S. HRG. 110–458

RISKS AND REFORM: THE ROLE OF CURRENCY IN THE U.S.-CHINA RELATIONSHIP

HEARING

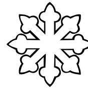
BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED TENTH CONGRESS

FIRST SESSION

MARCH 28, 2007



Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE

43–597—PDF WASHINGTON : 2007

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

COMMITTEE ON FINANCE

MAX BAUCUS, Montana, *Chairman*

JOHN D. ROCKEFELLER IV, West Virginia
KENT CONRAD, North Dakota
JEFF BINGAMAN, New Mexico
JOHN F. KERRY, Massachusetts
BLANCHE L. LINCOLN, Arkansas
RON WYDEN, Oregon
CHARLES E. SCHUMER, New York
DEBBIE STABENOW, Michigan
MARIA CANTWELL, Washington
KEN SALAZAR, Colorado

CHUCK GRASSLEY, Iowa
ORRIN G. HATCH, Utah
TRENT LOTT, Mississippi
OLYMPIA J. SNOWE, Maine
JON KYL, Arizona
CRAIG THOMAS, Wyoming
GORDON SMITH, Oregon
JIM BUNNING, Kentucky
MIKE CRAPO, Idaho
PAT ROBERTS, Kansas

RUSSELL SULLIVAN, *Staff Director*
KOLAN DAVIS, *Republican Staff Director and Chief Counsel*

CONTENTS

OPENING STATEMENTS

	Page
Baucus, Hon. Max, a U.S. Senator from Montana, chairman, Committee on Finance	1
Grassley, Hon. Chuck, a U.S. Senator from Iowa	3

CONGRESSIONAL WITNESSES

Schumer, Hon. Charles E., a U.S. Senator from New York	4
Graham, Hon. Lindsey, a U.S. Senator from South Carolina	7

WITNESSES

Roach, Stephen S., managing director and chief economist, Morgan Stanley, New York, NY	9
Prasad, Eswar S., Nandlal P. Tolani senior professor of trade policy, Cornell University, Ithaca, NY	11
Goldstein, Morris, Dennis Weatherstone senior fellow, Peter G. Peterson Institute for International Economics, Washington, DC	13
Makin, John H., visiting scholar, American Enterprise Institute, Washington, DC	15

ALPHABETICAL LISTING AND APPENDIX MATERIAL

Baucus, Hon. Max:	
Opening statement	1
Goldstein, Morris:	
Testimony	13
Prepared statement	37
Graham, Hon. Lindsey:	
Opening statement	7
Grassley, Hon. Chuck:	
Opening statement	3
Makin, John H.:	
Testimony	15
Prepared statement	60
Prasad, Eswar S.:	
Testimony	11
Prepared statement	66
Roach, Stephen S.:	
Testimony	9
Prepared statement	75
Schumer, Hon. Charles E.:	
Opening statement	4
Prepared statement	89

COMMUNICATIONS

National Retail Federation	93
US-China Business Council	96

RISKS AND REFORM: THE ROLE OF CURRENCY IN THE U.S.-CHINA RELATIONSHIP

WEDNESDAY, MARCH 28, 2007

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:02 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Max Baucus (chairman of the committee) presiding.

Present: Senators Schumer, Stabenow, Salazar, Grassley, Smith, and Bunning.

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The hearing will come to order.

Senator Grassley is currently testifying over on the House side, so he cannot be here at this moment. We will include his full statement in the record, and he will come over and join us as soon as he possibly can.

Welcome to the Finance Committee's second hearing on China. Today we examine China's currency exchange regime. I am pleased to welcome some of the world's sharpest minds to discuss it.

During World War II, when Mike Mansfield was a young Congressman, he had an encounter with China's currency exchange regime, back during World War II.

President Roosevelt had asked Mansfield to travel to China as his emissary. Before Mansfield departed, American officials briefed him on China's exchange rate. They advised him to bring $1,000 in $50 and $100 bills. They counseled him to exchange those dollars on the black market in China. At all costs, they told him, he should avoid the "unrealistic" government-imposed exchange rate.

Sixty years later, China's exchange rate still draws criticism. But today the value of China's currency affects every American.

Currency markets are global. Financial markets are international. No country can insulate itself from global markets, but countries and individuals can seize the opportunities that those markets create.

Some say that we cannot expect China to increase the value of its currency. Some say that we cannot expect the Treasury Department to cite China as a currency manipulator. Some say that we cannot expect China to accelerate financial market reforms. And some say we cannot expect America to pressure China's reformers.

But Americans are tired of hearing this litany of impossibilities. We want to know what China can do. We want to know what

America can do. And we want to know what both countries can do together.

Let us ask: How can China make the reforms that it needs to? How can China take the actions that are in the interests of China, America, and the world? And how can America help China to do so?

China can, and must, do more to let its currency appreciate and begin to allow market forces to determine its exchange rate. Some will say that China's currency has appreciated against the dollar a bit. But overall, on a trade-weighted basis, the value of China's currency remains largely unchanged since 2005 levels.

China can, and must, do more to liberalize capital flows and strengthen its financial sector. We know that China is nervous about the risks associated with these reforms. But China cannot learn to manage such risks in a vacuum. America—its public and private sectors—stands ready to help China develop the tools it needs to embrace flexible markets.

And China can, and must, give its citizens and companies greater flexibility to participate in global markets and in all of the opportunities they present. China has shown some creativity—such as its newly established $200-billion reserve fund. But it must use such tools in a way that brings stability, rather than uncertainty, to the global economy.

At the same time, America can do more to help China to deal with the potential pitfalls of reforms. America can do more to share our vast financial expertise. And, most importantly, America can do more to strengthen a relationship that holds so much promise for our own future.

China and America need to act on the possible. Postponing reform imperils China's growth and stability. Postponing reform carries deep risks for the world economy. And postponing reform will needlessly cloud the Sino-American relationship.

Senators Grassley, Schumer, Graham, and I are working together to reform America's approach to global exchange rates. Last fall, we pledged to work together to find a solution that is firm but fair and consistent with our World Trade Organization obligations. We are continuing that work.

Back during World War II, we do not know whether Senator Mansfield exchanged his dollars on the Chinese black market. The notes from his trip do not say.

We do know, however, that Mike Mansfield went to China. We do know that Mike Mansfield saw the possibilities. During World War II, Congressman Mike Mansfield said, and I quote: "We must awaken from our lethargy about the Orient. . . . We must not forget our future lies, in large part, in the Pacific. A friendly . . . China will be a safeguard for us in that area." Again, written back during World War II.

Senator Mansfield saw the possibility for a strong relationship between China and America, and he worked to realize that possibility.

Let us not forget that our future lies, in large part, in the Pacific. Let us deal firmly and fairly to advance Chinese currency reform. And let us work to develop the strong relationship with China that will be a safeguard to both our countries' futures.

OPENING STATEMENT OF HON. CHUCK GRASSLEY, A U.S. SENATOR FROM IOWA

Senator GRASSLEY. I want to thank the Chairman for convening this important hearing on the role of currency in our economic relationship with China. And, I want to thank our witnesses for their participation.

This hearing is part of a process that I agreed to last September with Chairman Baucus, Senator Graham, and Senator Schumer. After working on separate tracks in the last Congress, we agreed to try to work together this year to develop new legislation to address currency exchange rates.

The only pre-condition that we set was that any new legislation would have to be consistent with the obligations of the United States as a member of the World Trade Organization.

I look forward to today's testimony and to any written comments that may also be submitted to the Committee. Such testimony and commentary will help inform our joint effort.

I'm anxious to get started, because two things are apparent to me. First, there's a significant issue with respect to the artificial undervaluation of China's currency relative to the U.S. dollar. And second, our laws pertaining to oversight of currency exchange rates are in need of overhaul to better address the economic landscape of the 21st century.

With respect to the first point, why should we be concerned about China's undervalued currency? I'm concerned because of the risks and distortions that ensue. Most economists would say that in response to mounting bilateral and global trade surpluses, the Chinese currency should appreciate. But that's not happening. Instead, China has engaged in large-scale intervention to restrict appreciation of its currency.

I look forward to hearing what our witnesses think about the risks and distortions associated with such intervention. For example, to what extent does it create an incentive within China to over-invest in export-related production? To what extent does it make U.S. products and exports less competitive? Does it create the potential for higher inflation in China? Does it create an incentive for speculative investment and increase the risk of asset price bubbles in China? Over time, does it leave China more vulnerable to domestic and/or external economic shocks? Does it leave the United States more vulnerable to a sharp, disruptive movement in the value of the U.S. dollar? From a longer-term perspective, to what extent does it impede necessary reform of China's financial services sector? Those are some of the points I'm interested in exploring as we engage in this fact-finding exercise.

Now, I don't want to leave the impression that the issues lie entirely at China's doorstep. During yesterday's hearing on our economic relations with China, I noted that our trade deficit with China is very much a function of U.S. consumption, because we're producing more and exporting more than ever before.

When we purchase imports, we provide the foreign reserves that allow China to intervene in currency markets. In 2006, U.S. consumption of consumer goods accounted for almost 40 percent of our total trade deficit in goods. So there's clearly room for U.S. consumers to purchase less and save more.

At the same time, I think we should be able to rely on market forces to balance out the pressures of fluctuating international trade flows and differential interest rates on major currencies.

China is a major beneficiary of our open system of international trade, so they should be no different. That's not to say that China should act overnight. But I do think the Chinese government can, and should, be moving more quickly in that direction. It's in everyone's best interest that they do.

As for my second point, I note that our currency oversight laws date to 1988. Back then, our primary concern was with respect to the Japanese yen. Today it's with respect to China. Tomorrow, who knows?

We need to overhaul our laws so that the Treasury Department is generally empowered to respond more forcefully to significant currency imbalances. So, I intend to work on legislation that is not specific to any particular country or currency. It will be broader than that.

Finally, I invite comments from our witnesses with respect to the role that the International Monetary Fund can or should play in future oversight of currency exchange rates. I would further ask, to what extent is the IMF equipped to handle that role? Is reform of the IMF needed to ensure that it remains relevant to the needs of the global economy in the 21st century? And if so, how?

These are important questions that also need to be addressed as we move forward in developing new legislation.

Thank you, Mr. Chairman.

The CHAIRMAN. Now I would like to turn to our two eminent witnesses. I will begin with you, Senator Schumer.

STATEMENT OF HON. CHARLES E. SCHUMER, A U.S. SENATOR FROM NEW YORK

Senator SCHUMER. Well, thank you, Mr. Chairman. Thank you so much for your leadership on all of these issues and for scheduling this hearing. I know you said some of the greatest minds will be here to discuss this issue, and I think you meant on the second panel.

The CHAIRMAN. When I mentioned that, I saw the two of you kibitzing a little bit over that point. I knew that was the point you were making. [Laughter.]

Senator SCHUMER. Anyway, we look forward to hearing the great minds on the second panel as well.

Thank you and Ranking Member Grassley for holding these 2 days of hearings on our economic relationship with China and allowing Senator Graham and I to make a statement as a team. I know it is unusual for a member of the committee—and I am proud to be on the committee—to address the committee as a witness, but I felt it was important for me to sit here with my policy partner on this issue for 5 years now. Lindsey and I have been a trade tag team for a long time, and we look forward to developing a new currency bill with you and Senator Grassley over the next few months. And the fact that we have a whole separate hearing on currency both shows the importance of this issue—first day, all the other China issues; second day, currency—but it also shows the fact that

you, Mr. Chairman, are aware and involved in how to solve this problem. And we very much appreciate that.

Now, last year, as you know, Senator Graham and I ruffled a few feathers with our tariff bill, which we set aside at the very end of the Congressional session because we wanted to work with the Chairman and Ranking Member on a new currency bill that was WTO compliant. Senator Graham and I were both surprised when our bill received 67 votes on the floor in April of 2005. Yet we are convinced that the support for strong legislation on Chinese currency manipulation and other illegal trade practices has actually grown significantly in the 2 years since.

We never intended for our original bill to become law. It was a shot across the bow. As a result, having achieved some small measure of success, the 6-percent growth which we believe would not have happened, the 6-percent revaluation of the yuan which we believe would not have happened without our bill, we withdrew it and instead agreed to work with you and Senator Grassley to come up with new legislation.

The possibility for legislation in the 110th Congress is real because the number of people who will vote for strong legislation even exceeds the number who would have voted for our tariff bill last year. In other words, well-crafted legislation, WTO compliant and strong and effective, is likely to pass with a veto-proof margin during this Congress. And I say that not just to my colleagues here who are aware of the strength of this issue, but to the White House and to the Chinese.

That is the message I hope that the Chinese and the Bush administration take away from these hearings. The desire to pass tough legislation that is WTO compliant is very strong in this committee and in this Congress. I see one of our cosponsors of our legislation, Senator Bunning, here today.

Our goal in the 110th Congress should be to find a tough but fair bill that can pass the House, pass the Senate, and be presented to the President. And Senator Baucus, Chairman Baucus, Ranking Member Grassley, we look forward to working with you to craft such a bill. We believe it will happen this year, this session of Congress.

Let me say that there is no doubt China is making some progress in various areas. China has recently decided to permit foreign banks greater access to its domestic market for credit card and other everyday services. China is also making efforts to administratively reduce the trade deficit, for example, by changing export tax incentives.

What the Chinese should recognize, however, is that taking these steps only reinforces the notion that the pace of currency appreciation could be faster without harming their domestic economy. In other words, the same economic defect that these government policies are designed to achieve could be attained more broadly without cherry-picking and looking at specific areas by merely revaluing the yuan. Why they refuse to do so is still a mystery to all of us.

Although the pace of appreciation quickened slightly at the end of 2006, it froze to a standstill over the past month or so. Nearly all the experts still agree that the Chinese yuan remains significantly undervalued, that this undervaluation is the result of delib-

erate intervention by the Chinese government in world currency markets, and that this policy gives Chinese products a tremendous advantage in the United States market.

In fact, even though the currency has appreciated by about 6.6 percent since Senator Graham and I started our crusade, some would argue that the currency is even more undervalued now than it was when we started. Since the Chinese economy has grown so quickly over that time and our trade deficit with them continues to explode—over $232 billion in 2006 alone—the Treasury Department has repeatedly used a technical and legalistic dodge to determine that China does not manipulate its currency. We all know they intervene, on the order of $200 billion a year, to keep the yuan's value artificially low, yet our government cannot call a spade a spade. And the President wonders why the bipartisan consensus for free trade has eroded. As long as the administration sticks to this position, it is our view we have to proceed without them.

Treasury Secretary Paulson, a man I have great respect for, is trying to talk to the Chinese. Like his predecessors, he is learning that you will get a lot of talk and very little action. We have to take some action.

Now, let us leave aside for a moment what word we want to use to describe what the Chinese are doing and focus on its effects. I will be chairing in a few minutes the Joint Economic Committee hearing with Fed Chairman Bernanke. He has said that Chinese currency practices amount to an export subsidy. There is an emerging consensus that this is simply a fact, regardless of what our official reports may say.

Let me be perfectly clear, Mr. Chairman. The real protectionists in the debate over China's trade practices are those who argue we should do nothing or that we should continue to wait or that rapid change would upset the so-called harmonious society of China. These apologists are protectionist in a different sense. They are protecting China. Those of us who care deeply about American workers, who care about upward mobility for middle-class families, who care about our economic future, and who believe in free trade understand that free trade benefits America when our major trading partners follow the rules. And we know that pushing China is the right thing to do.

When I talk about this issue now, I feel a little bit like Vice President Gore must feel when he talks about global climate change. When he first started, he was regarded as a little bit out of the mainstream. But over time public opinion has evolved, and the overwhelming majority of the public is with him. The currency issue is similar on not so broad a scale. Senator Graham and I were focused on it before most people thought it was a real issue. Nearly 5 years later, every Senator might not agree on how to address it, but I think there is an overwhelming consensus that something needs to be done.

One other thing I would say, Mr. Chairman, before concluding, and I would ask unanimous consent that my entire statement be put in the record.

The CHAIRMAN. Without objection.

Senator SCHUMER. I do not believe the Bush administration can be counted on to protect American industry and workers from China's unfair trade practices. The President has four times rejected recommendations from the U.S. International Trade Commission under section 421 to grant import relief to U.S. industries. USTR has three times rejected 302 petitions to take action against China's currency. The Treasury Secretary has refused to cite China for manipulation in Treasury's semiannual report. Proceedings before the WTO, of course, are time-consuming and not getting us very far until we change the law.

So the bottom line is this, Mr. Chairman: If not now, when? If not us, who? The American public is waiting for us to take strong, fair action that will be effective. And I thank you for the opportunity.

The CHAIRMAN. Thank you very much, Senator.

[The prepared statement of Senator Schumer appears in the appendix.]

The CHAIRMAN. Senator Graham?

STATEMENT OF HON. LINDSEY GRAHAM, A U.S. SENATOR FROM SOUTH CAROLINA

Senator GRAHAM. Well, thank you, and I just would like to add to the litany of his closing comments: Where? If not now, when? If not us, who? Where? Here in this committee.

This committee is a great opportunity for Republicans and Democrats to come together and speak with one voice when it comes to China currency manipulation—not a draconian voice, not a voice of rhetoric to make a political point, but a reasoned voice that this is a world economy, a global economy, and there are rules that we all should play by.

The China currency issue depends on whose eyes you look through, and apparently when you look from New York and South Carolina, if you are in the manufacturing business, you see an advantage given to Chinese products 20 to 40 percent based on the currency alone. You see other business practices that make it almost impossible for you to compete in the global economy if you are from South Carolina and New York when it comes to China.

The 67 votes, Mr. Chairman, was an awakening of a sleeping giant called the Congress. I never will forget—and it has been a real pleasure working with Chuck on this—we started, you know, well, maybe we could do a resolution. And 5 years later, we are in the middle of what I think is a defining moment for a U.S.-Chinese relationship. The currency has come to define our relationship, for bad or worse. But Senator Durbin and Senator McConnell came to us after the vote and said, "What do you want?" Well, we did not think we would win. Honestly, we thought we would get into the 40s with Senator Bunning. We did not want to get embarrassed. The truth is that we tapped into a growing resentment in this body toward Chinese business practices that is bipartisan.

To my friends in the administration, I have enjoyed working with you. You have gone and you have spoken, and we have tried to play the good cop/bad cop. It is obvious what we have been trying to do, and we have had some small success. But now we need to come together as a country. The Congress and the administration

need to get behind some legislation that will be WTO compliant, and that, Mr. Chairman, is where you and Senator Grassley become the key players.

I think there is a bipartisan support network on this committee that could be used to change the Chinese-American relationship for the better. And when you look at our legislation, yes, it was tough. How do you get people's attention in this world? You have to be tough. The Chinese are tough. You know, that is the only way we got their attention: to threaten to put a tariff on their products if they did not change—something we do not want to do, something I am sure they do not want to have happen to their business enterprises. But that vote did bring some attention to this issue, and 6.5 percent is not nearly enough, but it is a beginning. And 10-percent GDP growth has occurred during this appreciation, so it can continue. But also the trade deficit has continued to grow.

