing in the last fifteen years has centered on international financial crises—the last forty years have been exceptional in terms of the number and severity of the waves of financial crises.

The paradox of the last sixty years has been the unprecedented global economic growth despite these waves of crises. There have been remarkable improvements in public health, longevity, education, and economic well-being in much of Asia, most of Southern Europe, and many other countries. Much of that success can be attributed to the openness of the global economy and the opportunity that developing countries have had to benefit from their ability to sell their manufactured goods in foreign markets. Access to foreign markets and especially to the U.S. market has been a catalyst for rapid economic growth throughout Asia. The U.S. market is especially important to these foreign countries because it is so large and diverse that foreign firms can enter with modest likelihood that they will take such a large share from domestic firms that they will then encounter a severe protectionist response. Americans should be proud of the success of the United States in advancing a more open global economy. Americans have benefited from the increase in the variety of foreign goods available in U.S. markets and the impact of these goods on the quality and variety of products that American firms have developed in response.

My comments today are in three sections. The first section reviews the US role as the dominant reserve currency country for nearly 100 years. The key idea is that the U.S.

dollar has evolved into a reserve currency because foreign central banks have concluded that it is a more effective store of value than any other currency.

The second section deals with measures to enhance the reserve currency role of the U.S. dollar. The United States is the dominant reserve currency country and should adopt measures to stabilize and strengthen the reserve currency role of the U.S. dollar. The objective of stabilizing this role is to reduce and minimize the susceptibility of the U.S. economy to shocks from other countries—like the shock that has led to these hearings. China and other foreign countries want trade surpluses, and the United States has passively imported the counterpart trade deficits, at substantial cost to the profits and employment in U.S. manufacturing firms and to the U.S. fiscal balance.

The third section deals with the global imbalances that have developed as a result of the industrialization in China. China's financial structure is distorted by some bizarre regulations. It is absurd that one of the poorest countries in the world has purchased more than $2,000 billion in U.S. dollar securities when that money could be used to help the 700 million or 800 million Chinese that have incomes that are still below and in some cases far below the poverty line. China should be encouraged to adopt measures to reduce its bilateral trade surplus with the United States. The objective of the U.S. attention should be on the need for an orderly reduction in China's trade surplus rather than on the value of the yuan in the currency market, which is one of several instruments of policy rather than a policy objective. An appreciation of the Chinese yuan of ten, fifteen, or thirty percent is not likely to lead to a significant reduction in the large Chinese trade surplus unless there are accompanying changes in financial structure in China. The Chinese economy has tremendous flexibility in costs and prices, and a large appreciation of the Chinese currency will induce a significant decline in costs; the decline in Chinese exports to the United States and the increase in its imports are likely to be modest. A policy proposal that can reduce the Chinese trade surplus with the United States in an orderly way is presented in this section.

THE US ROLE AS A RESERVE CURRENCY COUNTRY—THE HISTORY

The U.S. role as an international reserve currency country began more than one hundred years when the term "the gold standard" described the international monetary system. The British pound was even more important as a reserve currency. Firms headquartered in other countries and foreign central banks found it in their self-interest to acquire U.S. dollar securities and U.S. bank deposits to facilitate their international transactions. These groups were "voting with their feet"; they wanted to minimize transactions costs associated with international payments and receipts and enhance and protect the value of their financial wealth. .

One analogy for the evolution of the U.S. dollar as a reserve currency is provided by the development of money, which began in pre-history; coins manufactured from several different metals were developed to use in payments because the use of coins in payment was much less costly than barter, which was exceedingly time-consuming; comparative price shopping in a barter economy is a high cost activity. A money has three attributes—as a unit of account or measuring rod, as a means of payment, and as a store of value. Coins made of gold, silver, and copper were among the first monies. These coins complemented each other in transactions because they had different value-to-weight ratios and they were competitive with each other as stores of value. Gold eventually dominated silver as a store of value, partly because new silver discoveries led to decline in its price relative to the price of gold.

Paper money evolved because it was more efficient and less costly to use in payments than commodity monies, especially in payments of a very large amount and payments over large distances.

The U.S. dollar is a unit of account in the global economy; the prices of many commodities—gold, petroleum, coffee, palladium—are stated in the U.S dollar, even in transactions outside the United States. The U.S. dollar is a means of payment; when the Japanese importers of Mercedes and BMWs pay the German exporters, they first buy the U.S. dollars with Japanese yen and then use the U.S. dollars to buy the Euro. The U.S. dollar is a store of value; foreign central banks hold $5,000 billion of U.S. dollar securities.

