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Testimony of Treasury Secretary John W. Snow
before the
Senate Committee on Finance

June 23, 2005

Chairman Grassley, ranking member Baucus, members of the Committee, it is a pleasure to appear before you to testify on the matter of our economic relations with China. This hearing could not be more timely. China is playing a larger and larger role in the global economy and the Treasury Department has been intensely engaged on a broad range of Chinese financial and economic issues over the course of the last several years, particularly on the question of the yuan and flexible exchange rates. It is important that China move to a more flexible exchange rate regime, we have urged them to do so, and they have agreed that it is in their interest to adopt greater exchange rate flexibility. While it is in China's interest that they do so, it is also in the interest of the global adjustment process, which is a shared responsibility.

I appreciate the chance to address the issue of our economic relations with China in the context of this shared responsibility among major economic regions for tackling imbalances in the global economy. I had the opportunity to address some of these issues when I released my report last month on the foreign exchange practices of America's major trading partners and I look forward to revisiting these issues today. China's role in the global economy and its impact on this country are receiving a great deal of attention here at home and among traders and investors in financial markets around the world.

Although U.S. trade with China represents only about 10% of our overall trade, China is beginning to play a more significant role in the global economy. For the past decade China has pegged its currency to the value of the U.S. dollar. There was a time when such a policy may have contributed to global economic stability, but that is no longer the case today.

In my report to Congress, I determined that China did not meet the technical requirements for designation under the statute. However, it would be wrong to interpret this as acquiescence with China's currency regime. We have made it clear to China's economic leadership that reform of its currency policy is in its own interest, and in the interest of global financial system. After two years of intense engagement, it is clear that China today is prepared to introduce greater currency flexibility. China's currency regime contributes to distortions in its own economy and blocks the smooth adjustment of global imbalances. Furthermore, if current trends continue without substantial alteration, China's policies will likely meet the technical requirements of the statute for designation. China is now ready and should move without delay in a manner and magnitude that is sufficiently reflective of underlying market conditions.

Members of this Committee and many others in Congress have expressed to me their own dissatisfaction with China's currency policy. I take these concerns very seriously and I have enormous sympathy with these concerns. In addition, China, like all trading partners of the United States, must play by the rules. China's economy must be open to competition. Intellectual property rights have to be honored and violations effectively prosecuted under Chinese law.

But I cannot overstate my firm belief that resorting to isolationist trade policies would be ineffective, disruptive to markets and damaging to America's special role as the world's leading advocate for open markets and fair trade.

Acting on any of the punitive legislative proposals before Congress now would be counterproductive to our efforts - at this time. The unintended consequence would be to delay the concrete steps on currency reform that China should take for its own sake and for the sake of the global economy.

In addition, implementation of trade sanctions would lead to retaliatory policies against our exports, damaging the U.S. and the global economy. Walls will not protect America's workers and industry. We succeed not with barriers, but with the openness and dynamism which has always characterized our nation.

It is also appropriate to consider China's role in the global adjustment process.

Addressing Current Account Imbalances

Addressing imbalances in the global economy is a shared responsibility among the major economic regions of the world. While imbalances occur as the patterns of trade and investment flows shift between economic regions, uneven rates of growth in the major economies and inefficient or distortionary policies restrict adjustments and put stress on the global financial systems. Economic policymakers must address these imbalances now; delay increases the risk that adjustments will occur abruptly.

The international economy performs best when large economies embrace free trade, the free flow of capital, and flexible currencies. Obstacles in any of these areas prevent smooth adjustments. At best, such obstacles result in less than maximum growth; at worst, they create distortions and increase risks.

The United States is doing its part to address imbalances by aggressively tackling our fiscal deficit and our long-term liabilities. Because of strong growth and appropriate fiscal policy, the U.S. budget deficit in 2004 was well below projections, and with recent data, I expect further improvement in our fiscal deficit position this year. Some private forecasters predict that our fiscal deficit will be below 3% of GDP this year if we continue to hold the line on spending. We are also working to put in place innovative policies to increase the savings rate.