To our Chinese friends, if you are watching and listening, which I hope you are, you better understand that this is the one issue—there may be a few others, but this is one issue where Republicans and Democrats are together, and we are going to act because this affects all Americans. And we want to act in a way where it is a win-win for both countries, but it takes two partners to act to make it a win-win. And I am here to tell you, unfortunately, after 5 years, the progress has been slow, it has been painful, it has taken a lot of time and resources, and it needs to accelerate or worse things can happen.

Finally, the legislation was tough. Was it draconian? Yes, in many ways it was. But here is my question for this body: What is the effect of the status quo on the American business community? Draconian. If you are out there trying to compete in the global economy, playing by the rules, and this currency manipulation is allowed to continue to exist, it is devastating to you and your business. You can compete on cheap labor. You can compete when it comes to technology and innovation. But when the Chinese government gets in the game, you cannot beat them.

So to do nothing, Mr. Chairman, is just as draconian as a 27.5-percent tariff. The tariff may be off the table, but one thing is for sure from this hearing and this committee's support: The China currency issue is on the table, and it will be acted upon in a bipartisan fashion, and we will get relief. I hope it is a win-win. That is up to the Chinese.

Thank you for having this hearing.

The CHAIRMAN. Thank you, Senators, very, very much. You have been leaders on this issue. You have worked very hard for a long time, and we thank you very much for your contribution.

Now I will turn to our other experts, who include Stephen Roach, chief economist and managing director, Morgan Stanley, in New York. He will be followed by Eswar Prasad, who is a senior professor of trade policy at Cornell University in Ithaca. The third witness is Mr. Morris Goldstein, who is the Dennis Weatherstone senior fellow at the Peter G. Peterson Institute for International Economics. And, finally, we welcome John Makin, who is a visiting scholar at the American Enterprise Institute in Washington, DC.

Mr. Roach, you are first.

STATEMENT OF STEPHEN S. ROACH, MANAGING DIRECTOR AND CHIEF ECONOMIST, MORGAN STANLEY, NEW YORK, NY

Mr. ROACH. Thank you, Mr. Chairman, and I would certainly echo the comments of Senators Schumer and Graham that you are to be commended for holding these important hearings. I do concur with both the Senators on one aspect of their comments, and that is, getting China right could well be the most important challenge that the United States faces in the international economic policy arena in the 21st century.

As I see it, the truth of the matter is that, while there is no denying the strength of the U.S. and Chinese economies, we also have major problems in our economy and China has problems in its economy. I think the question before this committee today is whether a currency fix is the appropriate remedy to resolve these problems.

My answer, not to keep you in suspense—and it is detailed in my statement—is an unequivocal, no. In making the case, I start with the basic premise that a currency fix involves a shift in the relative prices between one nation and another, and in this case between China and the United States. And in considering the currency fix as a remedy for a massive bilateral imbalance between the United States and China, you must, therefore, consider the implications on both our economy and their economy. Let me make just three points in my summary in that regard.

Number one is America's macro context. I was disappointed not to even hear a word out of Senators Schumer's or Graham's mouth in that regard. The United States, whether we like it or not, has a huge savings problem, the likes of which the world has really never seen before. I have talked to you about this before, Mr. Chairman, but the numbers speak for themselves. We have had a 1-percent net national savings rate for the past 3 years—that is, the combined savings of individuals, businesses, and the government sector—adjusted for depreciation, and it is a record low for us. And so, lacking in domestic savings, we must import surplus savings from abroad in order to keep growing and run massive current account and trade deficits to attract the capital. That biases the United States toward a steady stream of trade deficits, whether it is with China or anyone else. The risk is, if you do something to alter the trade deficit with China without improving our national savings rate, the deficit just goes somewhere else. Most likely it would go to a higher-cost producer, which, in my opinion, would be the functional equivalent of a tax hike on the very American consumer you are trying to help out.

I think you heard a similar argument yesterday from Professor Bhagwati of Columbia University, and I certainly agree with him on that aspect of his testimony. I would ask you: How does a shift in the bilateral foreign exchange rate between the U.S. and China fix this aspect of America's macro problem? All too often you have experts come into these rooms, and they pay lip service to our savings problem, but then they go on to be very explicit in going after the Chinese. You cannot sweep the savings shortfall in the United States under the rug. This is a critical part of the relative problem between the United States and China.

Let me offer some brief comments on China's macro context. China is a poor but rapidly growing and transitional economy. It has made spectacular progress on the economic development front over the last 3 decades. There is no mistaking that. China, as a result of its unique economic model, though, has now a very unbalanced economy. Eighty percent of its GDP is in only two sectors: fixed investment and exports. Only 35 percent of its economy is in private consumption.

China knows it cannot stay this course. I was in Beijing last week, and I heard Premier Wen Jiabao say that very directly at the conclusion of the National People's Congress. I heard him echo it again in some private meetings that I and a few others attended with him as part of the China Development Forum. In his words, and I quote, the state of the Chinese economy is "unstable, unbalanced, uncoordinated, and unsustainable." The sustainability issue, by the way, is focused directly on China's huge environmental problems and excess energy consumption. And the Chinese government is putting policies in place right now that I think will ultimately lead to a pro-consumption rebalancing of the Chinese economy. That has two important benefits for China and for us.

Number one, it ultimately provides great opportunities for U.S. exports and would be more of a Chinese-led cure of our bilateral trade imbalance. It will shift the focus of Chinese trade flows from exports to imports.

And, number two—and this is critically important to all of us in the world—it will start to alleviate China's environmental threats and shift the structure of its economy away from an industrial production-driven model to more of a commodity-lite growth model, focused on private consumptions and services. That will take pressure off oil and commodity prices and will be a big plus also for us in the United States and in the world economy.

In terms of the point that Senator Graham just made, yes, China does compete on the basis of currency. There is no question about it. It also competes very effectively on the basis of labor costs, technology, infrastructure, and massive investments in R&D. Moreover, the numbers show very clearly, when you are looking at the so-called Chinese export threat, that over 60 percent of the export growth coming out of China in the last decade has been driven by Chinese subsidiaries of multinationals largely located in the West.

So who is China? Is China newly indigenous Chinese companies that are competing unfairly with us? Or is China subsidiaries of our companies that are there for economic, cost-efficiency reasons? And I ask you: Would a currency fix really alter this dynamic? Would it change the structural imperatives of China's transformation that is now going on? I would say that the answer to that at this point is no.

The final point, if I could have another minute?

The CHAIRMAN. Sure.

Mr. ROACH. The final point I would make is this is not to say that we do not face real problems in the United States. I certainly agree with Senator Schumer in that regard, that there are extraordinary pressures bearing down on the U.S. middle class, and we do have a widening disparity between record returns to capital, the record-high corporate profitability, and sharply declining rewards

to labor. We also have serious problems within the U.S. income distribution. But that raises a critical question: Are we really correct in pointing the finger at China for these problems, or do we want to take a long and hard look in the mirror and accept our own responsibility for this state of affairs?

So, again, the currency issue is an issue of relative prices. There are aspects of this issue that we need to address. There are aspects of this issue that China needs to address. There are issues that we need to collectively address. I have some thoughts and ideas as to what would be appropriate as policy recommendations, but I would reserve them for the question-and-answer session.

Thank you for your time.

The CHAIRMAN. Thank you, Mr. Roach, very much.

[The prepared statement of Mr. Roach appears in the appendix.]

The CHAIRMAN. Mr. Prasad?

STATEMENT OF ESWAR S. PRASAD, NANDLAL P. TOLANI SENIOR PROFESSOR OF TRADE POLICY, CORNELL UNIVERSITY, ITHACA, NY

Mr. PRASAD. Chairman Baucus and honorable members of the Senate Finance Committee, thank you for the opportunity to share with you my views on this very important bilateral economic relationship between China and the United States.

China's tightly managed exchange rate regime has clearly become a major thorn in this relationship, and the manner in which this matter is handled will have implications not just for the U.S. and China, but also for the smooth functioning of the global trade and financial systems.

I for one strongly believe that a confrontational approach calling for drastic policy actions, combined with threats of retaliatory steps if these actions are not taken, is not the way to make progress. This approach is unlikely to have a large or lasting impact on the U.S. trade deficit or, for that matter, imbalances in the Chinese economy that we have just heard about. It could also have unintended adverse consequences for the global trading system.

But Chinese currency reform need not be a zero sum game. There is a better way to help China in a few years to float its currency, free up capital flows, and put in place a better monetary policy framework. This would in turn boost consumption growth in China, increase demand for imports, and facilitate inflows of capital and financial expertise, including from the U.S. This would be win-win international financial diplomacy. It would improve Chinese macroeconomic performance and foster a more balanced relationship with the U.S. economy.

So why are the Chinese authorities reluctant to permit exchange rate flexibility if, as Steve Roach and various others have argued, it is in their own interest? They are, of course, concerned about short-term disruptions to the economy that could result from a currency appreciation. The merits of those arguments may be open to debate, but, more importantly, they have chosen to focus their energies on banking reforms and broader financial market development which they view as far more important priorities than currency reform. And therein lies a very big window of opportunity for

the international community, including the U.S., to catalyze substantive changes in the Chinese exchange rate regime.

There is an excellent basis, I believe, for translating the authorities' own policy priorities into a strong case for exchange rate flexibility. This is my core point: that the case for a more flexible exchange rate, which I think is an important one, should be made on the basis of a deeper set of policy priorities with the ultimate objective being balanced and sustainable growth in the longer term.

So let us trace the connections among different policies to see where currency reform fits in. As the Chinese economy becomes more complex and more connected to the global economy, it will become more exposed to more shocks externally and harder to manage through command-and-control methods. An independent monetary policy is a key tool for better macroeconomic management, as we have seen in the U.S. Monetary policy independence is, however, but a mirage if the central bank is mandated to attain an exchange rate objective.

Independent monetary policy in turn is essential for financial sector reforms. Using market instruments, such as interest rate policy, rather than government directives to guide credit expansion is essential to train state-owned banks in China to respond to market signals and become more robust financial institutions. In the absence of such instruments, the central bank has to revert to its old practice of telling state banks how much to lend and to whom, which hardly gives banks the right incentives to behave like commercial entities.

And then, for developing the domestic financial sector, opening up of the capital account to both inflows and outflows could also be beneficial. Indeed, the Chinese have begun opening the door to foreign strategic investors, including U.S. banks, to improve corporate governance and efficiency in their banks. However, there is a very clear lesson from history that opening the capital account while maintaining a fixed exchange rate could pose serious risks.

Let us now put these links together. Stable policies and a well-developed and efficient financial sector are crucial ingredients for balanced and sustainable growth. In turn, these two intermediate objectives would be helped by effective monetary policy and cautious capital account liberalization, and a flexible exchange rate is an absolute prerequisite for both of these. Thus, exchange rate policy has an important role to play, not in itself but in achieving these deeper policy reforms and also the ultimate objectives in terms of growth and welfare.

This leaves an important question on the table: What monetary framework could take the place of the fixed exchange rate? Marvin Goodfriend of Carnegie-Mellon University and I have developed a very specific package of proposals for a new monetary framework, and we think that this particular framework, which I am happy to talk about during the Q&A session, would, in fact, provide a basis for increasing currency flexibility and allow exchange rate reform to become integrated into an overall reform strategy.

Finally, framing the issue in this manner will serve as a basis for a more constructive engagement between the U.S. and Chinese economies. The U.S. in my view can indeed play a helpful catalytic role in the Chinese reform process, not through threats but by pro-

viding technical guidance and reorienting the discussion in a fashion that makes the linkages between currency and other reforms on which there is much broader consensus within China clearer. This is not to say that the U.S. should display infinite patience for reforms to take root. It will be very important to work with the Chinese to develop specific guidelines for intermediate goals, and, in fact, these could serve as concrete guideposts for the reform process, help break down internal resistance within China to the reforms, and generate momentum to help the forces within China that are predisposed towards making reforms. And as Steve Roach indicated, these forces are very much present.

To summarize, exchange rate flexibility is not an end in itself, but I believe it is a key piece of the puzzle. Ultimately, it is deep and enduring reforms that promote balanced and sustained growth in China rather than ad hoc actions at the behest of internal or external forces that will be serve the interests of the Chinese and U.S. economies and those of the global economy at large.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much. This is very, very interesting.

[The prepared statement of Mr. Prasad appears in the appendix.]

The CHAIRMAN. Mr. Goldstein?

STATEMENT OF MORRIS GOLDSTEIN, DENNIS WEATHERSTONE SENIOR FELLOW, PETER G. PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS, WASHINGTON, DC

Mr. GOLDSTEIN. Mr. Chairman, I appreciate the opportunity to testify before this committee on the important issue of China's exchange rate policies. I want to highlight four points that are developed more fully in my written testimony.

First, over the past 5 years things have gotten much worse, not better, on China's external imbalance and its exchange rate policies. China's global current account surplus has grown without interruption, mushrooming from about 1 percent of GDP in 2001 to roughly 9 percent of China's GDP in 2006. China now has the largest global current account surplus in the world in absolute dollar terms, and for the first 2 months of 2007, China's trade balance ran 225 percent above the pace for the first 2 months of 2006. In short, the Chinese government has been allowing China's global external imbalance to expand out of control.

China's real effective exchange rate, widely regarded as a much better measure of China's overall competitive position than the nominal exchange rate between the U.S. dollar and the Chinese RMB, has actually depreciated since the dollar's peak in February, 2002. Some would have you believe that because the RMB-U.S. dollar rate has appreciated by about 6.5 percent since June of 2005, we must be making progress on the exchange rate front. The sad truth is that the RMB is now grossly undervalued, on the order of 30 percent or more against an average of China's trading partners and 40 percent or more against the U.S. dollar. The appreciation of the RMB that has taken place to date against the dollar is completely inadequate to make a real dent in this huge surplus.

When it launched its much-heralded currency reform in July, 2005, the Chinese authorities said they intended to increase the

role of market forces in the determination of the RMB. No such thing has happened. The Chinese authorities have continued to intervene in the foreign exchange market in massive amounts to keep the RMB from rising.

Second point, the international community is now operating without an enforced international code of conduct on exchange rate policies. Although China is a member of the IMF, the Chinese authorities continue to assert that they do not accept the concept of currency manipulation. Simultaneously, the Fund's managing director has maintained repeatedly that he rejects a role for the Fund as global "umpire" of exchange rate policies. Meanwhile, the U.S. Treasury has ruled repeatedly in recent reports to Congress that it cannot find China guilty of currency manipulation because it cannot prove "intent" to manipulate. The practical upshot of this is that we now have a free-for-all on exchange rate policy. Indeed, it is as if a new IMF charter has been informally agreed under which there are two guidelines. Guideline number 1 covers the obligation of countries; it states, "member countries shall do as they wish on exchange rates." Guideline number 2 covers the obligations of the IMF for exchange rate surveillance; it says, "Sorry, it is not our job."

Point number 3, this lack of progress on improving China's exchange rate policies is bad news for China, the United States, and for the international monetary and trading system. China's seriously undervalued and manipulated exchange rate makes it much harder for China to move to a more balanced and consumption-driven growth path and to implement a more independent monetary policy. From the U.S. perspective, the failure of the RMB to appreciate significantly has limited the helpful contribution that exchange rate changes in Asia could make to bring about improvement in the U.S. global current account deficit and to reduce the risk of a dollar crash and a hard landing for the U.S. economy. And China's currency manipulation could lead to retaliatory trade responses in the U.S. and perhaps in Europe and Japan as well, much to the disadvantage of all parties concerned.

Point number 4, China should deliver right away a meaningful downpayment of a 10- to 15-percent appreciation of the RMB from its current level. Because China has waited so long to take decisive action, the undervaluation of the RMB can no longer be eliminated in one go. A sizable up-front adjustment is needed if China is to escape from being so far behind the curve. A modest upward rate of crawl of the RMB relative to the dollar—by, say, 5 percent a year—is not going to get the job done in an environment where the dollar itself is likely to be falling to help reduce the U.S. current account. The U.S. Treasury should press for putting the exchange rate issue at the very top of the agenda for the May, 2007 meeting of the Strategic Economic Dialogue and for keeping it there until greater progress is made.

Failure by China to drastically reduce its large-scale, one-way intervention in the exchange market should result in a finding of currency manipulation in the Treasury's May, 2007 report to the Congress. It is regrettable that, at least so far, U.S. Treasury Secretary Paulson has given higher priority to policy proposals that lie outside the realm of exchange rate policy, such as reforming Chi-

na's capital markets. To ensure that the U.S. approach to correcting global payments imbalances is evenhanded, the U.S. should indicate it is prepared to offer a new longer-term plan for greater and more durable fiscal consolidation in the U.S. Finally, the IMF should return to its roots by taking in earnest the role that its founders set out for it as the global umpire for exchange rate policies. The U.S. should marshal support from both industrial and large emerging economies to see that this happens. The problem with the IMF's existing guidelines for surveillance is not in their design but in their enforcement.

I look forward to answering your questions.

The CHAIRMAN. Thank you, Mr. Goldstein.

[The prepared statement of Mr. Goldstein appears in the appendix.]

The CHAIRMAN. Mr. Makin?

STATEMENT OF JOHN H. MAKIN, VISITING SCHOLAR, AMERICAN ENTERPRISE INSTITUTE, WASHINGTON, DC

Mr. MAKIN. Thank you, Senator Baucus, and thank you for inviting me to testify. My prepared testimony is submitted for the record.

You know, I guess we only have 5 minutes, and it is——

The CHAIRMAN. You can take 6.

Senator BUNNING. Or 7 or 8.

Mr. MAKIN. But, you know, I only have one point to make, but a lot of things follow from that, and that is simply this—and that is what I have tried to cover in some of the written testimony that I have submitted. The point is this: Certainly, China's policy of setting its currency at an undervalued level is unmistakably happening. You cannot accumulate $250 billion a year in foreign exchange reserves without doing that, so I do not know what the Treasury is thinking when they say that the Chinese are not manipulating their currency. They are.

However, currency manipulation is not the main issue. There has been much intransigence on the currency issue. More important is the question of where can we find some common interests, some things that everybody ought to worry about? And there I think it is clear that the financial risks that are entailed by China's policy of undervaluing its currency are substantial. You can set the price of your money or you can set the quantity, but you cannot do both. If you set the price of your money too low, as China is doing, you are going to have a huge increase in the quantity of money. Incipient and actual inflation are going to grow, and eventually you are going to have massive financial instability.

My main point today is that China is heading for a major financial crisis because they have allowed annualized growth of the money supply of 20 percent. So far the faster money growth is not showing up in goods inflation. It is showing up in asset market inflation. I suppose I could have a chart of the Shanghai stock market, but I can assure you it goes up very fast—well over 100 percent this year alone.

In February, we saw the first example of volatility in the market. Shanghai shares dropped by 9 percent in a single day. It has since come back, but we are seeing increasing signs that China cannot

sterilize the massive liquidity inflow resulting from their intervention policy. In other words, they have lost control of liquidity inside China. That is a lethal combination with China's poorly structured financial sector and a banking sector that is insolvent and run by a group of people who know little about how to manage assets.

So now that China is suggesting that they actually ought to diversify their reserves, I am even more nervous because now we will have the people who have mismanaged asset allocation start thinking about how to diversify $1 trillion in Chinese reserves. That is not the right way to go.