The primary reason that the U.S. dollar became a reserve currency at the end of the nineteenth century was that the United States then was much the largest economy, about three times larger than the British economy. Some foreign firms and foreign central banks acquired U.S. dollar securities because they had a "short foreign exchange position" in the U.S. dollar; their U.S. dollar payments may have been larger than their U.S dollar receipts. Some foreign central banks concluded that U.S. dollar securities were likely to be a more effective store of value—to retain their purchasing power over market baskets of goods and services than securities denominated in most other currencies.

Most of the acquisitions of U.S. dollar securities and U.S. real assets by non-Americans have been voluntary, although some foreign central banks were reluctant buyers of U.S. dollar securities in the 1960s; they would have preferred to hold more gold in their portfolios of international reserve assets.

The U.S. dollar evolved into the dominant reserve currency because U.S. dollar securities had advantages relative to securities denominated in other currencies, particularly as a store of value. The expectations of the central banks that bought U.S. dollar securities as a store of value have been satisfied. The real rate of return on U.S. bonds has been in the range of three to four percent in each of the last four decades. The real rate of return in the inflationary 1970s was negative, but that was made up in the 1980s.

During the last thirty years that the Unite States has evolved from the world's largest creditor country to the world's largest debtor country because of a surge in the foreign demand for U.S dollar securities, not because the U.S government borrowed abroad, and not because U.S firms borrowed abroad to finance expenditures in the United States.

Moreover in the last twenty years there has been a remarkable transformation in the motives for the purchases of U.S. dollar securities by central banks in a few foreign countries. Initially, foreign central banks purchased U.S. dollar securities because they wanted to hold more international reserve assets. More recently, the central banks in China and few other countries have purchased U.S dollar securities because they wanted to increase the employment in their export industries; they have maintained undervalued currencies to increase employment in their export industries. Their purchases of U.S. dollar securities have not motivated by the need for international reserve assets, their holdings of these assets are much larger than their need for international reserves. But their trade surpluses have been large, both absolutely and as share of their GDPs, and they have used the money acquired from their export surpluses to buy U.S. dollar securities because they concluded that they did not have any good alternatives.

There are two popular misconceptions about the relationship between the U.S. trade deficit and foreign purchases of U.S. dollar securities and the U.S. fiscal deficit. Consider the statement like "The United States receives a large volume of low cost imports from China and has gotten help in financing a significant part of its budget and current account deficits."

First consider the relationship between foreign purchases of U.S. dollar securities and the U.S. trade and current account deficits. If foreigners were not net buyers of U.S. dollar securities, the United States would not have trade and current account deficits. It's that simple—this statement follows directly from the balance of payments accounting identity. The United States developed a trade deficit because foreigners bought U.S. dollar securities and U.S. real assets, their purchases meant that their currencies had a lower value than they otherwise would have had in the market for foreign exchange, and their exports to the United States increased more rapidly than their imposts. If foreigners stopped buying U.S. government securities, their currencies would appreciate and in some cases sharply, and the U.S. trade and current account deficits would decline.

Thus purchases of U.S. dollar securities by the Peoples Ban k of China are the largest single cause of the U.S. trade deficit in the last five years. .

Now consider the relationship between the U.S. trade deficit and the U.S. fiscal deficit, which is more nuanced, partly because the factual needs to be compared with the counter-factual. The U.S. trade deficit is four percent of U.S. GDP; prior to the financial crisis the U.S. fiscal deficit was about three percent of U.S. GDP. Consider a mental experiment, the U.S. trade deficit disappears, perhaps because the foreign demand for U.S. goods increases by $600 billion, or because the U.S. demand for foreign goods declines by $600 billion and the U.S. demand for domestic goods increases by $600 billion. The increase in the demand for U.S. goods of $600 billion would lead to an initial increase in U.S. GDP $600 billion. The U.S. government's tax receipts would increase by $200 billion, the product of the $600 billion increase in U.S.GDP and a marginal tax rate of 30 percent. American households and firms would increase their spending by $360 billion, the product of the increase in the after-tax incomes of $400 billion and a marginal spending rate of 90 percent.