Our actions are important, but they alone will not be sufficient to unwind global imbalances. Simply put, large imbalances will continue if growth in our major trading partners continues to lag. European and Japanese GDP together exceeds that in the United States. These economies must continue to adopt and implement vigorous and necessary structural reforms to establish robust rates of growth – both for the good of their own citizens and to contribute to reduction in the imbalances in the global economy.

Greater flexibility in China is also a necessary component of the global adjustment process. Concerns of competitiveness with China also constrain neighboring economies in their adoption of more flexible exchange policies.

In China's interest

China's rigid currency regime has become highly distortionary. We know that it poses risks to the health of the Chinese economy, such as sowing the seeds for excess liquidity creation, asset price inflation, large speculative capital flows, and over-investment. It also poses risks to its neighbors, since their ability to follow more independent and anti-inflationary monetary policies is constrained by competitiveness considerations relative to China. Sustained, non-inflationary growth in China is important for maintaining strong global growth and a more flexible and market-based renminbi exchange rate would help the Chinese achieve this goal.

A more flexible system will also support economic stability in China. Currently, China relies largely on administrative controls to manage its economy – controls that are cumbersome and increasingly ineffective. An independent monetary policy will allow China to more easily and effectively pursue price stability, stabilize growth, and respond to economic shocks.

A more flexible system will allow for a more efficient allocation of resources and higher productivity. The current system is fueling over-investment and excessive reliance on export-led growth while under-emphasizing domestic consumption. Moreover, much of the investment and capital flows into these favored sectors and projects may not prove profitable under market-determined prices, which could lead to another investment hard landing, more non-performing loans and a weakened banking sector.

And a more flexible system would also quell speculative capital inflows that are costly to China's government and increasingly likely to prove disruptive. China's sterilization of capital inflows has limited effectiveness and is harmful to its banking sector.

Finally, recent history has taught us that it's better to move from a fixed to a flexible currency system during a period of strength, and not when economic weakness compels reform.

U.S. – China Engagement

In September of 2003, I began an intensive engagement with China, aimed at hastening China's move to a more flexible exchange rate. I believe that this financial diplomacy has yielded important results. Since then, China has taken critical steps to establish the necessary financial environment and infrastructure to support exchange rate flexibility.

* It has introduced a foreign currency trading system permitting onshore spot trades in eight foreign currency pairs and allowing banks to act as market makers.
* It has adopted measures to increase the volume of foreign exchange trading, for example: eliminating the foreign exchange surrender requirement for many commercial firms; allowing domestic Chinese insurance firms and the national social security fund to invest in overseas capital markets; and increasing the amount of foreign currency business travelers can take out of the country.
* It has taken steps to develop foreign exchange market instruments and increase financial institutions' experience in dealing with fluctuating currencies. Foreign exchange forward contracts can now be offered in China; foreign exchange futures are being developed; and domestic Chinese banks can now trade dollars against other foreign currencies, not just remnimbi.
* It has also acted to strengthen its financial sector and regulation, so that this sector is more resilient to any fluctuations in exchange rates.

As a result, China is prepared to introduce flexibility and should do so now.

China should take intermediate steps that reflect underlying market conditions and allow for a smooth transition – when appropriate – to a full float. A flexible system will provide China with a more sophisticated array of policy tools – namely an independent monetary policy – that will prove much more effective in achieving price stability and the ability to adjust to shocks. Today, I believe that the risks associated with delaying reform far outweigh any concerns with immediate action. The current system poses a risk to China's economy, its trading partners, and global economic growth.

It is critical that we address the issues of imbalances aggressively with the goal of raising global growth. Nothing would do more damage to the prospects of increasing living standards throughout the world than efforts to inhibit the flow of trade. However, it is incumbent on China to address concerns before mounting pressures worldwide to restrict trade harm the openness of the international trading system.

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