The right way for China to go is gradually to move toward allowing the private citizens in China who have accumulated tremendous wealth in the course of China's very rapid growth to diversify their own savings. Right now the Chinese government does it on behalf of the Chinese by buying Treasury securities. That is very convenient for the United States. And at some point, I think if they transition toward allowing more of the capital, more of the wealth that is growing in China to flow out, the currency problem would take care of itself. That is, we would have a situation where there would be less—you would have inflows and outflows. Right now China is like a goose that is being stuffed with liquidity. The central bank buys foreign exchange. It creates a tremendous increase in liquidity. It allows some of it to go out into global capital markets, but there is a tremendous growth of liquidity inside China that eventually is going to cause a financial bubble-then-collapse on the scale that we saw in 1997 and 1998 in Asia. The Chinese largely escaped that crisis in the late 1990s, but our next financial crisis is going to come from China.

While it is certainly true that there are trade issues, and my fellow panelists have covered them well, there is rising tension surrounding the massive increase in Chinese exports that is part and parcel of an undervalued currency. When exports are rising—I think Morris Goldstein said it—220 percent per year over the first 2 months of this year, it is ridiculous to suggest that the Chinese currency is not misaligned. But I am saying that there is a bigger danger than rising trade tension. The financial instability that is going to follow from this policy will spread to the rest of the world. I do not know what Chairman Bernanke is saying today to the Joint Economic Committee, but if the U.S. economy is simultaneously slowing, as I think the Fed is hinting it is, the finanical instability/rising trade tension problem is going to get worse.

We have seen it before, in the Asian tigers in 1997–98, and we saw a similar pattern in Japan through the 1970s and 1980s, when Japan had a huge domestic investment boom built on the back of an export surge, built in turn on the back of an undervalued currency. In the 1980s, the Japanese proved that the private sector can invest too much, and the stock market collapsed in 1990. And in the 1990s, the Japanese proved that the public sector could invest too much, after and during which they had a very long recession.

The Chinese are playing the same dangerous over-investment game that other Asian currencies have played of undervaluing the currency and pursuing export-led growth. The very least that the U.S. Treasury could do would be to increase the pressure on the

Chinese to stop interviewing and exacerbating the destabilizing over-investment trend.

Unfortunately, the Chinese are not going to change. Perhaps I should be more hopeful, but, remember, China is a single-party system; the Communist Party is in charge. The leaders of the Communist Party are people anxious to maintain the status quo. They do not really understand financial markets very well. And they are not going to allow China's very capable bureaucrats to make these radical changes. So I am very concerned that what we will see going forward is continued Chinese intransigence. Probably there will be some action from the Congress. Given what is happening in the trade sector, it would be understandable but perhaps unfortunate. But there it is.

That said, when I go to China and I talk to the very competent people who are actually doing the day-to-day work of running the system, I say, "Look, you have to start to allow money to flow out, you have to start to let the currency move, you have to upgrade your financial system." And they acknowledge that, yes, there is a lot to do here, but they are very much constrained by the powers that be, those who essentially make the big decisions in China. The big decision in China that has not been made is to allow the Chinese citizens who have gotten very wealthy very fast to invest globally. And so the money piles up; the currency continues to have tremendous incipient pressure and actual pressure to appreciate. And until we can convince the Chinese that it is really in their interest to let their citizens diversify their assets and not have the government do it, as is currently being proposed and discussed on the front page of the *Financial Times* today, we are going to have a serious problem and one that is probably worthy of great concern.

Thank you.

[The prepared statement of Mr. Makin appears in the appendix.]

The CHAIRMAN. Thank you, all of you. It has been very stimulating, very constructive, all four of you.

The basic question I have is, what are your thoughts on how to deal constructively with the inherent tension—you have touched on it, Mr. Makin—between free market forces in the world today in globalization that are just so vast and strong, on the one hand, and a centrally controlled economy on the other. Some of you suggested in your testimony that you have some ideas you might bring out in the Q&A on what regulatory reforms can be taken or what other reforms can be taken in China to help address the underlying problems, which are concomitant with the currency peg problem. But the question, for me, anyway, is how do we get from here to there? How can we as Americans be constructive in helping make all this happen a little more quickly? In some sense, China is a 3,000-year-old country. In another sense, it is only a 50-year-old country. I think when Secretary Summers was here not too long ago, he pointed out that in the 19th century, the Industrial Revolution, Europeans' incomes doubled in a lifetime. In China, they are increasing a hundred-fold in a lifetime. It is such a new and expansive country, and a lot of market forces have been unleashed, but it still is all controlled by Premier Wen Jiabao and President Hu and others.

So your thoughts on how we manage this in a solid and constructive way. Back in the 1990s, when the Asian tigers' currencies fell, I can remember this front-page photograph, a cover story of *Time* magazine. I think it was Summers and Rubin and the Fed Chairman all together working with countries to kind of control it, talking to bankers and so on and so forth. But I just sense there is not a lot of back-channeling communication between the U.S. policymakers, Chairman Bernanke, for example, and the head bankers and the President of China and so forth and developing trust in how to get from here to there.

So I would appreciate your thoughts on just how we can be effective here, some of the ideas that you have, and I will just go down the table here and start with you, Mr. Roach.

Mr. ROACH. Thank you. I think that there are a number of things that we can do in our approach in dealing with the Chinese that need to be carefully considered. I do think that we need constructive as opposed to destructive engagement with the Chinese, given the important role that they play in funding our massive external imbalance. I think we have to be very careful that we do not do anything that would significantly alter their appetite for showing up at the next Treasury auction. Their absence would, I think, have significant consequences for the U.S. dollar, real interest rates, and broader world financial markets.

I would argue that we need to do three things in particular in engaging the Chinese on a constructive basis.

Number one, do everything we can to help them encourage the pro-consumption rebalancing that I alluded to in my opening remarks. This shifts the Chinese trade dynamic from exports to imports, alleviates the external imbalance, and provides significant opportunity for U.S. industries who are engaged in exporting the types of products that the Chinese actually do have a voracious appetite for.

Number two, I think we really need to get off the currency fixation, which is understandably an outgrowth of our legacy of a manufacturing society, and look much more carefully at the intellectual property rights issue, which is right at the core of who we are today as a knowledge-based, information service-dominated society. There are huge issues with respect to China that need to be addressed and addressed aggressively, and I would urge you on this committee to look at this very carefully. This is not only in our best interest as the world's leading knowledge-based economy, but it is increasingly in China's best interest as they migrate from manufacturing to services.

And, thirdly, the issue has been pointed out repeatedly on the areas of Chinese WTO compliance. If there are issues there, if they have not lived up to the letter of the accession agreement that was signed several years ago, they must be held accountable for that, and we do have a WTO compliance mechanism that should be used more aggressively to deal with those issues if we do think that there are issues.

And, finally, I would be remiss in not saying, again, this is not just about us getting China to behave in a way that alleviates the tensions; we need to look at what we as a Nation need to do to al-

leviate those tensions by focusing on our very serious shortfall of national saving.

The CHAIRMAN. My time has expired, but very briefly, if any one of the remaining three want to answer—yes, Mr. Goldstein?

Mr. GOLDSTEIN. Well, I think there are three things that we can do.

First of all, we have to put much more emphasis on rules of the road for currencies, and those have to go through the IMF. We have such rules, and the problem is they are not being enforced. The IMF should be at the center of this. This is their job. I worked at the IMF for 25 years, so I am a little bit familiar with what their mandate is.

The CHAIRMAN. Why are they not doing it?

Mr. GOLDSTEIN. I do not know. Mr. de Rato says he does not want to do it. It is as if he wants to be a coach. He does not want to be an umpire. But we have enough coaches. What we need in this game is an umpire. That is the only way. You are not going to get globalization and keep market access where you want if people feel that they are getting totally unfair treatment. And this manipulation is unfair treatment, and it needs to stop, and someone needs to call it. And the agency that has to do that is the IMF.

The CHAIRMAN. Do they have the power to be the umpire?

Mr. GOLDSTEIN. They do. I think they can certainly make a ruling. A problem you have is right now I think this currency issue comes off as a difference of opinion between the U.S. and China. We want them to go fast; they want to go slow.

It cannot be a difference of opinion. What they are doing is illegal, and it has to be seen that way, and then it has to be negotiated.

The CHAIRMAN. Well, thank you very much.

Senator Bunning?

Senator BUNNING. Thank you, Mr. Chairman.

First of all, it seems to me—and I deeply appreciate all four of you being here—that there is a basic difference in my approach with China than all four of your approaches. One, Mr. Makin made the suggestion that they are a controlled economy. They are not free to do what they want. Most of the people who are bureaucrats over there are bureaucrats only because they make the decision that the higher-ups tell them to make. In other words, they do not have the option of adjusting their exchange rate like somebody over here does.

I find it unbelievable that we think we can deal with China as a non-Communist country, that there is free and open exchange. I can tell you this: six members of this committee's Trade Subcommittee took a trip to China to visit with their Trade Minister, and they refused to meet us. Refused to meet with us, sent some other bureaucrat to give us about 2½ hours. The congressional delegation was led by my good friend Senator Smith here, and they could care less what we thought as legislators.

This Strategic Economic Dialogue that was started is nothing more than talk, talk, talk; talk, talk, talk; never get anything done. I do not care if the President of the United States is dealing with the President of China or the Prime Minister or whoever it might be. We cannot get through and will not break through. And that

is one reason why the International Monetary Fund is not doing their job. They do not want to upset the Chinese government. And for us to sit here and expect them to comply with the WTO, that is one of the most hilarious things I have ever heard.

They passed all the laws; when they got to the WTO they said we are going to do X, Y, and Z; now they have not enforced one of them. Not one of them. You can walk down any street in Beijing, as we have, and you can buy anything you want, illegally made by the Chinese. Intellectual property laws are just being ignored completely by the Chinese government, even though the law is on the books.

So all your wonderful suggestions on how we are going to get this done legitimately and without any upset of the Chinese government—and we do not want to upset them because they own so much of our dollar assets—in my opinion is not the way to do it. We have to take action. The government of this country has to take action through its legislative body. The legislative body is the only one that is going to act because, obviously, our administration is frightened to do anything, either the Secretary of the Treasury or the Trade Representative or anybody who has anything to do with trade or banking or anything else. All good suggestions are not being taken seriously by the other side.

And I do not blame them. Right now they have the best of both worlds going for them. They cannot see past 1 year or 2 years. Unfortunately, looking 10 years down the road or 15 years down the road, we are going to have a tsunami of problems in China and U.S. relationships. And I can tell you this: I for one am so sick of listening to everybody make excuses for China and our relationship with that country, that I for one want to do anything I can, along with Senator Stabenow, to give us a remedy—a remedy for our relationship with the manipulation of their currency.

Thank you.

The CHAIRMAN. Thank you, Senator.

Senator Stabenow?

Senator STABENOW. Thank you, Mr. Chairman, very much for this hearing, and just to add to what Senator Bunning indicated, I am pleased to be joining with Senator Bunning in legislation that would take out the requirement to show intent when we are looking at currency manipulation. Every 6 months when the Treasury Secretary comes forward, he says, “Well, we all know that this is happening, but it does not quite meet the definition of the law.” And the question seems to be intent, as was raised by the panelists. And so we would take out the word “intent” and would allow this to be viewed as a subsidiary, which it is. We have had overall, because of China’s policies, a loss of over 1.5 million jobs in the United States, and over 800,000 of those jobs, good-paying jobs, are pegged to the currency policy, which is what I keep going back to, that it is an important discussion we are having. It is much more than theoretical. It is affecting real people’s lives every day by what is happening.

I did want to go in a little bit different direction, though, Mr. Chairman. I appreciate all of the witnesses, and I appreciate your inviting Mr. Goldstein, who included in his comments not only about the Chinese RMB but also the Japanese yen. And I did want

to follow up specifically because I concur with my colleague's concern about China, but I also want to speak from the standpoint of Japan where we see something similar happening. And, in fact, we have seen—not to advertise a book—in John Taylor's book called "Global Financial Warriors," where he stated that the U.S. actually has supported what Japan has been doing. He did not mean it as a criticism. He was just stating it as fact. But he did indicate that our policy toward exchange rate intervention in Japan was—and this is during 2001 to 2005—part of our effort to be supportive of quantitative easing. By not registering our strong objections to the intervention, effectively allowing it to happen, we made it easier on the Japanese to pump up their money supply. Unfortunately, the result, according to the *Economist,* has been the fact that the yen is undervalued by as much as 40 percent right now. And certainly coming from the great State of Michigan where 2.2 million vehicles came in from Japan, more than were built here last year, when you put a 40-percent discount on that, you are creating the most unlevel playing field I can imagine. And that does not even account for the fact that our automakers are paying for health care and pensions, et cetera. It certainly starts with an incredibly unlevel playing field.

The other concern that I have is that we are told that an increase of 1 yen to the dollar adds anywhere from $160 million to $260 million in operating profits of Japanese auto companies, which is fine, but since that is done in what I would argue is an illegal manner, we are creating a way for them, Mr. Chairman, to invest in alternative advanced battery technology or do other things to compete with us by taking those dollars and investing them and having more opportunity to do that than those in the United States are able to do.

So I did want to ask specifically about that. I have, in fact, introduced a bill today dealing with the Japanese currency situation. It is a very reasonable bill. It comes out of great concern that when we look at the last G–7 conference, the European members wanted to talk about the Japanese yen situation. It was only the United States and Japan that did not want to do it. And I believe that we need to put in place a series of report mechanisms and requirements to work with the IMF, to work with Japan, to require that we bring this to the G–7, so that we can begin to address what clearly not only has been identified but put into a book that it was conscious American policy.

So after those comments, let me just ask particularly Mr. Goldstein if you might speak to what is happening with the Japanese yen and how you see that, as well as the Chinese situation, being of concern.

Mr. GOLDSTEIN. Senator, I think there are some elements in common and some important differences between the yen and the RMB. Both are undervalued. I think you are right that the yen is substantially undervalued. The question is: What is Japan doing that is illegal to make that happen?

In China's case, we have large-scale, one-way, prolonged intervention year after year, 10 percent of GDP. This is robbing the car right in front of the police station. This is the most obvious case of manipulation you can get.

Now, you referred to the John Taylor book. Japan was involved in very heavy intervention, massive, in 2003 and the first quarter of 2004. Since then, they have stopped. So making the case that somehow Japan is manipulating I think is a much harder one than for China. You might argue that the interest rate should be a little higher given where that economy is going, but this is not a case of intervention being the tool for manipulation.

Senator STABENOW. If I might just intercede and just ask, would you not agree that the Bank of Japan has sent many messages that, in fact, they are open and willing to do this again, and as a result of that the yen's real effective exchange rate has been at the lowest in 20 years? So they certainly have sent every indication, every message. Even though you are right it is indirect, it is not as obvious in what they are doing, the effect is the same in terms of what is happening right now.

Mr. GOLDSTEIN. Well, were they to start doing it again, then I would say they are manipulating. And if they do it for a prolonged period—the three adjectives that, you know, one looks at with manipulation on intervention are "large scale," "prolonged," and "one way." That is what we have had in China. If Japan starts doing it again, I think that they also ought to come under very high scrutiny. But I have not seen it since the first quarter of 2004.

Senator STABENOW. Yes, sir?

Mr. ROACH. Just one thing. Do not forget, Japan has been through a period of rolling recessions and deflation for 15 years. It is debatable whether they have come out of that. So to deal just with the currency in isolation I think overlooks a key aspect of Japan's own economic conundrum.

Senator STABENOW. And I appreciate that. Let me just say in conclusion, though, that the reality is that we are looking at an undervaluation of up to 40 percent which is affecting Americans and American jobs and American businesses. And so to that extent, while it is different and less obvious, I would argue that, again, going back to the question of intent, we need to look at what is happening as well as intent or how obvious it is that there are impacts.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator Smith?

Senator SMITH. Thank you, Mr. Chairman.

Gentlemen, thank you for your presence here today. I could echo many of the comments my colleagues have made. I could certainly point out the amazement, you know, that I shared with Senator Bunning when seven members of the United States Senate Finance Committee went to Beijing, and they did not want us to meet with their Trade Minister. But it gave us time to wander the streets of Beijing and see all the flagrant, frankly, violations of Chinese law, Chinese agreements, international law, in terms of the theft of intellectual property.

I could dwell on those things, but I will not. I guess I really want to focus on a question that our Chairman touched on. I would like you to speak to it in a little more depth, and that is, on a macro level, are we in a place now where we lend so much—or the Chinese buy so much—of our currency, so much of our debt, that they

are now our financier so that we do not have leverage to change their behavior through pressure because, if we did, it would lead in this country to high inflation, punitive interest rates, collapsing stock and housing prices? Are we at that point in our relations with China and in terms of just immutable economics that that is where we are?

Mr. PRASAD. First of all, Senator, let me say that rather than thinking about China as having a sort of choke hold on the U.S., I think one could flip it around and think about exactly how it is that the U.S. could help itself in this relationship. And I think this is where the issue of constructive engagement comes into play.

Senator Bunning spoke about how China is a command-and-control economy, and that is in a sense very valid. But one thing that is very important for the Chinese leadership is still to maintain high and relatively stable growth, because to them that is a very important part of being able to maintain the current status quo.

So in a sense, reorienting the dialogue in a way that makes these sorts of connections I was talking about clear to them and how this is very important for the longer-term growth, not just outward growth but employment growth, I think is very important. And once you start working through the connections, then two things become very apparent. One is that through these mechanisms you will improve Chinese consumption growth because right now growth is very heavily biased towards investment growth and exports, so getting the Chinese consumer to consume more is very important. Second, getting the capital account more open will give U.S. financial firms and other financial firms from abroad more of a foothold in China. And for this, again, I think exchange rate flexibility should be seen as a part of the story.

So I think there is a very important element of getting this into the dialogue that basically by making these connections, you achieve what is in the Chinese interest, and that I think is ultimately going to benefit the U.S. as well.

Senator SMITH. I agree with you. I think clearly we can demonstrate a community of interest with us and the Chinese. But I guess really the question is: Who goes into chaos first—us or them?

Mr. ROACH. Just briefly, the short answer to your question is, yes, we are at a point where we have been asleep at the switch in dealing with the link between not saving at home and building up these massive current account deficits in the United States. At today's level of the current account deficit, we need $3.5 billion of inflows from abroad every business day of the year. The Chinese are playing a big role in this. If we close them down, we are going to have to lean on somebody else.

So we are in a much more precarious place from a macroeconomic point of view for precisely the reasons that you address. This is our problem that we need to address. There are issues with China that we can deal with, but we cannot lose sight of the question you just raised.

Senator SMITH. All right. You other gentlemen, real quick. I do not want to take my colleagues' time, but it is a very important question.