The increase in spending of $360 billion would lead to an increase in U.S. GDP of $360 billion. The U.S. government's tax receipts would increase by an additional $108 billion, the product of the increase in U.S. GDP of $360 billion and the marginal tax rate of 30 percent. Households and firms would increase their spending by 90 percent of the increase in their after-tax incomes of $252 billion. U.S. GDP would increase by an additional $227 billion. U.S. fiscal revenues would increase by $68 billion.

The increase in U.S. GDP from the reduction in the U.S. trade deficit of $600 billion would be several times larger than $600 billion, and the increase in the tax receipts of the U.S. government would approach $400 billion. Moreover unemployment compensation payments and other government expenditures would decline, at least to the extent that there is significant excess capacity in the U.S. economy.

For most of the years between 2002 and 2007, the U.S fiscal deficit was in the range of $250 billion to $400 billion. A significant part of the U.S. fiscal deficit prior to the recession that began in 2008 can be attributed to the U.S. trade deficit, which resulted from the purchases of U.S. dollar securities by foreign firms, governments, and central banks.

Yes, the foreign purchases of U.S. dollar securities have helped finance the U.S Government's fiscal deficit that was caused in significant part because these purchases caused the U.S. trade deficit. But it is important to remember at each moment the interest rates on U.S. dollar securities are the price of the stock of all debt—all debt, personal, corporate, and government—and the annual foreign purchases have been small relative to the stock of debt and have had a modest impact on U.S. interest rates.

There have been two periods in the last ten years when the surge in foreign payments to the United States has contributed significantly to the U.S asset price bubbles. The first was in 1997 and 1998, following the Asian Financial Crisis. The second was in 2002 after the Chinese trade surplus began to increase. A sharp increase in money flows to a country often goes into the asset market and induces a significant increase in asset prices.
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MANAGING THE RESERVE CURRENCY ROLE OF THE U.S. DOLLAR

For most of the last one hundred years the United States could ignore the problem of managing the reserve currency role of the U.S. dollar. That luxury was possible because foreign holdings of U.S. dollar securities were small relative to U.S. GDP and to the U.S. net international investment position. Moreover, through most of this period, the United States was a creditor country

That is no longer the case. Foreign holdings of U.S dollar securities are large relative to U.S. GDP. The surge in foreign purchase of U.S. dollar securities has caused the transformation of the United States from the world's largest creditor country to the world's largest debtor.

International monetary arrangements often are in flux, especially as the relative size of countries changes. Some observers have concluded that the U.S. role as a reserve currency country is too costly. Perhaps. Consider the alternatives to the continuation of the U.S. role as a reserve currency country. One alternative is that some other country develops a reserve currency role, and supplants the U.S role, much as the United States supplanted Britain. That seems highly unlikely in the next ten to twenty years, although the Euro may become more of a reserve currency. The other dominant alternative is that an international institution develops its own currency, much as the European Monetary Union led to the creation of the Euro to supplant the currencies of ten or eleven of its members. That also seems unlikely

As long as the U.S. dollar remains a reserve currency, it is a U.S. responsibility to ensure that the costs of this role to the American economy are minimized while the advantages to our trading partners remain large. The objective in managing the U.S. reserve currency role is to minimize the likelihood and the severity of the shocks to the U.S. economy from changes in the foreign demand for U.S. dollar securities Increases the foreign purchases of U.S dollar securities lead to declines in the competitiveness of American goods in foreign markets; if foreign central banks increase their purchases of U.S. dollar securities, the U.S trade deficit increases, and employment and profits in U.S, manufacturing increase. In contrast, if there were a sudden sharp decline in the foreign demand for U.S dollar securities, the U.S. trade deficit would decline sharply, which could lead to an increase in the U.S, inflation rate if the increase in demand is larger than the excess capacity in U.S, manufacturing industry.

One opportunity to manage the U.S. reserve currency role occurred in the 1960s; there was then a shortage of monetary gold. The world price level had more or less doubled in the 1940s and the 1950s, largely as a result of finance associated with World War II and the relaxation of ceilings on prices and wages that had been adopted during the war. The U.S. government was adamantly against raising the U.S. dollar price of gold, primarily for domestic and foreign political reasons. The markets brought about the inevitable, and there was a surge in the U.S. dollar price of gold. Now the United States no longer has the option to increase the U.S. dollar price of gold.

There are two different approaches to managing the foreign demand for U.S. dollar securities. One is centered on the U.S. trade account, and on the relation between U.S.

imports and U.S. exports. The other is centered on U.S. financial accounts, and the foreign demand for U.S, dollar securities.