Mr. MAKIN. Let me offer a comment. You know, I remember in terms of who is in control here—and I want to echo a comment that

was made before. I recall an experience in August of 1971 when the United States was under a great deal of pressure about its currency policy. People were very unhappy with the U.S. for not doing more to adjust, and the Nixon administration took unilateral action, which in effect caused the dollar to depreciate a great deal. And then-Treasury Secretary Connally very effectively negotiated, because the foreign governments were all saying the dollar needs to go down, it is terrible, blah, blah, blah. And he said, "Well, how about 20 percent?" And they all shut up real fast, because if the dollar goes down by 20 percent, our friends in Asia, who are very dependent on exports to the U.S., will find themselves in a much more difficult position. Furthermore, access to our wealth storage markets—*i.e.,* the Treasury market—is very valuable. I am always amazed to hear the U.S. current account balanced called "unsustainable." Something that has been going on for 4 or 5 years has to have some element of sustainability, and it is that, where else are the Chinese going to store hundreds of billions of dollars if not in the U.S.?

So I think we have considerable leverage with the Chinese, and in terms of what to do, we could start by having the Treasury acknowledge that they are manipulating the currency and then try to engage with the government to get them to move faster on financial deregulation, including more presence of sophisticated financial managers in China from Western financial institutions, like Goldman Sachs, I suppose, and allow the Chinese citizens, again, to invest more abroad. Let them choose.

That said, I go back to what I admitted before. The people you are talking to are not the people in charge.

Senator SMITH. We tried to talk to them, too.

Mr. GOLDSTEIN. Senator, I agree here with Mr. Makin. I think the idea that we cannot do anything on the currency, we cannot call a spade a spade because we have to worry that if we do so, interest rates will soar here because of Chinese holdings of Treasuries, I think that is very much overdone. I think this is a large liquid market. The Chinese understand they have multiple objectives. We bring cases before the WTO, other things. We criticize human rights, military build-up, other kinds of things. It does not lead to a massive sell-off of U.S. Treasuries every time we criticize China. So I think these are exaggerated fears.

The CHAIRMAN. Thank you very much, Senator.

Senator Grassley?

Senator GRASSLEY. Thank you very much, and I want to explain to the committee and to the witnesses that I was gone the first hour because I was testifying before the Government Oversight Committee of the House of Representatives on a GSA issue that I have been investigating.

I am going to start with Mr. Roach. In your testimony, you acknowledge that China needs to develop and implement new technologies that would lead to cleaner GDP. China has already made a heavy investment in advanced industrial gasification technology which will substantially reduce particulate emissions and allow for carbon capture. Dow, Shell, General Electric, and Siemens have announced almost 60 major projects that have either been built or are

under contract in China. Ironically, advanced industrial gasification technology is still a start-up technology in this country.

In the Energy Policy Act of 2005, we provided that this technology is eligible for both government loan guarantees and investment tax credits, but yet the chemical and fertilizer industries continue to be concerned over the apparent lack of available investment from the United States financial markets.

From your perspective, where you sit at Morgan Stanley, can you comment on how China can engage in such extensive investments when the exact same technology in the United States struggles to find investors?

Mr. ROACH. That is a very tough question. China has a huge environmental problem. In my prepared statement, I outlined some of that. And I noted that the Chinese are now more focused on moving to a cleaner GDP than I have ever seen them. The Chinese admitted, Senator Grassley, that last year they failed to hit their emission reduction targets as well as their energy conservation targets. They cannot tolerate another failure.

Why can't we in the United States galvanize public support into dealing with environmental issues in the way that the Chinese have? You would know the answer to that better than I do. It is discouraging, and I think it does reflect the fact that there is not a broad political consensus in this country, a bipartisan coalition, behind these issues.

China can, of course, do a lot of things because of the nature of its system, but let me be very clear that they are a single-party system and at least last year did not make the progress that they wanted to make. They are redoubling their efforts this year. I think a year from now you will see more progress from China. They are much more at a crisis point on the pollution area than we are.

Senator GRASSLEY. But you just answered my question in the sense of a political body making a decision. What is there about Dow, Shell, General Electric, and Siemens investing in that country that we cannot get the same investment in this country?

Mr. ROACH. They have the opportunity and perhaps the incentives to do so. They can also partner with the government, an option that is not available in the United States.

Senator GRASSLEY. All right. Professor Prasad, in your testimony you state that the international community can be helpful in putting the exchange rate issue in a broader context. How, specifically, do you envision that working? And, specifically, is there a role for the International Monetary Fund? And if so, is the IMF properly equipped to handle this role? Or is reform of the IMF needed?

Mr. PRASAD. Senator, I was the IMF's Division Chief for China until recently, and I have just started at Cornell University, so I feel it would not be appropriate for me to talk about what the IMF's role should be. But I think the substance is very important, and I think the substance is really that we need to think about putting this discussion in the framework that will allow progress to be made.

I had spoken during my remarks about what monetary framework could really enable progress to be made, so, as I said, Marvin Goodfriend of Carnegie-Mellon University and I have argued that China should adopt an inflation objective which is basically a long-

run target range for the inflation rate and an explicit acknowledgment that low inflation is a priority for monetary policy.

So what does this do? What it does very critically is take the emphasis away from the exchange rate. It allows the exchange rate to become more flexible in the context of a broader reform package. But it focuses on what monetary policy can really achieve in the context of getting better growth and more sustained growth.

So, over time, the inflation objective would provide a basis for increasing currency flexibility, financial sector reforms, capital market opening and so on. So one could essentially set up very specific guideposts in terms of each of those steps that lead towards an objective, and this has been used in the past. For instance, when the Chinese agreed to WTO accession, they put in place a few commitments. There are questions about whether they have fully met the commitments or not, but they did use it very effectively to effect internal change by getting the resistance to reforms broken down and getting some more power on the side of those who did care about the reforms.

Senator GRASSLEY. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator Schumer?

Senator SCHUMER. Well, thank you, Mr. Chairman, and I thank both of you for having this hearing and working with us. And I apologize to the witnesses for not being here. I read their testimony before, but I am chairing the Joint Economic Committee where Mr. Bernanke is, so I am going to have to get back there soon.

Anyway, Professor Prasad, you argue that a flexible currency is a prerequisite for China to have a modern financial sector, not the other way around. It is interesting, because Secretary Paulson actually makes the opposite argument. He argues the Chinese cannot possibly float their currency before they reform their financial system, and that is what the Chinese government says as well.

Could you elaborate a little on the contradiction between what they say and you say?

Mr. PRASAD. This is a hugely important point, Senator. By flexibility, let me be clear that one does not mean a complete float of the currency. So if the currency were to float completely, you would need a completely open capital account, and that in my view is where the risk arises. Because if you open up the capital account fully without having exchange rate flexibility in place, then money could flow out at the merest whiff of danger. And this is a serious concern because in China the financial system is still not in good shape.

So if you allow a route for capital to flow out very quickly at the first sign of trouble, and if your exchange rate is being tightly managed at the same time, you run into trouble. And this is where, in fact, I think there is some educational element to making it clear to the Chinese that exchange rate flexibility is not the same thing as capital account opening, that it ought to come first.

Senator SCHUMER. It is sort of an escape valve. It relives some of the—I do not mean an escape valve, but like that anti-pressure valve on the pressure cooker, it allows some of the steam out.

Mr. PRASAD. It is a prerequisite, so if you did have capital desiring to flow out, having a flexible exchange rate would take some of the pressure off.

Senator SCHUMER. Exactly. All right.

Mr. Goldstein, in your testimony you state that we lack an international code of conduct on exchange rate policy. That is for sure, as the Chinese show. This allows the IMF and Treasury to dodge conclusions that China is a currency manipulator. I agree with both of those things.

Could you just give us a little idea what a well-designed code of conduct would look like? You can answer briefly now, but I would ask unanimous consent that maybe Mr. Goldstein be given the ability to answer that in writing in some more elaborate way.

The CHAIRMAN. Without objection.

Mr. GOLDSTEIN. Sure, Senator. Well, actually, we have a code. We have surveillance guidelines at the Fund that talk about things that countries can and cannot do, and one of the things they are not supposed to do is engage in large-scale, prolonged, one-way intervention in the exchange market. That is what China has been doing. And then there are other things dealing with trade policy and capital account measures and a number of others.

But it is not that we do not have the code. The problem is there is no enforcement of the code.

Senator SCHUMER. Right.

Mr. GOLDSTEIN. So when someone is doing something in obvious noncompliance, nobody says anything about it.

Senator SCHUMER. What do you suggest?

Mr. GOLDSTEIN. Well, I think as much pressure as can be brought to bear, both on the Fund and on the U.S. Treasury, to start calling those things straight. For example, I would not support any initiatives by this Managing Director until they get back in the business that they were created for, namely, to do the exchange rate surveillance. We certainly should not have voted for a quota increase for certain countries, for China when they were doing this.

So we have the WTO on trade policy as the umpire. Now we need something else on currencies, and the Fund is the place. If they were doing their job, the Congress would not have to be involved.

Senator SCHUMER. You are right. So you believe in ratcheting up the pressure using other economic levers to get that to be done?

Mr. GOLDSTEIN. Yes. I think it is not a second-order, arcane issue.

Senator SCHUMER. No, it is not.

Mr. GOLDSTEIN. What the Fund does is really important because, if the Fund were to rule that the Chinese are manipulating, it would have a lot more weight than the U.S. Treasury.

Senator SCHUMER. I would just ask you to elaborate on an enforcement mechanism.

Finally, a last question to Mr. Makin. You state that China is spending up to 15 percent of its GDP just to keep the yuan's value at below-market levels. Do you have any surmise at what point this becomes unsustainable? At what level of GDP does this reach a crisis with far-reaching consequences for the global economy? Or does it never?

Mr. MAKIN. Senator Schumer, I think my full testimony suggests that we are close to that crisis. I certainly agree with your comments on intervention, but I tried to emphasize that the consequences of the intervention are to create a huge burst of liquidity inside China that threatens instability on the scale that we probably saw in the 1997–98 Asian crisis. So I think we are close to a financial crisis inside China. We got a hint of that in the Shanghai market last month. We are seeing a lot of volatility there.

Let me just add a suggested reply to your question to Morris Goldstein. You know, I think that the behavior of Asian countries—and others, but mostly Asian countries—in the currency markets over the last decade has been inappropriate and counterproductive. The Japanese stopped only after having massive intervention. The Chinese are intervening at a level that is absolutely ridiculous and counterproductive for them. That is one of the points I have tried to make to the Chinese, and many of the Chinese bureaucrats agree.

I think two steps are called for. One, the Treasury simply has to cite China as a currency manipulator; and, secondly, the Secretary of the Treasury should say that we believe that exchange rates should be determined in the market, period. And I think that would go a long way toward getting exchange rates back to the level——

Senator SCHUMER. I would make a quick comment, with the Chairman's indulgence. I agree with you. When we visited China, Senator Graham and I, we found a lot of the economic people agreed. But the political people are so afraid of change, or at least change that they cannot control, that they reject doing it. I do not know if you agree with that.

Mr. MAKIN. I agree.

Senator SCHUMER. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

I would like you, Mr. Prasad—and others who want to can chime in here—to help us better understand the degree to which China's initiative in the QDII—that is, the Qualified Domestic Institutional Investor program—is working. As I understand it, certain Chinese insurance companies as well as the national Social Security fund can invest in overseas debt and money markets, open up a little bit the private sector, slightly. In addition the QFII, or the Qualified Foreign Institutional Investor, actions that China is starting to take to "liberalize," how much of an effect is that? And is that something we should encourage?

Mr. PRASAD. Senator Baucus, some progress has been made on that front. There has not been that much of a take-up of those and other schemes to allow capital to flow abroad, because there has been a fairly restrictive amount of asset classes that these QDIIs and so on can invest in. But the broader issue again comes to what this is meant to achieve.

At one level, allowing capital to flow out either through QDIIs or through allowing individual investors to take money out is a good thing. It helps individual investors and the economy to diversify its portfolio internationally. But the problem is that, if that is seen as primarily a route to avoid doing the right thing, which is moving

towards greater flexibility, then I think it does not really accomplish its objective. So as a substitute, it does not really work.

In terms of allowing QFII in, again, I think it is a very important part of the overall reform strategy to, in a controlled way, allow capital in to achieve what they think is very important, which is domestic financial market development. And on that, I think the emphasis is exactly right. They need to not only improve the domestic banking system, but to broaden financial markets, to get the equity markets in better shape, and the bond markets.

The CHAIRMAN. I would ask each of the four of you: What would happen if China were to move to a free market flexible exchange rate, say within a period of 1 year? What if a year from today it is 100 percent and they just move up fully? What would happen? What are the benefits and what are the costs? What is good and what is not so good? You raised your hand first, Mr. Makin, and both the pluses and the minuses, what do you expect? What would happen?

Mr. MAKIN. Well, there certainly would be some choppiness in currency markets and financial markets, but I think the bottom line is ultimately it would be a good thing. There are big problems in China right now. There are far too many resources in the traded goods sector, which shows up in their need to subsidize exports. Too many companies are not focused on the domestic economy, so that message would be to move toward a more balanced allocation of resources inside China.

The Chinese individuals who now have—you know, I think Americans take for granted all the ways we have to save, from housing to mutual funds and so on. And the Chinese have very few ways to save. So if you opened up financial markets, Chinese households would not have to get 2.5 percent from a state bank that is insolvent. There would be mutual funds formed, and they could start to invest abroad, and that would be a good thing to do.

The CHAIRMAN. Mr. Roach?

Mr. ROACH. I completely disagree. So from me, you get the typical lack of consensus for the economic experts. China is not a market-based economy. It is a blended economy. They are moving to marketize their economy, and they are actually moving at amazing speed. But to impose a market-based foreign exchange mechanism on a blended economy I think would be a recipe for disaster. The Chinese will not do it.

The CHAIRMAN. For example, what would happen?

Mr. ROACH. I think the financial system, which has made baby steps in the area of reform, especially the banks, would be very destabilized. I think the lack of capital markets in China, especially the bond market, would be set back significantly in China. And I think it would be an unmitigated disaster for the Chinese equity market. I would not recommend this as a prudent course of policy in any way whatsoever.

The CHAIRMAN. And what effect would that have on the United States?

Mr. ROACH. The Chinese could certainly cease to be a significant purchaser of U.S. Treasuries, which would have consequences for the dollar and real interest rates. I am less certain of that because another international lender may fill the void. But if you are ask-

ing me what would this mean for China, I think it would be a source of huge instability.

The CHAIRMAN. Mr. Prasad?

Mr. PRASAD. I used to be a bureaucrat, so let me give you a middle-of-the-road, consensus-building answer. [Laughter.]

I think that exchange rate flexibility by itself would be a very good thing for China. A pure float of the currency, which would mean a very open capital account, would expose the——

The CHAIRMAN. That is what I am talking about.

Mr. PRASAD. A pure float I think would be risky for the reasons that Steve Roach is talking about. But I do not think they need a free float right now. What they need is a more flexible exchange rate so that they have a better monetary policy so they can control the economy better. That should come first. The rest can come later. I think the rest is very important as well, but it should come next.

The CHAIRMAN. I am sorry. I do not quite understand the difference between free float and more flexibility. What do you mean?

Mr. PRASAD. So you can have the currency floating and responding to market forces, but without capital being allowed to freely come into and out of an economy.

The CHAIRMAN. All right.

Mr. PRASAD. So if you have capital coming into and out of an economy, that allows an additional dimension to which the exchange rate has to adjust. But you can have the exchange rate adjusting in response to trade, productivity, and other fundamental forces. You do not have a pure float, and for that you need an open capital account, which I think China is not ready for.

The CHAIRMAN. Mr. Goldstein?

Mr. GOLDSTEIN. Well, I think the effects would be mostly good. The exchange rate would appreciate because they would no longer be intervening to hold it down. Their current account would start to fall. They would be able to move interest rates up to help restrain investment. They would start to have less excess capacity in those export industries where it is now very large.

Yes, there would be some job loss in traditional export industries in China that have low margins, but on the whole, this would be a very good thing. And there would be less calls for trade retaliation in this country and others because they would begin to play by the rules.

So this would be a good thing. It would not be a disaster for the financial system.

The CHAIRMAN. Mr. Makin?

Mr. MAKIN. I just wanted to add that I think the Chinese would prefer a free-floating system. If you just allow the currency to float without opening up the capital account, there will be a strong tendency for it to appreciate, which is what they do not want. I think if you had a free float with free capital markets, it could go either way, which is what is supposed to happen in a free currency market.

It is very dangerous to constrain the exchange rate system between a float and a fixed rate because you bring in an element of arbitrariness that we see leads to ad hoc intervention programs. So I think you have to kind of go either to a floating system or a fixed

system. Again, you can control the price of money or the quantity. It has to be a clean move.

The CHAIRMAN. Does anybody else want to comment on that question now that you have reflected on it further?

Mr. ROACH. Well, you asked within 1 year, though, right?

The CHAIRMAN. Yes, a year.

Mr. ROACH. Again, I just reiterate my point that for a blended transitional economy, 1 year would introduce huge new risk into the Chinese reform equation, which would have significant implications for them, and for the global economy—an outcome which could really wreak havoc on world financial markets.

Mr. GOLDSTEIN. Senator, I would just say that I think the main problem is the RMB is too low. We need it to go up. It can go up. Either they can do a step revaluation like they did in July—but they only did it by 2.1; they need to do it by 10 or 15—or they can stop intervening and it will float up. Either way, the key thing is to get the price of the currency up. That is the main problem. Later on, we can talk about exactly how they——

Mr. ROACH. But, Morris, even you said right now you would not recommend a big move within a short period of time.

Mr. GOLDSTEIN. Well, I would recommend 10 or 15 percent in a short period of time.

Mr. ROACH. But that was not his stipulated scenario.

Mr. GOLDSTEIN. I would not go 40 in 1 year, but I would go 10 or 15 to get the thing moving because this——

The CHAIRMAN. I am sorry for taking your time, Senator Grassley. But what rate of appreciation do you think makes sense? What rate over what period of time? Very quickly.

Mr. MAKIN. Nobody knows.

The CHAIRMAN. Well, your best guess. Come on. [Laughter.]

Mr. MAKIN. I do not have to guess if you float the currency. Let the markets decide.

The CHAIRMAN. What is the right policy? Let us say you are a Chinese policymaker. You are the top guy. You are the one in charge. What would you do if you really wanted——

Mr. MAKIN. If you cannot float the currency——

The CHAIRMAN. Pardon me?

Mr. MAKIN. You cannot float the currency, so you have to pick a number, right?

The CHAIRMAN. No. I will rephrase my question. Just all things considered, the United States and China, our relationship and so forth, we all agree it is a problem: the currency peg, manipulation. So I am asking how do we, just that alone—well, if we start to appreciate the currency, if China starts to appreciate its currency and there is more flexibility in the exchange rate, I assume they will move more quickly in opening up the capital markets at the same time and put pressure on to do so, or they will realize they have to do so. So what rate do you think we as Members of Congress and the United States of America should reasonably push to accomplish our objective here?

Mr. MAKIN. Senator, I am not going to cooperate on this. In a sense, one of the main reasons that China's currency policy is bad is it puts the U.S. Congress in a position of needing to advocate a particular rate of movement. What they need to do is get out of the

intervention business and let the currency move at whatever rate the market decides.

The CHAIRMAN. So you would just open it up now today.

Mr. MAKIN. Yes.

The CHAIRMAN. All right. Mr. Goldstein?