Measures to strengthen the U.S. reserve currency role could be applied to all U.S. transactions or they could applied to transactions with those foreign countries that have been large buyers—excessively large buyers--of U.S. dollar securities.

First consider several measures that could be applied to transactions in goods. One measure would apply a temporary tariff of ten percent or fifteen percent on imports from countries that have trade surpluses that are judged to be large. Another measure would require that countries that wish to sell in the United States would have to attach a coupon that they had purchased from U.S. exporters. These exporters would be given a coupon when the goods leave the United States, and they would be to the

Now consider the range of instruments that are available to the U.S authorities that would impact the foreign demand for U.S. dollar securities. The direct instruments include changes in interest rates on U.S. dollar securities, a new issue of U.S. dollar securities that would be similar to TIPS, a tax on interest income of foreign central banks, and controls that would limit foreign purchases of U.S. dollar securities.

CHINA'S INDUSTRIALIZATION AND ITS MASSIVE TRADE SURPLUS

The ratios of the U.S. trade deficit to U.S. GDP and of the increase in U.S. international indebtedness to the increase in U.S. GDP in the last several years have been too large to be sustainable. The single most important counterpart of the U.S. trade deficit is the Chinese trade surplus. China has been reluctant to increase its imports from the United States as its exports of manufactures to the United States have increased rapidly.

China has been one of the great economic success stories of the last fifty years. . Taiwan was one of the earliest, followed by Japan, and then South Korea and most recently Thailand and Malaysia. These countries experienced exceptionally high rates of economic growth when workers move from the farms and villages to the cities and the factories and initially produced inexpensive manufactured goods that were exported. Each of these countries has been able to achieve a rapid growth in its exports because of the openness of the U.S. market to foreign goods.

The pattern of economic growth in China is similar to those in other countries in Asia that have achieved high rates of growth. Productivity gains in some sectors of manufacturing have been exceptionally high, and these sectors have been able to reduce their selling prices while paying higher wages to attract labor. The high incomes in manufacturing have led to increases in demand for agricultural products and services; because productivity gains in these sectors have been modest, the prices charged by the sellers in these sectors have increased, and the real incomes of those in these sectors have increased. The increases in the prices charged by these sectors have dominated the declines in the prices charged in the export-oriented sector of manufacturing.

The pattern to money flows between countries at different stages of economic development generally conforms with economic intuition and theory. Money flows to a country during the early stages of its industrialization in response to anticipated high rates of return associated with its rapid rate of economic growth. Thus the money flows to the United States during the nineteenth century were consistent with this pattern. The most rapidly growing countries almost always have trade deficits—much like the United States had trade deficits in the first half of the nineteenth century. Then when their growth rates slowed, the pattern of money flows has been reversed, and the money flows from the countries that formerly had been growing rapidly.

China has been an exception to this pattern. China is the only country that has exported large amounts of money during the early stages of its industrialization, when its per capita GDP has been much lower than those in the countries that received this money. This perverse pattern of money flows has resulted because financial regulations have limited the interest rates that banks could pay on their deposits and quantitative restrictions set by the Chinese government that limited the ability of Chinese banks to increase their loans. This quantitative restriction appears to reflect the concern that the more rapid increase in bank loans would lead to an increase in the inflation rate. Perhaps. But if China were to re-arrange its financial structure so that its imports more or less matched its exports, the total supply of goods and services available to the Chinese economy would increase immediately by five or six percent, which would put very significant downward pressure on the overall price level The money that China has used to buy U.S dollar securities instead could have been lent to business firms in China, and China's imports then would have increased to match the increase in its exports.

The United States is under no obligation to have a trade deficit because China wants to have a trade surplus. If the Chinese currency had been freely floating in the last ten years, then the rapid increase in its exports would have led to an appreciation of its currency, and China's imports would have increased rapidly—and dampened upward pressure on the consumer price level. Instead the Chinese currency had been pegged, and the large trade imbalance has put downward pressure on U.S. prices and incomes.

China's trade and current account surpluses are too large relative to the ability of its trading partners to adjust to the counterpart trade deficits. Moreover, the Chinese trade surplus has been increasing. Further, the prospect is that that as the growth rate in China slows, as it inevitably will, then money flows from China will increase and the Chinese trade surplus will increase further.

A larger Chinese trade surplus means that the trade deficits of some other countries will increase. The U.S. trade deficit is likely to increase. The United States has no obligation or commitment that requires that it passively accept an increase in its trade deficit because China wants to have a larger trade surplus.