Mr. GOLDSTEIN. Well, I would favor 10 or 15 percent immediately, and keep controls on the capital outflows. I think that is the main danger, given the weak financial system, that capital could flow out. But as long as you keep controls on the outflows pretty much, then after you have done the 15, then you can start to stop the intervention and let the market start to take it up. But you need that downpayment.

The CHAIRMAN. Mr. Prasad?

Mr. PRASAD. Now I will put on my professor's hat and say, "It depends." But, really, the fact is the objective, as you put it, is the key issue, and I think the exchange rate should be seen as a relative price, which is not crucial to the objective except through these indirect channels. The objective is: How do you get Chinese domestic demand rising so they can suck in more U.S. imports? How do we get them to open up their financial markets so that U.S. firms can have more of a presence there? And for that, flexibility again is very important, not a particular level of the exchange rate. As an economist, it is very hard to tell what the right level is.

The CHAIRMAN. Mr. Roach?

Mr. ROACH. I will be the outlier. Stay the course, 3 to 5 percent a year, push on other issues—IPR and America's savings agenda.

The CHAIRMAN. Thank you. I have gone way, way over my time. Senator Grassley?

Senator GRASSLEY. Mr. Goldstein, in your testimony you make a number of recommendations regarding the actions that the IMF should take with respect to currency oversight. How do you propose that we induce IMF to take those actions? And what steps can this committee take?

Mr. GOLDSTEIN. Well, as I suggested earlier, I would not approve any other initiatives by this Managing Director, this Fund management, until such a time as the Fund got back seriously into the exchange rate surveillance business. They ought to be issuing their own report indicating which currencies are being manipulated. They ought to activate this special consultations tool, which they have not used in about 20 years, where you just have a special mission devoted to the exchange rate, and one can put pressure.

I think it is also important that the Treasury take the first step by naming them as manipulators if they do not change their behavior. It is hard to ask the IMF to do this if Treasury in its own report to the Congress says, you know, "not guilty." Then you are asking the IMF to find them guilty after its largest shareholder has just let them off the hook.

So you have to start with your own house. Call it as it is, and start putting whatever pressure we can on the IMF to do what it was created for. As a colleague of mine puts it, it is one thing to be a conscientious objector; it is another thing if you are Commandant of the Marine Corps. And they are the Commandant of

the Marine Corps when it comes to currencies. That is what they need to be doing, in everybody's interest.

Senator GRASSLEY. In regard to your statement about this downpayment of appreciation 10 to 15 percent, are there risks associated with the approach, particularly in terms of fostering speculative capital flows and anticipation of further currency appreciation as opposed to the market?

Mr. GOLDSTEIN. Well, the best thing, you know, of course, would have been to do it in 2003, 2004. That is when some of us were talking about it, and then the misalignment was smaller. Then you could do it all in one go.

The problem, when it gets very big and you cannot do it in one go, is when you start to do it by anything more than a trivial amount, people come to expect it and then they realize they can make money on the appreciation. So then you start to get a big capital flow.

But given where we are, I would say the best we can do, let us do 10 or 15 and then try to float the currency after that. But in a way, we are already in the world of the second best. They let it get very big, and we cannot do it all at once, so we have to now break it up. But doing 4 or 5 percent a year is just not going to cut it because the dollar is falling as well.

Senator GRASSLEY. Thank you very much, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Grassley.

As you all heard, Senator Grassley and myself and Senators Schumer and Graham have agreed to put together legislation addressing Chinese currency problems, and we want to do it right, certainly WTO consistent, something that advances the ball, helps us get to more flexible exchange rates more quickly. Your advice as to what should or should not be in our legislation? What teeth, what leverage should be in and what should not be in, in your judgment? We want to be effective here. We certainly want to act. We are a little bit impatient. We want to be responsible, but yet, you know, be fair but firm.

Your thoughts on what should be in the bill. Some of you said, sure, call a spade a spade, a manipulator. The next question is: All right, saying that, what do we do? What should the legislation provide?

Who wants to go first?

Mr. ROACH. Well, correct me if I am wrong, but you and Senator Grassley did propose a framework to deal with many of these issues last year, Senator.

The CHAIRMAN. Yes.

Mr. ROACH. And I personally was very much in favor of the framework the way you laid it out. As I understand it, since you recognized that the U.S. Treasury did not have the staff to go through a full-blown exercise twice a year, you would turn that over to the economists at the IMF.

You also argued—and I think this is a very good point—to change the concept of currency concern, away from the politically contentious issue of manipulation, which implies intent and motive, to one of misalignment, which is more of an analytically objective framework.

I thought those were excellent proposals. You also addressed the issue of the current foreign exchange review process by the Treasury. Actually, today, if you find a trading partner guilty of manipulation, there are no consequences. All the U.S. is required to do under those circumstances is to enter into negotiations. Under the bill that you introduced last year, there would be direct consequences that would flow from an IMF adjudication of a currency misalignment.

So I like the framework. I think you are going down the right road here. But, again, please do not think that the currency fix is the silver bullet that will address all the deeper issues that we have discussed today.

The CHAIRMAN. Other thoughts?

Mr. PRASAD. Chairman Baucus, first of all, I would like to support your emphasis again on taking the issue away from manipulation, which I think is not really economically terribly well-defined or constructive, in this context especially.

I think putting exchange rate flexibility in a broader context is important, and, in that context, things like the Strategic Economic Dialogue might have a role. But I think it is very important also to put more teeth into them in terms of thinking about the very specific intermediate steps that could be used as guideposts for this. The Chinese are very effective at using deadlines when they see the process as being in their own interest, and I think, again, the WTO accession example indicates that the reformers do use this quite effectively. So I think coming up with very specific guideposts is going to be important in this process, but within the context of a much broader framework.

The CHAIRMAN. Any ideas what some appropriate teeth might be?

Mr. PRASAD. One can think about very specific measures in terms of how much flexibility you allow, how much you open up the capital account, what sort of inflows and outflows you allow, and so forth. But, again, this has to be thought of in terms of a framework. If you thought of setting in place an inflation objective over a period of 5 years or 3 years, it immediately backs into a number of implications for the exchange rate and for capital account opening.

The CHAIRMAN. Thank you.

Mr. Goldstein?

Mr. GOLDSTEIN. Mr. Chairman, I would base it still on the IMF exchange rate surveillance guidelines. That is, as best we can, I think we do not want to have two sets of criteria, one in the IMF and one in the Congress. I actually think it is not a good idea to go to misalignment in the sense that many currencies are misaligned, but it does not tell you whose fault it is. You really need to have something that affects conduct, like intervention.

For example, a lot of people think the dollar is overvalued, but you would not say that we are manipulating, I do not think.

So I would go with the guidelines. I would have some teeth by saying countries who are found to be manipulating do not get market economy status; they cannot have quota increases in the Fund. And I think ultimately, although it should not be the first consequence, but down the road market access to the U.S. market has

to come up because you have to have something in the back that says if you persistently keep doing the manipulation, you will pay something in terms of market access.

The CHAIRMAN. What kind of market access?

Mr. GOLDSTEIN. Well, the U.S. market. Either it is going to be some kind of trade measure—I think in the end if you have persistent noncompliance after you have already ruled them to be manipulators, after you have tried the market economy and the other things, you have to have something that has consequences. I hope that does not happen, but if we get real recalcitrance just going on and on, then I think you have to do something along Schumer-Graham lines or something like that.

The CHAIRMAN. Mr. Makin?

Mr. MAKIN. Senator Baucus, first, I certainly want to commend your constructive attitude toward this process. I think it is important to keep that in mind.

The currency issue is about how you divide up the pie, and in addressing it, you do not want to make the pie smaller. And that is very difficult to do. Again, if you start limiting access to U.S. markets or undertaking some punitive measures that are unilateral, I do not think the U.S. Congress can legislate for China with regard to what they do with capital flows and so on.

This is a very difficult and touchy problem. I do not know the answer. I would ask that you would allow me to think about it and come back to you with some written comments.

The CHAIRMAN. That would be very helpful. In fact, in that regard I am going to keep the hearing record open until the propitious date of April 13th, Friday the 13th. I would appreciate any additional comments from any of you by that date.

In addition, I and other Senators will have questions for all of you right away. Hopefully you can answer those questions on a timely basis.

I have to run here, but this has been very helpful. It is very constructive. Thank you very, very much for taking the time and for your thoughts. You have helped advance the ball.

Thank you very much.

[Whereupon, at 11:57 a.m., the committee was adjourned.]

APPENDIX

Additional Material Submitted for the Record

Assessing Progress on China's Exchange Rate Policies

Morris Goldstein
Dennis Weatherstone Senior Fellow, Peterson Institute for International Economics

Testimony before the Hearing on "Risks and Reform: The Role of Currency in the U.S.–China Relationship"
Committee on Finance, U.S. Senate
Washington DC, March 28, 2007

Introduction and Preview

Mr. Chairman, I appreciate the opportunity to testify before this committee on the important issue of China's exchange rate policies. In my remarks, I want to demonstrate how meager has been the progress over the past five years in improving those policies; why this lack of progress matters for the economies of China and the United States, and for the international monetary and trading system; why several popular arguments and excuses for why more can't be accomplished are unpersuasive; and finally, what can and should be done to accelerate progress over the next year or two.

Previewing what follows, I will be emphasizing the following broad themes.

First, over the past five years, things have gotten much worse – not better – on China's external imbalance and its exchange rate policies. China's global current-account surplus soared to 9 percent of GDP in 2006 and the renminbi (RMB) is now grossly under-valued – on the order of 30 percent or more against an average of China's trading partners and 40 percent or more against the US dollar. The 6 ½ percent appreciation of the RMB against the US dollar since June 2005 has not even been sufficient to halt the cumulative improvement in China's competitiveness over the 2002-2007 period – much less to make a real dent in China's huge external surplus.

Second, the international community is now operating without an enforced international code of conduct on exchange rate policies. Although China has been engaging in large-scale, one-way intervention in exchange markets for the better part of four years, the Chinese authorities continue to assert that they do not accept the concept of currency manipulation. Meanwhile, the US Treasury has refused to label China as a "currency manipulator" despite overwhelming evidence to the contrary and the Managing Director of the IMF continues to reject the role of global umpire for exchange rate policies that was laid out for the Fund in its charter.

Third, this lack of progress on improving China's exchange rate policies is bad news for China, the United States, and for the international monetary and trading system. China's seriously under-valued and manipulated exchange rate makes it much harder for China to move to a more balanced and consumption-driven growth path and to implement a more independent monetary policy. It likewise handicaps efforts to strengthen China's banking system and raises doubts about China's intention to become a responsible stakeholder in the international monetary and trading system. From the perspective of the United States, the failure of the RMB to appreciate significantly has limited the helpful contribution that exchange rate changes in Asia could make to bringing about an improvement in the US global current-account deficit and to reducing the risk of a dollar crash and a hard landing for the US economy. If China continues to stonewall by blocking a significant real appreciation in its currency, it could adversely affect the operation of the global exchange rate system by generating an unfavorable demonstration effect for currency policies in the rest of emerging markets; just as important, China's currency manipulation could lead to retaliatory trade responses in the

United States and perhaps in Europe and Japan as well – much to the disadvantage of all parties concerned.

Fourth, several popular arguments that maintain that it is neither feasible nor desirable for China to take faster and bolder action in reducing markedly the under-valuation of the RMB are anything but convincing. A significant appreciation of the RMB will not be disastrous for China's growth, employment, or social stability. Bolder exchange rate action on the RMB will not cause major disruptions to China's banks, nor is it necessary for bolder exchange rate action to await further financial-sector reform in China. The IMF does not have good reasons for rejecting the role of global umpire for the exchange rate system. And having the US Treasury label China as a currency manipulator will not be counter-productive in motivating the desired exchange rate outcome.

Fifth, China should deliver right away a meaningful "down payment" of a 10-15 percent appreciation of the RMB from its current level. Because China has waited so long to take decisive action on the growing under-valuation of the RMB, the under-valuation can no longer be eliminated in one go. A sizeable up-front adjustment is needed if China is to escape from being so far behind the curve. A modest upward rate of crawl of the RMB relative to the US dollar -- by say, 5 percent a year – is not going to get the job done in an environment where the dollar itself is likely to be falling to help reduce the US current-account deficit. Bolder exchange rate action should be accompanied by an expansion and redirection of government expenditure toward weaknesses in China's social safety net – so as to reduce the incentives for such high precautionary saving. The US Treasury should indicate to the Chinese that henceforth it will consider movements in China's global current-account surplus, in China's real effective exchange rate, and in

China's monthly intervention in the exchange market as the key benchmarks for assessing progress on external adjustment and on currency reform. The Treasury should press for putting the exchange rate issue at the top of the agenda for the May 2007 meeting of the Strategic Economic Dialogue and for keeping it there until greater progress is made. Failure by China to drastically reduce its large-scale, one-way intervention in the exchange market should result in a finding of "currency manipulation" in the Treasury's May 2007 Report to the US Congress. To ensure that the US approach to correcting global payments imbalances is seen as even handed, the US should indicate that it is prepared to offer a new longer-term plan for greater and more durable fiscal consolidation in the United States. Finally, the IMF should return to its roots by taking up in earnest the role that its founders set out for it as the global umpire for exchange rate policies. The problem with the IMF's existing guidelines for exchange rate surveillance is not in their design but rather in their enforcement. There is no such thing as effective no-fault exchange rate surveillance.

Four Indicators

If you just read the press releases coming out of Beijing and Washington DC over the past five years, you might think that a significant improvement was well underway in China's external imbalance and its exchange rate policies. Let me recap four indicators that are more meaningful than the press releases and that yield quite a different verdict.

Indicator number one. China's global current account surplus has grown without interruption over the past five years, mushrooming from about 1 percent of its GDP in

2001 to roughly 9 percent of GDP in 2006.[1] China now has the largest global current-account surplus in the world in absolute dollar terms and it is larger relative to the size of the economy than even the troublesome US global current-account deficit.[2] And for the first two months of 2007, China's trade balance – which typically makes up the lion's share of the current account – ran 225 percent above the pace for the first two months of 2006. In short, the Chinese government has been allowing China's global external imbalance to expand out of control.

Indicator number two. China's real effective exchange rate -- widely regarded as a more comprehensive and superior measure of China's overall competitive position than the nominal exchange rate between the US dollar and the Chinese RMB – has actually depreciated by about 2 percent since either the dollar peak in February 2002 or the dollar's average value in 2001.[3] External payment adjustments call for appreciations of real effective exchange rates, that is, for declines in competitiveness, in countries with large global current-account surpluses. But China's real effective exchange rate has moved in a direction opposite to what is needed. Some would have you believe that because the RMB-US dollar rate has appreciated by about 6 1/2 percent since June of 2005 – from 8.28 RMB to the dollar to roughly 7.73 (as of March 22, 2007) – we must be making real progress on the exchange rate front. The sad truth is that the RMB is

---

[1] Note too that this large expansion of China's global surplus has occurred during a period when world oil prices have increased sharply (China is a net oil importer) and when China's growth rate of real GDP has been very rapid (pushing up its demand for imports).
[2] The U.S. global current-account deficit in 2006 was $857 billion – or 6.5 percent of our GDP. China's global current-account surplus in 2006 – expressed as a share of its GDP – was also considerably larger than was Japan's in the period of considerable bilateral trade friction with the United States.
[3] An "effective" exchange rate index is a weighted average of the country's exchange rate against its major trading partners, where the weights on individual currencies are typically related to the importance of that country in the home country's trade. A "real" exchange rate index adjusts movements in the nominal exchange rate for differences in inflation rates between the home and foreign country, since higher inflation represents a decline in price competitiveness just like an appreciation of the home currency. A "real effective" exchange rate index combines these two features.

now grossly under-valued – on the order of 30 percent or more against an average of China's trading partners and 40 percent or more against the US dollar – and that the appreciation of the RMB that has taken place to date against the dollar is completely inadequate to make a real dent in this huge surplus.[4]

Indicator number three. When it launched its much-heralded currency reform in July 2005, the Chinese authorities said that they intended to increase the role of market forces in the determination of the RMB. No such thing has happened. The Chinese authorities have continued to intervene in the foreign exchange market in massive amounts – to the tune of about $20 billion a month over the past year – to keep the RMB from rising; this is the same level of monthly intervention as in the six months prior to the announcement of the "new" exchange rate system. In each of the past three years, China's exchange market intervention has amounted to roughly 10 percent of its GDP – a truly extraordinary amount. Moreover, this heavy exchange market intervention has been accompanied by large so-called "sterilization" operations, thereby short-circuiting the process (of domestic monetary expansion and rising inflation) by which large reserve accumulation would otherwise lead to a deterioration in China's competitive position even with little flexibility in the (nominal) RMB exchange rate.[5] Whatever the rhetoric, the facts say that the RMB remains a heavily managed, quasi-fixed exchange rate.[6]

---

[4] For estimates and analysis of the under-valuation of the RMB, see Morris Goldstein and Nicholas Lardy, "China's Exchange Rate Policy Dilemma," American Economic Review, May 2006; Morris Goldstein, "Renminbi Controversies," Cato Journal, Spring/Summer 2006; and William Cline, "Estimating Reference Exchange Rates," Paper presented at Workshop on Policies to Reduce Global Imbalances," Washington DC, Bruegel, Korea Institute for International Economic Policy, and Peterson Institute for International Economics, February 8-9, 2007.

[5] When the monetary authorities "sterilize" the effects of exchange market intervention, they take offsetting actions (e.g., selling bonds or bills to the public) to ensure that changes in international reserves don't have much effect on the domestic money supply (and hence on the domestic inflation rate). It is often argued that if countries engage in heavy exchange market intervention, then they should not be allowed to also engage in heavy sterilization -- lest they block the changes in competitiveness that are necessary for

Indicator number four: compliance with China's obligations on exchange rate policy as a member of the IMF. Although each member country is obligated under the Fund's charter to desist from " ... manipulating exchange rates....," and although one of the leading pointers of currency manipulation is large-scale, prolonged, one-way intervention in exchange markets, the Chinese authorities continue to assert that they do not accept the concept of currency manipulation. Simultaneously, although that same IMF charter enjoins the Fund to exercise "... firm surveillance over the exchange rate policies of member countries..," the Fund's Managing Director, Mr. Rodrigo de Rato, has maintained repeatedly that he rejects a role for the Fund as global "umpire" of exchange rate policies. Meanwhile, the US Treasury Department, while increasingly critical of China's exchange rate policies, has ruled repeatedly in its recent reports to Congress that it cannot find China guilty of currency manipulation because it cannot prove "intent" to manipulate. The practical upshot of this is that the international community is operating without an enforced international code of conduct on exchange rate policies. Indeed, it's as if a new IMF charter has been informally agreed under which there are two guidelines on exchange rates. Guideline I covers the obligation of countries; it states: "member countries shall do as they wish on exchange rate policies." Guideline II covers the obligations of the IMF for exchange rate surveillance: it states: "Sorry, it's not our job."

---

effective balance-of-payments adjustment. China has been engaging in both heavy exchange market intervention and heavy sterilization of increases in its international reserves.