The U.S. Government should seek an agreement with the Government of China on an orderly reduction in the Chinese trade surplus with the United States. Chinese officials should be asked to provide their estimates of the "end game"—how they believe that the Chinese trade and current account surplus will evolve.

The United States should indicate to China the maximum acceptable bilateral trade imbalance, and a time line for the orderly reduction in the Chinese trade surplus.

There are several different measures that the China can adopt to reduce its trade surplus. One that receives a great deal of attention is to allow the yuan to appreciate. Another is to reduce its import barriers and to encourage imports, even to the extent of subsidizing imports. A third is de-regulate its financial structure. There may be other changes in policy. These measures can be used together.

The U.S. government should allow China to decide how to reduce its extraordinarily large bilateral trade surplus with the United States.

If the bilateral Chinese trade surplus with the United States remains larger than that deemed acceptable, the U.S. Government should adopt measures to supplement any that might be adopted by the Chinese to reduce its large trade surplus. One measure is ten percent tariff on imports from China; the tariff rate would be increased until the trade imbalance declines to a sustainable value.

A second measure is to link U.S. imports from China to U.S. exports. U.S. exporters would receive "trade points" for each dollar of sales from the United States; these points would be recorded at a special account in the Department of Commerce. These exporters would be free to sell these points to firms that want to import. U.S. firms that want to import from China would be obliged to acquire the appropriate number of these points in the free market before these goods would be allowed to enter the United States.

U.S. exports would be promoted by this arrangement because the revenues of U.S. firms that sell abroad would be higher because of receipts from the sale of the "trade points." U.S. import growth would be slower because the U.S. dollar cost of imports would be higher because of the amount that importers would have to pay for these points.

U.S. exporters would receive points regardless of the destination of their sales. Only imports from countries that have trade surpluses deemed exceedingly large would be required to participate in the point arrangement.

The U.S. Treasury would change the number of points required to import goods from China to ensure that there is an orderly decline in the trade imbalance. adjustment. .

The introduction of "trade points" to supplement the market price is not a first best solution, which would involve measures by countries that have large trade surpluses to increase their imports

Measures that the United States might adopt to reduce its trade deficit would bring forth cries of protectionism, protectionism. These protests are nonsense, a country that that has a trade deficit of three, four or five percent of its GDP is not protectionist.

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July 6, 2010

VIA E-MAIL & FACSIMILE

The Honorable Sander Levin
Chairman, Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: Public comments for The American Iron and Steel Institute on the full Committee hearing March 24, 2010, on the exchange rate policy of the Government of the People's Republic of China, and its impact on the U.S. and global economies.

Dear Mr. Chairman,

These comments are filed by The American Iron and Steel Institute (AISI) on behalf of its U.S. member companies, pursuant to the March 15, 2010 advisory requesting written statement for consideration by the three Subcommittees and for inclusion in the printed record of the hearing. AISI's U.S. member companies account for over 75 percent of the raw steel produced annually in the United States.

I. China's Undervalued Exchange Rate: The Single Largest Subsidy to Chinese Manufacturers and the Key to China's Export-Led Growth Strategy

Over the past 16 years, China's currency (the "RMB") has been pegged to the U.S. dollar, severely undervalued and a key element in the Chinese government's successive 5-year plans to transform China into "the world's factory." This fundamental exchange rate misalignment -- maintained through strict currency controls and massive government intervention -- has been central to a Chinese economy that has been geared to, and remains overly dependent on, export-led growth.

It has not been China's only subsidy or protectionist measure in its "strategic" industrial policies to promote economic development and preserve social stability. However, with the RMB undervalued by as much as 50 percent according to some economists, it is the single largest government subsidy to manufacturers in China, and it was a major cause of the global structural imbalances that contributed significantly to the world financial meltdown and to the Great Recession of 2008-2009.

From behind a "currency wall of protection," China has promoted its own jobs, investment, production, R&D and exports at the expense of the manufacturers in the U.S. and elsewhere. This mercantilist currency policy has carried with it certain costs for the Chinese economy (e.g., asset bubbles and inflation) and for Chinese manufacturing industries (e.g., higher costs for dollar-denominated raw material imports). However, its main effect has been to help build up China's "strategic" industrial sectors – including steel and steel-related industries – into global powerhouses capable of dominating world markets irrespective of genuine cost-competitiveness.

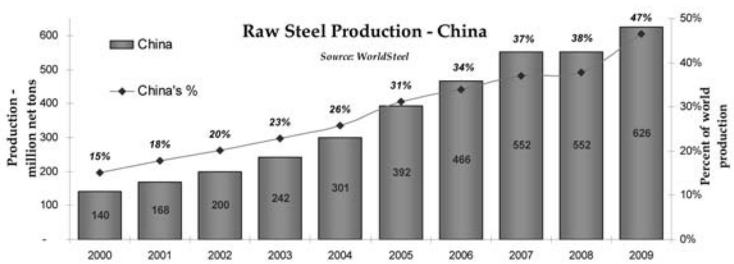
II. China's Currency Mercantilism: The Case of Steel

Steel provides a "window" on the "China Inc." economic development model.

- As many outside analysts have correctly noted, China's steel industry is not low-cost. It faces numerous internal structural challenges, such as industry fragmentation and water and energy shortages; and it must import enormous amounts of iron ore at very high world prices.

- Yet, because of import barriers, raw material export restrictions, border tax manipulations, intellectual property rights violations, dumping, Customs fraud and massive subsidies -- including currency manipulation to keep the RMB severely undervalued -- China has been able to build the world's largest steel industry by far.

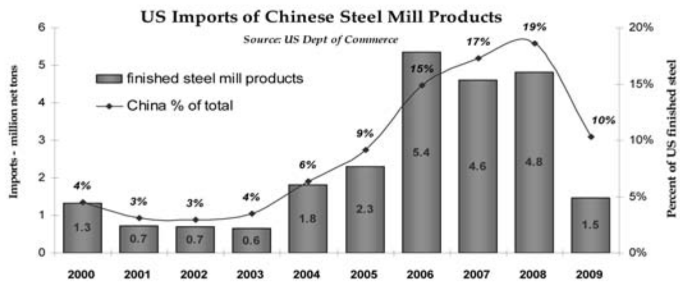
From 2000 to 2009, China went from having 15 percent to 47 percent of world steel production. Even more spectacularly, by 2012 -- China's steel capacity, in spite of its high cost status, is projected to grow to an astounding 840 million metric tons or roughly seven times that of the United States.



Not surprisingly, as the government of China was building and directing the world's largest steel industry (which remains over 90 percent government-owned), there was an inevitable and unprecedented surge of unfairly traded steel exports to the U.S. and other world markets.

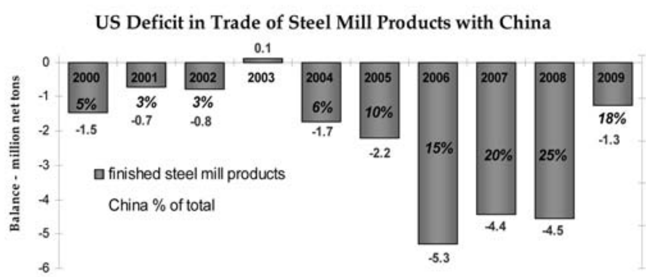
- Thanks to pervasive dumping and tens of billions of dollars in local, provincial and central government subsidies (including the huge currency subsidy), China went from being 3 percent to19 percent of total U.S. finished steel imports (between 2002 and 2008).

- In the process, as steel imports from China rose from only 600,000 tons a year (in 2003) to nearly 5 million tons a year (by 2008), America's steel companies, employees and communities all suffered significant and long-lasting injury.



Source: U.S. Department of Commerce

Meanwhile, the U.S. steel trade balance with China went from being a slight surplus for the United States (in 2003) to China accounting for 25 percent of the total U.S. trade deficit in finished steel mill products (by 2008). The recent decline in China's direct steel exports to the United States is the result of two main factors: (1) U.S. trade law enforcement vs. dumped and subsidized imports from China; and (2) the global economic crisis (which produced a Great Recession in the U.S. and a massive domestic infrastructure-focused stimulus program in China). However, the effects of the crisis are temporary and, as conditions unwind, and unless trade laws are strengthened and strictly enforced, we can expect China to return to a practice of exporting huge quantities of steel – and unemployment.