[6] Yes, there have been some welcome steps to create a market infrastructure and financial instruments that would assist the development of a floating exchange rate for the RMB (e.g., the introduction of interbank foreign currency trading and allowing banks to act as market-makers in foreign currency) – but these steps pale in significance next to the bottom-line, external imbalance and real exchange rate developments emphasized above.

Why It Matters

If progress on correcting China's external imbalance and on removing the large under-valuation of the RMB has been very slow or non-existent, some might say that it doesn't matter that much. I beg to differ.

Obviously, China's exchange rate policies matter most to China itself. The Chinese authorities have concluded for good reasons that they want to move from an investment and export-led growth strategy to a more balanced path that is driven by consumption and domestic demand.[7] They also would like to move toward a more independent monetary policy, to continue to strengthen their banking system, and to be regarded as a "responsible stakeholder" in the international system, with a role commensurate with China's growing weight in the world economy.

But China's seriously under-valued and manipulated exchange rate puts at risk achievement of all these worthy objectives. It's hard to restrain investment and to reduce the volatility of aggregate demand growth when you can't raise interest rates by much because doing so might attract large speculative capital inflows – thereby putting stronger upward pressure on the exchange rate. It's hard to divert resources away from exports and to reduce excess capacity in important tradeable goods industries when a highly under-valued RMB is sending price signals that go in the opposite direction. It's hard to improve the performance of banks when they have to hold an ever larger share of relatively low-yielding sterilization bonds in their portfolios, when they are subject to repeated increases in reserve requirements, when an under-valued exchange rate generates large increases in international reserves – some of which, even with heavy

[7] See Nicholas Lardy, "China: Toward a Consumption Driven Growth Path," Policy Brief Number PB06-6, Peterson Institute for International Economics, October 2006.

sterilization operations still finds its way into excessively rapid increases in bank loans, and when central authorities tell local credit officers how much and to whom to lend. And it's hard to maintain reliable access to industrial countries' markets for your exports and foreign investments -- and indeed, to convince others that you merit a larger leadership role in helping to manage the international monetary system -- when you insist (contrary to your membership obligations at the IMF) that your exchange rate policy is solely a matter of your national sovereignty and that others should accept a timetable for your external adjustment that might run into decades rather than the medium term.

Although their impact is often exaggerated, China's exchange rate policies also matter for the United States. I say exaggerated because the US economy is operating at full employment, and China's exchange rate policies are clearly not a key driver of aggregate employment in the United States, although they may impact particular industry groups. Likewise, one only has to look at China's weight – about 15 percent – in the Federal Reserve's trade-weighted index for the dollar to realize that isolated movements in the RMB would only have a limited effect on the US global current-account deficit; for example, a 20 percent appreciation of the RMB would by itself translate into only a 3 percent depreciation in the trade-weighted dollar; such a small dollar depreciation might improve the US global current account by perhaps $40-55 billion – a modest contribution if the aim is, say, to reduce last year's US current account deficit of $857 billion by about half. It is also true that there are important measures that the United States can and should take on its own to improve our aggregate savings – investment imbalance --

especially efforts to produce a durable reduction in the US budget deficit over the medium term.

Still, it is a mistake to downplay the helpful role that exchange rate changes in Asia can make to bringing about an improvement in the US external imbalance and to reducing the risk of a dollar crash and a hard landing of the US economy. Here, a significant real appreciation of the RMB could be an important catalyst. If the real effective exchange rate of the US dollar has to depreciate by say, another 15-20 percent to bring the US current-account position and the trajectory for US net foreign assets into a more sustainable position without an undue sacrifice to US economic growth, some other currencies clearly have to go up in value. The euro, the Canadian dollar, the Australian dollar and some other market-determined exchange rates have already experienced significant real appreciations and cannot do that job all by themselves. Japan plus emerging Asia carries a 40 percent weight in the dollar's average value. To get any kind of reasonably balanced burden of adjustment, the Asian region should absorb its fair share of the aggregate appreciation of non-dollar currencies, particularly given the large current-account surpluses and high reserve holdings in that region. Some Asian currencies – especially the Korean won, the Indonesian rupiah, and the Thai baht – have already shown sizeable real appreciations but a group of other Asian currencies – including the Chinese RMB, the Japanese yen, the Taiwan dollar, and the Malaysian ringgit – have not; most of them actually have depreciated in real effective terms since the dollar's peak in February 2002. Since China is a key competitive benchmark for others in the region, a significant appreciation of the RMB would make it easier for others to countenance an appreciation in their currencies. In short, what happens to

Chinese exchange rate policies matter for the United States because it affects how real exchange rates move in Asia more broadly and the latter is relevant for achieving an orderly correction of the over-sized US current-account deficit. To take an example, a 25 percent real appreciation vis-à-vis the dollar in China, Japan, and the rest of emerging Asia would probably improve the US current-account position by roughly $130-180 billion.

China's exchange rate policies also carry important implications for the future operation of the international monetary system and for efforts to maintain an open international trade and investment climate. If China continues to block a meaningful real appreciation of its currency, I see two risks for the system.

First, we could get a most unfavorable "demonstration effect" for currency policies in the rest of emerging markets. Suppose the lesson of China's exchange rate policies comes to be seen as follows: use a combination of heavy and persistent intervention in the exchange market, plus large-scale sterilization operations, and you too will be able to generate and sustain a highly under-valued real exchange rate that will be advantageous for achieving rapid economic growth. In such a case, we would see in the future much less real exchange rate appreciation in surplus countries and a smaller role for exchange rates in the correction of external imbalances. This would be distinctly bad news for the global economy and for the US economy.

The second risk is that China's currency manipulation will eventually lead to a retaliatory trade policy response in the United States – and perhaps in Europe and Japan as well. This will in turn destroy prospects for achieving what I have previously called a

win-win "grand bargain" between the industrial countries and the emerging economies.[8] In that grand bargain, the emerging economies would get good access to the large markets in the industrial countries for their exports and their foreign investments and they would obtain "chairs and shares" (greater representation and voting power) in the groups and institutions that manage the world economy that were consistent with their growing economic weight. In exchange, the industrial countries would get improved access to the growing markets in the emerging economies as well as a pledge from the emerging economies that the latter would play by the agreed "international rules of the game" on currencies, trade, and international property rights.

To believe that China can continue with its exchange market intervention policies for another say, five years and maintain a highly under-valued exchange rate that provides what Fed Chairman Bernanke rightly dubbed a "subsidy" to its exporters and still enjoy uninterrupted access to the US market is, I think, a fantasy.[9] Eventually, patience will run out and countervailing measures of one kind or another will be adopted – much to the long-run disadvantage of both sides. If there is not perceived "fairness" in exchange rate policy and not some agreement on what constitutes internationally acceptable behavior on exchange rate policies, it will be very difficult to sustain forward momentum on an open trade and investment climate or on globalization more broadly. If there is no competent and objective international umpire to referee disputes on exchange rate policy, then we will have lots of national "freelancing" as national legislatures step into the breach. Similarly, if the US Treasury sets a standard of proof for intent to manipulate

---

[8] See Morris Goldstein, "Exchange Rates, Fair Play, and the 'Grand Bargain,'" Financial Times, April 21, 2006.

[9] Ben Bernanke, "The Chinese Economy: Progress and Challenges," Remarks at the Chinese Academy of Social Sciences, Beijing, China, December 15, 2006.

that is in practice unreachable and rules "no foul" even after the third largest trading country in the world intervenes in amounts equal to 10 percent of GDP for three years running, sees its global current-account surplus grow eight to ninefold in five years, has its real effective exchange rate moving in the wrong direction, and is simultaneously experiencing booming economic growth -- then one shouldn't be surprised if the legislature comes to view those reports as a whitewash.

Myths That Thwart Progress

If progress on China's exchange rate policies has been slow or non-existent and if this carries adverse implications, what is preventing us from moving ahead faster? Well, one impediment has been a set of arguments maintaining that faster and bolder action on reducing China's external imbalance and its RMB under-valuation would be neither feasible nor desirable. Given time constraints, let me mention just four of these myths.

A very popular one is that a significant real appreciation of the RMB would be disastrous for China's growth and employment and hence, also for its social stability. I don't buy it. Between 1994 and early 2001, China's real effective exchange rate appreciated by roughly 30 percent; yet China's average growth rate during that period was 9 percent and in no single year did growth drop below 7 ½ percent. Employment in China's export industries accounts for roughly 5 percent of total employment – not 30 or 40 percent. During the period when China's investment and export-led growth has been most pronounced, employment growth has been noticeably slower than when growth was more oriented toward consumption and domestic demand.[10] If there is concern that

[10] See Nicholas Lardy, "China: Toward a Consumption Driven Growth Path," Peterson Institute for International Economics, October 2006.

significant RMB appreciation alone would be too contractionary, there is the attractive option of pairing it with an increase in government expenditures directed at health, education, and pensions. Such a strengthening of the social safety net would reduce the need for such large pre-cautionary saving and would contribute, along with the demand effects of increased government expenditure, to a larger reduction in China's external imbalance. Accepting the principle that countries should be allowed to manipulate the exchange rate so as to boost employment would make it impossible to discourage "beggar they neighbor" exchange rate policies at the international level: all countries have full employment objectives and it is not clear why some countries concerns in this area should be elevated above those of others. Why, for example, should an extra worker employed in China's export industry count for more than an extra one in Bengladesh, or Egypt, or South Carolina?

A second contention is that an appreciation of the RMB much beyond the rate of recent years would cause major disruptions to China's financial sector, particularly its banks, and that bolder exchange rate action has to wait until China's financial system is much stronger than today.

As outlined earlier, I think huge reserve accumulation, the need to place low-yielding sterilization bonds with the banks, and the reliance on window guidance to manage bank lending, actually makes large exchange rate under-valuation the enemy – not the ally – of bank reform. In the first two months of 2007, the growth of bank lending was again (as it was in 2003 and the first part of 2004) running far in excess of its target.

All of the major financial crises in emerging economies over the past dozen years or so have been characterized by large currency mismatches on the eve of the crisis.[11] But China's banks and their customers are much less vulnerable on the currency mismatch front than were the earlier crisis countries: China is a net creditor – not a net debtor -- in its overall foreign exchange position; where bank capital is required to be held in dollars, reports indicate that most of the currency risk is being hedged in the market; China's exporters have lower debt-equity ratios than firms in other sectors; and most of the largest exporting firms are foreign-owned and do not obtain the bulk of their financing in China's domestic market.

The most pressing constraints and challenges for China's banks do not stem from an appreciation of the RMB. China does have to be careful not to implement too quickly a wholesale liberalization of restrictions on capital outflows. This is because a completely open capital outflow regime could lend itself to a nasty bout of capital flight if Chinese banks were to suffer a spate of bad news. This is why I and my Peterson Institute colleagues have argued for some time that capital account liberalization should not be confused with currency reform in China and that the former should take place on a later time schedule than a significant appreciation of the RMB.[12] The correct diagnosis is that full capital account liberalization in China has to wait for a strengthening of China's banking and financial system – not that exchange rate appreciation has to wait for financial sector reform.

---

[11] See Morris Goldstein and Philip Turner, Controlling Currency Mismatches in Emerging Markets, Peterson Institute for International Economics, 2004.

[12] See Morris Goldstein and Nicholas Lardy, "Two-Step Currency Reform for China," Asian Wall Street Journal, September 12, 2003; and Morris Goldstein, "Adjusting China's Exchange Rate Policies," Peterson Institute for International Economics, 2004.

The principal challenge facing Chinese banks is how to increase profitability as China's overall financial market is being further liberalized. Owing in large part to a high incidence of bad loans, the return on equity in China's banks has historically been extremely low. Going forward, the Chinese authorities have indicated that they want to expand the roles of commercial paper, bond, and equity markets. Given China's large external payments surplus, they also would like to liberalize gradually restrictions on capital outflows. The rub is that if China's savers and borrowers do obtain greater access to alternative sources of funds and alternative investment opportunities, the huge prevailing spread between lending and deposit interest rates in Chinese banks (on the order of 350-400 basis points) – which is currently being maintained by restrictions/controls on interest rates – is likely to fall sharply. Jon Anderson of UBS has estimated that even a 100 basis point decline in this spread would have been sufficient to completely wipe out the profits of the four largest state-owned banks in 2005.[13] How then is profitability going to be maintained or increased if international banks in this post-WTO-entry landscape have a comparative advantage vis-à-vis domestic banks in generating fee-based income, if state-owned banks are reluctant to close yet many more branches and lay off many more employees, and if restrictions on majority ownership by foreign banks limits what can be accomplished in improving the credit allocation process.

Myth number three is that the IMF should not act as a global umpire for exchange rate policy – notwithstanding the mandate in its charter – because doing so would conflict with the IMF's role as "trusted advisor" to its member countries. But why should the two roles conflict unless the Fund were giving countries advice on exchange rate policy that

---

[13] See Jon Anderson, "The Sword Hanging Over China's Banks," UBS Asian Focus, UBS, Hong Kong, December 15, 2006.

violated its own currency manipulation guidelines? And even if the two roles did conflict, why is not the umpire role the more important one? Most games have two teams, two coaches, and at least one umpire – not two teams, three coaches, and no umpire. When there is no umpire, the quality of play invariably suffers. The IMF is the only institution with the mandate and resources to carry out the umpire role successfully; in contrast, there are many others who can act as a trusted advisor to countries.

Yet a fourth weak argument is that having US Treasury name China (or others) as a currency manipulator would only be counter-productive in motivating the desired exchange rate outcome and would brand the US as protectionist to boot. One might ask: why is the alleged link between external criticism and lack of policy reform peculiar to exchange rate policy? The US government does not refrain from criticizing publicly China's human rights abuses or its military buildup for fear that doing so will slow progress. In a similar vein, if the US government is willing to challenge publicly the legality of various aspects of China's trade policy or its protection of intellectual property rights, why must currency manipulation be treated differently? What sense does it make to ask China to be a "responsible stakeholder" if it is not acceptable for the United States to speak out when China is acting irresponsibly? And since when is condoning currency manipulation the friend of open markets? Does it make the United States "protectionist" to identify shortcomings in China's intellectual property regime?

Whether or not the US Treasury names China as a "currency manipulator," the Treasury will need to negotiate with the Chinese on altering China's exchange rate policies. But there is an important difference. When the Treasury finds that China has not been engaging in manipulation, it reduces the dispute to a bilateral difference of

opinion about how fast China should move on increasing the flexibility of the RMB – with China preferring a slow, gradual approach and the US favoring a more rapid one. After twenty five years of favorable experience with a gradualist approach to policy reform in other areas, the Chinese authorities think they know better which approach works best and favor their own view. In contrast, if China were found to be engaging in currency manipulation –not just by the US Treasury but also by the IMF – it would send a strong signal that the international community regards China's exchange rate policy not only as ill-advised but also as illegal and as counter to China's membership obligations in the IMF. The latter finding is apt to be a more powerful catalyst for a policy change in China than is a simple difference of opinion on the optimal speed of moving to a higher RMB. But it will be difficult to persuade the IMF to conduct a serious inquiry into China's alleged currency manipulation practices if the US Treasury itself rules repeatedly in its own reports to the US Congress that no currency manipulation has in fact taken place.

What to Do?

If recent developments in China's exchange rate policy are worrisome and if the arguments against faster and bolder policy actions are weak, what should China, the United States, and the IMF do to prevent a train wreck from taking place sometime over the next few years?

The priority for China should be to deliver right away a meaningful "down payment" of a 10-15 appreciation of the RMB from its current level. This could be accomplished either by a step revaluation of the RMB or by cutting way back on China's exchange

market intervention so that the RMB floated upwards. If China had acted in 2003-2004 to deal in a timely manner with its growing current-account surplus and with the RMB under-valuation, it could perhaps have erased the misalignment in one go. But the under-valuation of the RMB has now become so large, that a phased approach to exchange rate adjustment has become necessary. That said, it should be clear by now that a very modest rate of upward crawl of the RMB relative to the US dollar is not going to solve the problem. If the dollar depreciates in real effective terms by say, 15-20 percent over the next two to three years time, then say, an annual 5 percent appreciation of the RMB with respect to the dollar is not going to deliver the needed large appreciation in China's real effective exchange rate, that is, the RMB's path in real effective terms will be heavily influenced by the decline in the dollar. China has to escape from being way behind the curve on exchange rate adjustment. Drawing out the needed appreciation of the RMB over too long also carries that risk that once a non-trivial upward crawl of the RMB comes to be widely expected by markets, it could induce large speculative capital inflows. All of this is why Nick Lardy and I have long called for a significant step revaluation in the RMB as the first part of "two-step" currency reform for China.[14] Bolder exchange rate action should also be accompanied by an expansion and redirection of government expenditure toward weaknesses in China's social safety net, that is, toward the health, education, and pension areas – so as to reduce the incentives for such high precautionary saving. China should also abandon the rhetoric that the RMB exchange rate is a matter of Chinese national sovereignty and should reaffirm its commitment to the exchange rate policy obligations placed on all members of the IMF.

---

[14] Morris Goldstein and Nicholas Lardy, "Two-Step Currency Reform for China," Asian Wall Street Journal, September 12, 2003.

For its part, the United States needs to clarify and to strengthen its message on what it wants China to do on exchange rate policy, while simultaneously demonstrating its willingness to make a larger contribution of its own toward reducing global payments imbalances.

The U.S. Treasury should indicate to the Chinese that henceforth it will consider movements in China's global current-account surplus, in China's real effective exchange rate, and in the monthly amount of China's intervention in the exchange market as the key benchmark indicators in assessing China's progress on external adjustment and on currency reform. The Treasury should press for putting the exchange rate issue at the very top of the agenda for next meeting in May 2007 of the Strategic Economic Dialogue (SED) with China, and for keeping it there at future meetings of the SED until there is much greater progress in reducing both China's global external imbalance and its exchange rate under-valuation. The US authorities should also seek to marshal support from both other industrial countries and large emerging economies for establishing the Fund as the global umpire for exchange rate surveillance – recognizing that the alternatives are apt to be either a "free for all" on exchange rate policy or a patchwork of disjointed manipulation findings and trade policy responses from national legislatures. As part of this role, the Fund would be expected to make more frequent use of its "special consultation" tool whenever either another country or Fund staff raised questions about potential currency manipulation; the Fund would also begin issuing its own semi-annual report on exchange rate policies. Until such a time as the Fund assumes this role, the US Treasury should continue to issue its twice-yearly reports to Congress on international economic and exchange rate policies – but with the expectation that failure by China to

make a significant change in its exchange rate policy would result in a finding of "currency manipulation" in the May 2007 report.[15] It is regrettable that at least so far US Treasury Secretary Paulson has given higher priority to policy proposals that lie outside the realm of exchange rate policy (e.g., reforming China's capital markets). While reforms and improvements in China's capital and financial markets would offer many dividends in the long term – including to US financial service firms that want to be more deeply involved in China's financial development, such reforms are not a necessary pre-condition for making faster progress on China's exchange rate and external imbalance problems; nor should one discount the distortions and competitive disadvantages faced by other segments of the US economy due to China's real exchange rate under-valuation.