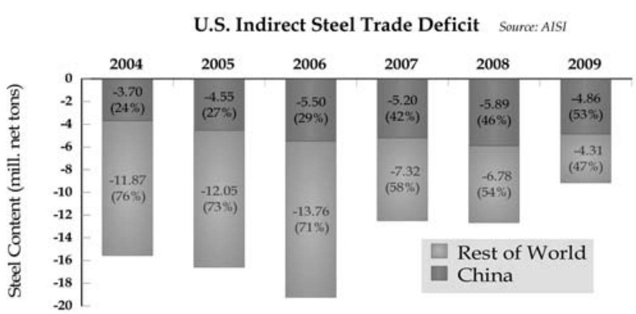
Source: U.S. Department of Commerce

III. China's Currency Mercantilism: The Case of Steel-Intensive Industries

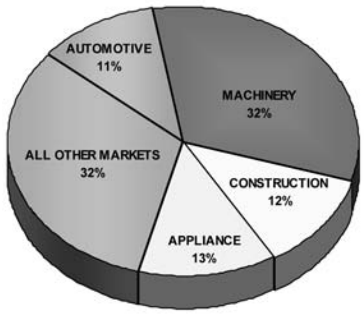
The subsidy and trade protection effects of China's currency undervaluation are a problem not only for steel but for our domestic customers and the entire U.S. manufacturing base. According to a recent study by the Economic Policy Institute (EPI), in the years between 2001 and 2008, when the U.S. experienced nearly $1.5 trillion in cumulative manufacturing trade deficits with China, the U.S. lost 2.4 million manufacturing jobs due to China trade, including 150,000 jobs in the metals industry. Between 2000 and 2009, China went from being 22 percent to 52 percent of the total U.S. manufacturing trade deficit. For a single country to account for 52 percent of America's manufacturing trade deficit is unsustainable both politically and economically.

Since roughly 75 percent of manufactured products contain some steel, we see much the same trends in U.S. "indirect" steel trade, which is basically our manufacturing trade balance expressed in tons of steel.

Aided by currency undervaluation and other unfair trade practices, the U.S. indirect steel trade deficit with China grew from 3.7 to 5.9 million tons between 2004 and 2008, during which time China went from being 24 percent to 46 percent of the total U.S. indirect steel trade deficit. Indeed, even in the Great Recession year of 2009, as America's total indirect steel trade deficit with the world declined significantly, China's share of this deficit increased again -- to 53 percent.



China currently is shipping approximately six million tons of steel a year to the United States in the form of steel-intensive manufactured goods such as automotive, machinery, construction and appliance products.



Indirect Steel Imports from China by End-Use Market

In 2009, imports of manufactured goods from China contained about 6 million tons of steel

Assisted by numerous types of industrial subsidies, as well as by the huge subsidy of currency undervaluation, these indirect Chinese steel exports to the U.S. are currently running at a rate that is roughly triple that of China's direct steel exports to the United States.

IV. The U.S. National Interest in the Post-Crisis Period: A Significant Rebalancing of World Trade Flows and Real Solutions to Address China's Currency Mercantilism

Global structural imbalances (with excessive savings, investment and exports by China, and excessive consumption/imports and inadequate savings/investment by the U.S.) were a major cause of the global financial meltdown and the worst recession since the Great Depression. There is now a stated desire on the part of both countries for "rebalancing," i.e., more domestic consumption-led growth in China and more export-led growth by the United States.

AISI strongly supports such global rebalancing (which will take time) and, for the U.S., we also endorse the President's National Export Initiative (NIE) with its goal of doubling U.S. exports over the next five years. The economic reality we are facing, however, is that approximately 70 percent of U.S. exports are manufactured goods and, in China -- the country with which we have the largest bilateral trade deficit by far -- mercantilist and market-distorting practices continue to proliferate.

At the same time, China has just turned the challenge of a global economic crisis into an opportunity to further enhance its world economic and manufacturing clout. In the crisis year of 2009, China both (1) poured hundreds of billions of dollars into upgrading its domestic infrastructure and (2) increased its foreign reserve holdings by more than $450 billion (to over $2.4 trillion and counting).

Accordingly, we have stressed to U.S. policy makers that, if we are really serious about the goal of doubling U.S. exports over the next five years, the U.S. government will need to:

- Address Chinese currency manipulation;
- Enforce trade agreements;
- Negotiate better trade agreements;
- Enforce trade laws;
- Obtain greater market access in China and other big emerging markets; and
- Promote a pro-manufacturing agenda for the United States, with no unilateral U.S. regulation of manufacturers' greenhouse gasses.