As suggested earlier, the Chinese exchange rate problem is part of the wider issue of achieving a better and more equitable pattern of burden-sharing in correcting global payments imbalances. To ensure that the US approach to this problem is seen as "even handed," the US authorities should assure the Chinese (and others) that the same benchmarks and methodology used to evaluate progress on external adjustment and exchange rate policy in China will be applied to other economies – be they industrial economies or emerging markets. Equally important, the United States should indicate that it is prepared to offer a new longer-term plan for greater and more durable fiscal consolidation in the United States. This in turn should give more confidence to other

[15] My Peterson Institute colleague, C. Fred Bergsten, has argued that as a spur to negotiation and to galvanizing a multilateral effort to reduce existing payments imbalances, the US Treasury should inform its G-7 colleagues and the IMF of its intention to label China as a currency manipulator in its next report to the US Congress (unless China makes a significant down payment in correcting its RMB under-valuation); see C. Fred Bergsten, "The Chinese Exchange Rate and the US Economy," Testimony before the Committee on Banking, Housing, and Urban Affairs, January 31, 2007.

countries and to private markets that the United States is addressing adequately its low national saving rate while making room for an expansion in US net exports that would accompany a depreciation in the real effective exchange rate of the dollar.

Last but not least, the IMF should return to its roots by taking up in earnest the role that its founders set out for it as the global umpire for exchange rate policies. It should be apparent by now that the "multilateral consultation process," launched with much fanfare by IMF management in April 2006, is no substitute for that umpire role. The WTO is already serving in a parallel role as global umpire for trade policies. Through the rulings of its adjudication panels, it is becoming clearer over time what is and what is not internationally acceptable trade policy. A similar exercise has to begin for exchange rate policy at the IMF. The best protection against protectionist trade policies is the assurance that a competent, unbiased international umpire is considering seriously potential abuses of exchange rate policy and issuing fair, well-reasoned findings. A good place to begin that exercise would be with the two controversial cases of the Chinese RMB and the Japanese yen. Such an exercise would be helpful in clarifying, for example, whether the under-valuation of the Japanese yen should be regarded differently than the under-valuation of the RMB because the Japanese authorities have not been engaging in large-scale, prolonged, one-way intervention in exchange markets since the first quarter of 2004, whereas the Chinese authorities have been doing so for several years running. There is no point in having a set of internationally-agreed guidelines for IMF surveillance of exchange rates if these guidelines are not enforced.

Mr. Chairman, to sum-up, the role of currency in the US-China relationship – the very title of this hearing – has not been handled well over the past four years. The primary

responsibility for this unsatisfactory state of affairs lies with China itself. The Chinese authorities have waited far too long in dealing decisively with their rising external imbalance and the growing under-valuation of their currency and they have not honored their obligations on exchange rate policies as a member of the IMF. But the United States and the IMF have hardly covered themselves with glory either on solving these problems. The US Treasury's almost exclusive reliance on "quiet diplomacy," the vague pleas for "greater flexibility of exchange rates in countries with large current-account surpluses" instead of calls for an immediate and significant appreciation in the real effective exchange rate of the RMB, and the tortured reasoning to justify a conclusion that China has not intended to "manipulate" its exchange rate (when all evidence pointed to the contrary) -- have sent weak signals to China and have produced meager results.[16] In addition, the United States has not done enough on fiscal policy consolidation to make a sufficient contribution to reducing our own large saving-investment imbalance. Meanwhile, the IMF has been largely "asleep at the wheel" in carrying out its own obligation to exercise "firm surveillance" over the exchange rate policies of its member countries.[17] There is no such thing as "no fault" exchange rate surveillance and no set of exchange rate guidelines will work in the absence of the will to enforce those guidelines. All things considered, a different approach is needed if we are to achieve greater progress in reducing global payments imbalances and in deterring trade policy actions that would be in no country's best interests. In this statement, I have outlined what an alternative approach might be and why I think it could generate better results. I look forward to answering your questions.

---

[16] The "greater flexibility" mantra has been a favorite in repeated G-7 communiques and in statements by US Treasury officials.

[17] The "asleep at the wheel" characterization of IMF surveillance on exchange rate policy was first offered by US Treasury Under-Secretary Tim Adams; see Tim Adams, "The IMF: Back to Basics," in Edwin Truman (editor), Reforming the IMF for the 21st Century, Peterson Institute for International Economics, April 2006. In a similar view, see Morris Goldstein and Michael Mussa, "The Fund Appears to be Sleeping at the Wheel," Financial Times, October 3, 2005.

China's Risky Currency Policy

Testimony Before the

Senate Finance Committee

Hearing on:

"The Role of Currency in the U.S.-China Relationship"

March 28, 2007

Washington, DC

John H. Makin

American Enterprise Institute

Overview

The risks attached to China's policy of heavy intervention in foreign exchange markets aimed at preventing appreciation of the yuan to market clearing levels go well beyond the serious, chronic trade tensions that have arisen from such measures.[1] The results of massive dollar purchases totaling over $700 billion since 2004 include: a damaging distortion of resource allocation inside China, building inflation pressure, and intensifying asset market bubbles. These problems are being exacerbated by the surfeit of liquidity that results largely from China's heavy currency intervention.[2]

As Chinese monetary authorities attempt to deal with the rising inflation pressures in markets for goods, labor, and assets, risks increase for a return to a 1997-style Asian financial crisis that could entail damaging global financial turmoil. Already, modest tightening measures in the form of small increases in official interest rates and higher reserve requirements for banks aimed at absorbing excess liquidity have resulted in increased turbulence in China's Shanghai-based stock market. China's A-share market fell by 9 percent on February 27 initiating, in turn, sharp falls in equity prices worldwide that erased well over $1 trillion in wealth while causing higher volatility in asset markets. More such turbulence will follow if China continues the dollar buying that is the equivalent of printing too much money even as its economy and asset markets continue to overheat.

Rising Trade Tensions

Compounding the rising tension in Chinese and global asset markets tied to China's heavy currency intervention is the rising tension tied to China's resultant ever-rising trade surplus. An undervalued currency, like China's, results in too many resources in the traded goods sector and rising pressure to rely on exports for growth—a chronic problem in most of Asia, but one that has grown especially acute in China. The irritant arising from China's trade surplus has grown even more acute this year. The February 2007 trade surplus for China was $23.76 billion—three times larger than the market's expectation. For the first two months of 2007, China's trade surplus totaled $39.6 billion, 226 percent above the same period a year ago.

While these trade figures may contain some distortions, such as export shipments of steel, textiles, and other manufactured goods being rushed out in anticipation of reduced export subsidies, the evidence of ever-rising pressure to utilize excess capacity in China's export sector is unmistakable. The surge in Chinese exports tied to an undervalued currency and to export subsidies is boosting trade tensions globally. The rising probability of trade wars threatens one of the pillars underlying unequaled global growth and wealth creation over the last several decades.

Inadequate Chinese Adjustment Measures

China contends that it is allowing the adjustment of its exchange rate to occur slowly while it attempts to rein in rising domestic inflation pressure. Last April 24th, Zhou Xiao-chuan, Governor of the People's Bank of China, contended in the *Wall Street Journal* that "The speed

of moving forward (on yuan appreciation) is ok. It's good for China and welcomed by many other countries."

At that time, the yuan had appreciated against the dollar by a total of 3.3 percent, even including the initial 2.1 percent yuan revaluation on July 21, 2005. Since then, the yuan has appreciated against the dollar by about another 5 percent, but on a trade-weighted, inflation-adjusted basis (inflation has been held down in China below U.S. levels by price controls) the yuan revaluation is far less. The reality of continued yuan undervaluation is underscored by the rising level of dollar-selling intervention required to cap yuan appreciation, not to mention China's surging trade surplus in 2007.

If China had allowed prices to rise instead of mandating caps on prices of important commodities like gasoline, there would be less pressure for the yuan to rise in value. Both the intervention to cap the yuan's appreciation and the capping of domestic prices are continuing to build up potentially disruptive inflation pressure inside China.

Chinese Currency Intervention Has Been Massive

While the degree of undervaluation of China's currency is underscored by the continuing rise in its trade surplus and the continued upward pressure on domestic liquidity, it is probably useful to put the scale of Chinese currency intervention into historical perspective. The $250 to $300 billion being spent annually by China to contain yuan appreciation is the equivalent of nearly 15 percent of China's GDP. U.S. intervention on that scale would amount to over $1.5 trillion annually.

Beyond that, China's currency intervention has persisted at extraordinary levels—even as measured against heavy past intervention by other major currency peggers like Japan during the 1980s. From 1974 to 1985, just before the Plaza Accord forced the dollar down, Japan's accumulation of foreign exchange reserves from currency intervention had resulted in a trebling of its reserves. In comparison, from 1994 to 2005, China's reserves have risen by over 30 times to above $1 trillion or nearly half of GDP.

This unprecedented intervention clearly constitutes currency manipulation on a massive scale. It is, more importantly, becoming unmanageable to a degree that seriously jeopardizes the stability of the Chinese economy and the global economy.

Currency Manipulation is Destabilizing

China's aggressive currency manipulation both manifests and creates some serious problems facing China's people and policymakers. The Chinese people, having seen remarkable wealth creation over the past decade, increasingly need to find safe and profitable places to store their wealth. China's population is aging rapidly, thanks to its one-child policy. In about 25 years the share of its population above 60 years of age will exceed what will by then be a ratio of about 24 percent in the United States. If China were to reduce restrictions on capital outflows, the pressure for yuan appreciation would ease. At the same time, wealth storage could be diversified outside the narrow range of government bonds and U.S. mortgage-

backed securities currently being purchased by the Chinese government with the proceeds of dollar buying aimed at capping yuan appreciation. Without recourse to global asset (wealth storage) markets, Chinese citizens are left with only the recourse of placing deposits in China's insolvent banks or, alternatively, chasing prices of stocks and real estate even higher, leading eventually to the turbulence and collapse already hinted at during February in Shanghai's stock market.

The risk of destabilizing inflation is rising in China. China's M2 money supply, thanks largely to continued heavy currency market intervention, has been rising at an average rate of about 15 percent over the past year. However, over the last three months, China's annualized money growth rate has jumped to over 20 percent. Meanwhile, the Chinese economy is reported to be growing at a rate of about 10 percent, while the inflation rate for consumer prices over the past year has been 2.7 percent, up from the 1 percent level of a year ago, but still modest. There is a serious discrepancy in these numbers. With the money supply growing at over 20 percent and nominal GDP (the sum of real growth and inflation) rising at between 12 and 13 percent, the ratio of money to GDP must be rising at a rate of about 10 percent a year. To validate these numbers, either the demand for money in China has to be growing rapidly (*unlikely*) or alternatively, the inflation plus growth numbers are way too low. If money demand is stable, that is if Chinese citizens wish to hold a fairly constant portion of their income as M2 money balances, it is true by definition that nominal growth (the sum of real growth and inflation) has to equal money growth.

Normally, when money growth exceeds nominal GDP growth (the best proxy for the increase in the demand for money), inflation follows until nominal GDP rises through higher inflation to equal money growth. In China's case, inflation could rise to over 10 percent given its 10 percent output growth in order to equal M2 money growth rates of above 20 percent.

If the Chinese government is suppressing an inflation problem through price controls or misrepresenting its inflation numbers, it will only succeed in doing so temporarily. Incipient inflation pressures are already building in China with the reported inflation rate having risen from 1 percent to nearly 3 percent over the past year. The Chinese government is showing signs of concern about rising inflation pressures forcing it to clamp down even harder with more administrative controls on prices or to pursue other measures such as higher bank reserve requirements and rising mandated interest rates. These measures have proven inadequate. What's really needed is an end to the currency pegging that allows the yuan to appreciate. Before long, that measure would eliminate the upward pressure on the money supply while mitigating inflation pressure through a stronger currency that would induce the Chinese to purchase more foreign goods made cheaper by virtue a stronger yuan.

China's Alternatives

In the face of rising trade tensions, rising domestic inflation pressures, and rising asset market volatility, China has choices. It could stop intervening to prevent yuan appreciation or it could, alternatively, relax restrictions on capital outflows. More capital outflows would reduce or eliminate excess demand for the Chinese currency that exists under present arrangements. The Chinese, however, have made it clear that they do not think that their

insolvent banking system could survive substantial capital outflows, and they are probably correct in this assessment. Therefore, the only viable alternative is to allow a steady, measured, substantial appreciation of the yuan, perhaps at a rate of 10 percent per year. The result would be a gradual slowdown of the liquidity flows into China and a gradual reduction in the growth rate of its traded goods sector. Demand would shift to domestically produced goods and would thereby help to reduce the excess capacity put in place after years of overinvestment driven, in turn, by China's prodigious savings.

That said, the outlook for such changes is not promising. The needed adjustments, particularly those in China to reduce global imbalances have been known for some time but little progress has been made by the Chinese in undertaking those adjustments. While the Chinese have listened politely to entreaties from Treasury Secretary Paulson, concrete measures to reduce the imbalances in China have been limited. Beyond a recent, modest acceleration in the pace of yuan appreciation, on March 17 China raised its one-year benchmark lending rate by 27 basis points to 6.39 percent. This is far below China's nominal growth rate of over 12 percent. Nominal growth provides a rough guide to an appropriate level for a policy interest rate. Meanwhile, the one-year deposit rate will be increased, again modestly, to 2.79 percent from 2.52 percent—still far below the yields outside China.

Consequences of Inaction

When thinking about the problem of global imbalances and China's role therein, the high probability that what should be done will be left undone compels one to anticipate what the actual result of persistent global imbalances will be.

The danger is even greater for the Chinese economy than for the U.S. or global economy. The disruption in the Chinese economy from a surge in inflation and from attempts to curb it with administrative controls would be substantial. That said, the fallout from an inflation surge in China would spread well beyond its borders. Indeed, this prospect represents a more immediate danger to the global economy than do the possible restrictive trade policies that may result from growing frustration over China's currency manipulation and attendant rising trade surplus.

If China continues on its current path, we may expect to see a crisis erupt sometime in the next twelve months comparable to the Asian currency crisis that erupted in 1997. China's inability to control the rising liquidity growth associated with ever-rising capital inflows and its reduced ability to sterilize the impact of those inflows on the domestic money supply will continue to boost inflation while continuing to push more and more speculative funds into real estate and stocks inside China. If the Chinese try to control inflation simply by putting caps on prices, as already may have been the case given the discrepancy between money growth and nominal GDP growth, the result will be rising shortages of goods whose prices are being held below market level and attendant rising social disorder. Long gas lines already exist in China and signs of social unrest are on the rise. If, alternatively, the Chinese simply permit inflation to rise rapidly, the result will again be more social instability.

The severe disruption of a Chinese economy that has accounted for a large portion of the growth of exports, especially in Asia over the last several years, will jeopardize both Japan's shaky economic recovery and growth in key Asian economies such as those of South Korea, Indonesia, and Taiwan. A sharp Asian slowdown would also reduce capital flows to the United States while reducing the growth of U.S. exports to that dynamic region. The same would hold true for Europe. In short, the vibrant global economy that we have enjoyed for a number of years could be put severely at risk by negative repercussions from China's intransigence on currency policy. The United States might seize the initiative by directly indicating more forcefully its desire to see the dollar depreciate (as opposed to calling just for yuan appreciation) as a necessary condition to move toward reducing its external deficit. In effect, Treasury Secretary Paulson has said as much, urging the Chinese to speed up yuan appreciation in order to relieve the pressures on global goods markets and global asset markets.

Some yuan appreciation would help to signal a need for appreciation of most Asian currencies, including the Japanese yen, which on a real or trade-weighted basis has weakened by nearly 15 percent over the past several years. The Chinese and the leaders of other major nations of the world economy cannot continue, simultaneously, to complain about global imbalances while resisting exchange rate adjustments, specifically a weaker dollar that would help to mitigate those imbalances. The longer we wait to address the problem, the worse and more disorderly the resolution will be.

---

[1] For further analysis of these themes, see: John H. Makin, "China Needs to Float the Yuan—for China's Sake," American Enterprise Institute, *Economic Outlook*, May 2006. www.aei.org

[2] For further analysis of problems in China resulting from overinvestment and from its shaky, underdeveloped financial system, see: John H. Makin, "China: The Unplannable, Planned Economy," American Enterprise Institute, *Economic Outlook*, June 2004. www.aei.org

SENATE FINANCE COMMITTEE HEARING ON
"RISKS AND REFORM: THE ROLE OF CURRENCY IN THE U.S.-CHINA RELATIONSHIP"
MARCH 28, 2007

Exchange Rate Flexibility in China: Why it Really Matters and How to Make Progress

Eswar S. Prasad
Nandlal P. Tolani Senior Professor of Trade Policy
Cornell University

I. Introduction

Chairman Baucus and honorable members of the Senate Finance Committee, thank you for the opportunity to share with you my views on this important bilateral economic relationship between China and the United States.

This relationship is relevant not just to the two economies themselves; it may also have implications for the smooth functioning of the global trade and financial systems. The rising linkages between the U.S. and China of course now stretch far beyond just trade and finance, to a variety of geopolitical and global security issues. Nurturing this relationship is therefore of considerable importance.

The currency issue has in recent years become a major thorn in this relationship. With the U.S. trade deficit reaching record levels and the bilateral trade deficit with China swelling, China's tightly managed exchange rate regime has come under increasing scrutiny. China's rising trade surplus, not just with the U.S. but the world at large, and its rapid accumulation of foreign exchange reserves have led to accusations of currency manipulation, with some observers calling for a drastic revaluation of the currency. There have also been calls for imposing large tariffs on U.S. imports from China if there isn't rapid progress on exchange rate reform.

I strongly believe that a confrontational approach calling for immediate and drastic policy actions is not the way to make progress in this matter. This would simply poison the U.S-China relationship in a manner that could have deleterious long-term consequences on many fronts. Furthermore, this approach is unlikely to have a large or lasting impact on problems such as the U.S. trade deficit or imbalances in the Chinese economy, and could make matters worse for everyone by creating instability in the global economy.

There is a great deal of commonality of economic interests between the two countries and it is these shared interests that should be the basis for a mutually beneficial economic relationship. What this requires is that the issue of exchange rate flexibility in China be placed in the broader context of reforms to the Chinese economic structure.

Chinese currency reform need not be a zero sum game. There is a better way to help China, in a few years, to float its currency, free up capital flows with fewer risks, and put in place an independent interest rate policy regime. This would, in turn, boost

consumption growth in China, increase demand for imports, and facilitate inflows of capital and financial expertise. This would be win-win international financial diplomacy--it would improve Chinese macroeconomic performance and defuse tensions abroad.

The first step is to recognize that exchange rate flexibility, while an important policy priority, is hardly an end in itself. It is, however, an important building block for other reforms—especially reform of the financial sector—which the Chinese recognize as being vital for economic stability and which they have focused a great deal of energy and resources on.