On the issue of Chinese government currency manipulation in particular, we have said that, unless this problem is effectively addressed, our goal of doubling exports over the next five years will never be achieved. In our recommendations to U.S. policy makers, we have stressed that, *"By undervaluing its currency, China effectively provides an export subsidy to its manufactured goods, giving Chinese producers an unfair advantage in their home market and in third country markets. The U.S. government must press China to end this trade-distorting practice."*

AISI supports a two-pronged approach to China trade of both dialogue and enforcement but, on the issue of Chinese government currency manipulation, it should be clear to everyone by now that the time for dialogue is over and the time for trade enforcement is here.

It is likely correct to conclude that the government of China will act on the currency issue only when it feels that it is in its own economic and political interest to do so. However -- regardless of whether, how and when China acts on this issue -- the U.S. government has a responsibility to act in our national economic interest, which is to defend against China's currency mercantilism, so that we can make more things in America, promote more manufacturing in the United States and reverse the manufacturing jobs loss in our country.

We must never forget that, just as Chinese government currency manipulation and other unfair Chinese trade practices have cost millions of good jobs in traditional U.S. manufacturing industries, so too will these policies – if left unaddressed – cost millions of good, future "green collar" U.S. manufacturing jobs.

In January 2009, at the height of the economic crisis, Treasury Department Secretary Timothy Geithner told the Congress in writing that, *"President Obama – backed by the conclusions of a broad range of economists – believes that China is manipulating its currency ... [and that the President has pledged] to use aggressively all the diplomatic avenues open to him to seek change in China's currency practices."* The time for aggressive action is long past due.

The evidence is overwhelming that the government of China has been manipulating its currency and, in recent weeks, Members of Congress have been ramping up the pressure for action on the China currency front. As the Congress is now recognizing: the problem of Chinese government currency manipulation is a "core" structural problem in the world trading system and it poses a continuing threat to U.S. jobs and to the still very fragile U.S. economic recovery.

At the same time, there is increasing recognition internationally that the government of China's currency manipulation is not just a problem for the U.S. alone. China's ongoing manipulation of its currency is harming manufacturing competitors from North America to South America and from Europe to Africa. In recent weeks, the international pressure has been building, and the call for significant change in China's currency practices has been echoed by the Heads of both the International Monetary Fund (IMF) and the World Bank.

In consideration of all of these factors, the AISI urges the following course of action:

- The Treasury Department, in its next report, should at long last cite the government of China as a "currency manipulator";
- The U.S. government should make currency manipulation of the type practices by China actionable under U.S. trade remedy laws, and the Commerce Department should apply countervailing duty (CVD) law to currency subsidies;
- The Congress should pass urgently, and the Administration should sign promptly into law, H.R. 2378, the bipartisan "Currency Reform for Fair Trade Act";
- The Administration should use every other available tool, including coordinated and aggressive diplomatic pressure, to persuade the government of China to correct the fundamental misalignment of the RMB; and, if necessary,
- The Administration should pursue legal action in the WTO to protect U.S. rights.

V. Conclusions

The government of China is manipulating its currency, and has been doing so for many years. This currency manipulation has been devastating not just to the American steel industry, but to the entire U.S. manufacturing base. While the government of China continues to do what it believes is in its national interest, the U.S. government has an urgent responsibility to defend U.S. national economic interests in this matter.

To correct global structural imbalances, promote U.S. jobs and exports, foster a robust and sustainable recovery and defend and rebuild our manufacturing base, it is absolutely essential to address the problem of Chinese government currency manipulation. To deal effectively with this problem will take more than dialogue. The time for aggressive U.S. government action is long past due. It is time to cite China as a currency manipulator, enact an effective trade law remedy (H.R. 2378), increase international diplomatic pressure and pursue WTO action if necessary.

The recent announcement by Treasury Secretary Geithner that the United States will delay its semi-annual report on currency to allow multilateral diplomacy, over the next three months, more time to work with the government of China should lead the Congress to expedite its enactment of an effective U.S. trade law remedy provision to address fundamental currency misalignment. The historical record of relying on dialogue and diplomacy alone to address the problem of Chinese government currency manipulation gives no cause for optimism. We need U.S. trade remedy tools now to defend ourselves against currency manipulation and the domestic job losses it causes.

The AISI, on behalf of its U.S. member companies, appreciates this opportunity to provide written comments to the Ways and Means Committee on the exchange rate policy of the Chinese government and on the impact this policy has had on the U.S. and global economies.

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