Now that Chinese policymakers have started allowing greater—if still very modest—exchange rate flexibility, a key issue is what monetary policy framework will take the place of the fixed exchange rate as an anchor for inflation expectations. Marvin Goodfriend (Carnegie-Mellon University) and I have developed a specific package of proposals for a new monetary framework that would foster macroeconomic stability and help make progress towards the multiple goals laid out above.[1]

China should adopt an inflation objective—a long-run target range for low inflation—in place of the exchange rate objective as a new anchor for monetary policy. An inflation objective, coupled with exchange rate flexibility, would work best to stabilize the Chinese economy and enable policymakers to deal nimbly with various domestic and external shocks that the economy will inevitably face as it grows more complex and market-oriented, and more connected to the global economy. Focusing on inflation stability is also the best way for monetary policy to achieve broader objectives such as financial stability and high employment growth. Thus, this framework will provide the macroeconomic stability that will enable financial sector development and other more fundamental reforms to take root. It will also place the issue of exchange rate flexibility in a broader domestic context rather just on its role as a solution for trade imbalances.

Framing the issue in this manner is relevant for economic as well as political reasons, and will serve as a basis for a more constructive engagement between the two economies. The U.S. does have a crucial catalytic role to play in the Chinese reform process. But this can be done in a way that generates results rather than just kicking up a lot of dust. This is not to say that the U.S. should display infinite patience for reforms to take root. The efficacy of both technical advice and practical guidance should be regularly evaluated against benchmarks of actual progress. The importance of simultaneous and complementary reforms in several dimensions needs, however, to be recognized by Chinese policymakers and to be emphasized by U.S. policymakers as part of the bilateral policy dialogue.[2]

Ultimately, it is stable and sustained growth in China—rather than ad hoc policy actions at the behest of internal or external forces—that will best serve the interests of the Chinese and U.S. economies, as well as those of the global economy at large.

---

[1] Marvin Goodfriend and Eswar Prasad, 2007, "A Framework for Independent Monetary Policy in China," *CESifo Economic Studies*, Vol. 53, No. 1.

[2] Eswar Prasad and Raghuram Rajan, 2006, "Modernizing China's Growth Paradigm," *American Economic Review*, Vol. 96, No. 2, pp. 331-36.

II. The Costs of an Inflexible Exchange Rate

Based on their own public remarks, it is fair to say that the Chinese authorities recognize the complications that arise from having a tightly managed exchange rate relative to the U.S. dollar. This exchange rate objective makes it difficult for the People's Bank of China (the central bank) to use interest rate policy to guide credit growth and pursue other domestic objectives. In recent years, offsetting the strong pressures for currency appreciation generated by the strong productivity growth in China has been an increasingly difficult task. Moreover, forcing the nominal exchange rate to remain stable has contributed to a rising trade surplus and large capital inflows over the last few years, leading to a gusher of liquidity pouring into the domestic banking system and making the monetary authorities' job of controlling credit expansion much harder.

The availability of abundant and cheap money has played a big part in the remarkably high rate of investment growth, which has been a key contributor to growth in recent years. The fact that this investment growth is in large part driven by state-owned enterprises and financed by state-run banks, neither of which are run as commercial market-oriented entities, creates serious concerns about the efficiency and sustainability of such investment. This could result in a resurgence of nonperforming loans in the banking sector in the future, setting back the progress that has been made in recent years.

Furthermore, the lack of financial market development and the general increase in macroeconomic uncertainty has made households nervous, increasing their savings to very high levels and restraining consumption growth. These problems and concerns are not news to anyone—indeed, the Chinese leadership has itself highlighted the seriousness of the domestic imbalances and sought to address them forcefully.

In present circumstances, however, a sizeable increase in policy interest rates to make financing of investment more expensive and to boost consumption growth—both stated objectives of the government—could trigger more inflows of capital from abroad. The expectation of a currency appreciation and an increase in interest rates would be too powerful a temptation for money from abroad, even if it had to find its way into China through unofficial channels. Thus, the exchange rate regime has made monetary policy subservient to the objective of maintaining a stable exchange rate relative to the U.S. dollar, hampering its use to promote domestic objectives.

A more flexible exchange rate, which would almost certainly result in a currency appreciation in the short term, would provide much more room for monetary policy maneuver. Giving the PBC room to raise interest rates by freeing it from having to target the exchange rate would help rein in credit to enterprises and deter reckless investment, reducing the risk of a boom-bust cycle. Indeed, higher inflation is not the only risk on the horizon—there are also risks of asset price bubbles and of future deflation resulting from a buildup of excess capacity if investment growth is not restrained.

So why are the Chinese authorities so reluctant to allow for a more flexible exchange rate when it is clearly in their interest? Among the concerns they have articulated are that allowing the currency to appreciate could, in the short run, hurt export competitiveness,

harm the agricultural sector by making food imports cheaper, and expose domestic banks to risks of currency volatility. None of these in itself seems like a compelling reason to avoid currency appreciation. In any case, the broader benefits of a flexible exchange rate are obvious and would far outweigh these factors. But the costs of a currency appreciation would of course be borne by small groups that therefore complain the loudest, and they have been quite effective at blocking major changes.

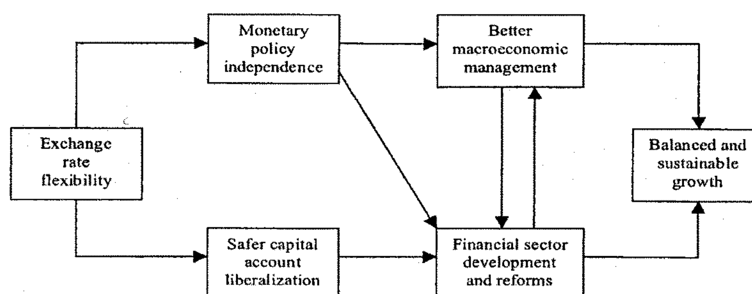
A more salient point is that the Chinese authorities are putting a great deal of emphasis on banking reforms and broader financial market development, which they view as far more important priorities than currency reform. These are indeed crucial reform priorities for long-term growth. But there seems to be an underlying notion, which can be gleaned from public statements of Chinese officials, that any disruptions arising from a shift in the exchange rate regime might make such core reforms harder to implement.

Therein lies a big window of opportunity for the international community to catalyze substantive change in the Chinese exchange rate regime. It turns out that there is an excellent basis for translating the authorities' own priorities into a strong case for making the exchange rate more flexible.

III. Why is Exchange Rate Flexibility Important? It's Not All About Trade

The case for a more flexible exchange rate should be made on the basis of a deeper set of policy priorities, with the ultimate objective being stable and sustainable growth in the longer term. The connections among the different objectives are subtle but highlight the need to take a more holistic approach to the reform process, including currency reforms.

Making the Right Connections



An independent monetary policy is a key tool for improving domestic macroeconomic management and promoting stable growth and low inflation. As the Chinese economy becomes more complex and market-oriented, it will become harder to manage through command and control methods as in the past. And, as it becomes more exposed to global

influences through its rising trade and financial linkages to the world economy, it will also become more exposed to external shocks. Monetary policy is typically the first line of defense against macroeconomic shocks, both internal and external. Hence, having an independent monetary policy is important for overall macroeconomic stability.

Monetary policy independence is, however, a mirage if the central bank is mandated to attain an exchange rate objective. Capital controls, which prevent money from moving in an out of an economy easily, do insulate monetary policy to some extent. But capital controls are notoriously leaky (the unofficial flows into and out of China itself are ample testimony to this) and tend to become increasingly less effective over time. Thus, a flexible exchange rate is a prerequisite for an independent monetary policy.

Independent monetary policy, in turn, is a key input into financial sector reforms. Until the late-1980s, lending operations of state-run banks (which still dominate the financial landscape in China) were determined by the government. The legacy of directed lending lives on in some ways, especially since Chinese banks have still not developed risk-assessment expertise or been given the right incentives to lend on commercial principles. Thus, using interest rate policy, rather than government directives, to guide credit expansion is essential to encourage banks to become more robust financial institutions. Trying to foster the commercial orientation of the banking sector in the absence of monetary policy tools to guide credit and money growth vitiates banking reforms.

The argument that the financial system needs to be fully modernized before allowing currency flexibility has it backwards. Indeed, durable banking reforms are likely to be stymied if the People's Bank of China's (PBC) ability to manage interest rates is constrained by the exchange rate objective. The PBC then has to revert to its old practice of telling state banks how much to lend and to whom, which hardly gives banks the right incentives to assess and price risk carefully in their loan portfolios. This makes financial reforms even more complicated than they already are.

Another requirement for broader financial market development is a stable macroeconomic environment, for which again good macroeconomic policies, including effective monetary policy, are necessary. On the flip side, the lack of effective macroeconomic management could generate risks via the financial sector. In the absence of room for maneuver on interest rates, liquidity flows into the economy could result in asset price bubbles, including in the real estate and stock markets. These markets could become vulnerable to sudden and unpredictable shifts in investor sentiment, which could send them tumbling at the slightest provocation, with broader ripple effects throughout the economy.

For developing the domestic financial sector, opening up of the capital account—to inflows as well as to outflows—could also serve as an important catalyst. Inflows can bring in technical expertise on developing new financial instruments, creating and managing risk assessment systems, and improving corporate governance. Indeed, the approach of using foreign strategic investors, including U.S. banks, to improve the efficiency of domestic banks is a strategy the Chinese authorities see as playing a useful role in their overall reform effort. Allowing outflows would help increase efficiency by

creating competition for the domestic banking system and limiting the captive source of funds (bank deposits) that now keep domestic banks flush with liquidity.

However, opening the capital account ahead of introducing greater flexibility in the exchange rate could pose serious problems in the future.[3] History is replete with examples of countries that opened up the capital account while things looked good, even while keeping their exchange rates fixed, and were then subject to large exchange rate depreciations when they were subject to sudden stops and/or reversals of capital flows.

Ultimately, stable macroeconomic policy and a well-developed and efficient financial sector are crucial ingredients for stable, balanced and sustainable growth. Exchange rate policy is clearly not an end in itself but, as shown by the connections depicted above, has an important role to play in achieving these deeper policy reforms and also the ultimate objectives in terms of growth and welfare.

The Broader Case for A Flexible Exchange Rate

- Changes in the exchange rate regime or level will not by themselves solve trade imbalances or other structural imbalances in the Chinese economy.
- But exchange rate flexibility (rather than just revaluation of the currency to a different level) is a prerequisite for monetary policy independence, which in turn is essential for effective domestic macroeconomic management.
- An independent monetary policy will foster macroeconomic stability, improve the composition of growth (away from a heavy reliance on exports and inefficient investment), and set the stage for more fundamental reforms, including reform and development of the financial sector.
- Thus, exchange rate flexibility is not an end in itself but a key component of the overall reform process that is needed to foster balanced and sustainable growth.

IV. Reorienting the Debate: An Alternative Monetary Policy Framework

For an emerging market economy, keeping domestic inflation low and stable, and controlling inflation expectations, is always a difficult challenge. For all its flaws, the exchange rate link to the U.S. has served as a useful anchor for inflation expectations in

[3] Eswar Prasad, Thomas Rumbaugh and Qing Wang, 2005, "Putting the Cart Before the Horse? Capital Account Liberalization and Exchange Rate Flexibility in China," in *China and the World Economy*, Vol. 13, No. 4, pp. 3-20. For a good summary of this article, see the Economics Focus column of the *Economist* magazine, March 18, 2005

China. So what could serve as a suitable alternative anchor for inflation expectations in place of a tightly managed exchange rate?

China should adopt an explicit inflation objective—a long-run range for the inflation rate and an explicit acknowledgement that low inflation is the priority for monetary policy—as a new anchor for monetary policy. An inflation objective, coupled with exchange rate flexibility, works best to stabilize domestic demand in response to internal and external macroeconomic shocks. Indeed, focusing on inflation stability is the best way for monetary policy to achieve broader objectives such as financial stability and high employment growth.

Over time, the inflation objective would provide a basis for currency flexibility. Thus, exchange rate reform will be seen as a key component of an overall reform strategy that is in China's short- and long-term interests, rather than as a policy that is aimed at appeasing foreign interests.

The time is right for making the switch—economic growth is strong and headline inflation is low. At an operational level, the PBC could continue its current approach to monetary policy, which includes setting targets for money and credit growth. The crucial difference would be to switch the strategic focus from the exchange rate to the inflation objective, which means that the currency could appreciate or depreciate in response to more fundamental economic forces such as productivity growth.

But how could such a regime—which is in many ways similar to that advocated for the U.S. by Ben Bernanke—work effectively in an economy with a weak financial system? The basic condition is that banks' balance sheets must be robust to interest rate fluctuations. The PBC has already made good progress on this front by clearing bad loans from the books of the key large banks and recapitalizing them. Full modernization of the banking system is a long way off, of course. But it would be inadvisable to wait for that outcome before moving to a new monetary framework. Indeed, as noted earlier, effective monetary policy is necessary for pushing forward with financial sector reforms.

I am not advocating a full-fledged inflation targeting regime, although this could serve as a useful long-term goal. The approach I have outlined above is more practical for the foreseeable future, and it should deliver most of the benefits of formal inflation targeting.

Two related points are worth noting. Independent interest rate policy requires a flexible exchange rate, not a one-off revaluation or a sequence of revaluations. A flexible exchange rate buffers some of the effects of interest rate changes, especially in terms of offsetting the temptation for capital to flow in or out in response to such changes. A one-off revaluation can solve this problem temporarily, but could create even more problems subsequently if interest rate actions in a different direction become necessary, or if investor sentiment and the pressures for capital inflows or outflows shift. This is why the focus on a large one-time revaluation to atone for past sins doesn't get us anywhere, either in terms of the policy debate or in terms of effecting reforms that really matter.

Exchange rate flexibility should also not be confused with full opening of the capital account. An open capital account would allow the currency to float freely and be market-determined. But the exchange rate can be made flexible and the objective of monetary policy independence achieved even if the capital account is not fully open. Indeed, as noted above, there are good reasons why it is preferable to move more gradually on capital account opening than on exchange rate flexibility. A free float with an open capital account is a useful long-term objective, but is not a high priority in the short run.

Elements and Implications of an Alternative Monetary Policy Framework

- A low inflation objective—a long-run target range for low inflation, with an explicit recognition that price stability is the main priority of monetary policy—would enable monetary policy to make its best contribution to macroeconomic stability and to longer-term goals of high and sustained growth.
- This framework would be relatively easy to put in place given China's present economic circumstances. It would provide for operational continuity but would require a change in the strategic focus of monetary policy.
- It would provide a broader context for undertaking reforms to the exchange rate regime, which are essential for effective independent monetary policy.
- Independent interest rate policy requires a flexible exchange rate, not a one-off revaluation or a series of revaluations.

V. How to Make Progress

The debate about the Chinese exchange rate regime has been distorted in some ways, and made political rather than substantive, by placing it in the narrow context of the U.S.-China trade balance. There is an important strategic (and educational) element related to putting the exchange rate issue in a broader context. This is where external pressure from the international community can be helpful, not in the form of threats but by reorienting the discussion in a fashion that makes the linkages between currency reform and other reforms—on which there is broad consensus within China—much clearer.

Furthermore, working with the Chinese to develop deadlines for achieving specific policy goals would be useful if done in a collaborative rather than confrontational manner.[4] These intermediate steps could serve as concrete guideposts for the reform process and help break down internal resistance to the reforms. Commitments that the Chinese made in the context of accession to the World Trade Organization, for instance, have helped to galvanize internal reforms. In China—as in any other country—there are some groups

[4] The Goodfriend-Prasad paper (see footnote 1), for instance, lays out some intermediate steps and goals along the path to organizing the monetary framework around an inflation objective.

that stand to lose disproportionately from certain reforms, even if those reforms may be hugely beneficial overall. This is precisely where external pressure, if applied judiciously, can be helpful in generating enough momentum to help the forces that are predisposed towards undertaking reforms. A confrontational approach, on the other hand, could well prove counterproductive by bolstering the forces opposed to reform and allowing them to paint certain reforms as being detrimental to China and in the interests only of other countries.

In particular, rather than push for a massive one-off currency revaluation or threaten to impose trade sanctions, it would be far more productive to actively encourage and assist China to undertake deep and enduring reforms that would promote sustained and stable growth. This is ultimately the best contribution that China could make to an orderly resolution of global current account imbalances. And for this, currency flexibility is an essential but hardly sufficient policy priority.

The China Fix

Statement of
Stephen S. Roach
Chief Economist
Morgan Stanley[1]

Before the
Senate Finance Committee
Hearing on

"Risks and Reforms:
The Role of Currency in the US-China Relationship"

March 28, 2007

All eyes are on China as you in Washington grapple with the pressures bearing down on American workers. Many believe those pressures stem primarily from a massive US foreign trade deficit that hit a record $765 billion in 2006 — more than double the shortfall of 2001. Large and ever-widening trade deficits are associated with a shift from domestic to foreign sourcing of US aggregate demand — squeezing both the employment and real wages of the American workforce. With the bilateral trade imbalance with China accounting for close to 34% of America's overall deficit on international trade in goods and services in late 2006, China has been singled out for special attention in the policy debate. If we can fix the "China problem," goes the argument, beleaguered American workers will be much better off as a result.

This is a very dangerous line of argumentation. Not only does it ignore the critical role that we in the United States can and should play in shaping our own destiny but it fails to appreciate the special problems that China is facing in its own journey on the road to economic development. Moreover, the Washington fix is centered mainly on the currency lever — the belief that a sharp upward adjustment of the renminbi in the 25-35% range against the US dollar would alleviate the principal source of pressure bearing down on American workers. The foreign exchange rate is not the answer, in my view. China competes not just on the basis of its currency but also from the standpoint of cheap labor costs, modern infrastructure, access to state-of-the-art technologies, and increasing investment in human capital and basic research. You in the Congress need to ask yourselves an important hypothetical question: How would you feel if you got your way on the Chinese currency adjustment but found that after three or four years the pressures bearing down on American workers had only intensified? As I see it, that's a very real risk that should not be taken lightly.

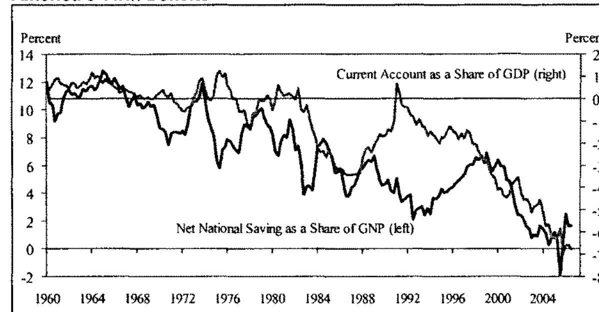
Macro Context

America's massive trade deficit — with China or anyone else, for that matter — has not arisen out of thin air. It is an unmistakable outgrowth of an extraordinary shortfall of domestic saving of businesses, households, and the government sectors, combined that drove the net national saving rate to historical lows of just 1% over the past three years (see Exhibit 1 on the following page). For an economy like the US,

[1] Note: Portions of this statement were presented previously by Mr. Roach as testimony before the Subcommittee on Trade of the House Ways and Means Committee on February 13, 2007.

where the political constituency for rapid economic growth is very powerful, saving shortfalls create an inherent bias toward chronic trade deficits. America is left with no choice other than to import surplus saving from abroad in order to fuel its appetite for growth. The only way to get that foreign capital is to run large current account and trade deficits.

Exhibit 1
America's Twin Deficits



Source: Bureau of Economic Analysis, Morgan Stanley Research

The geographic distribution of those deficits then follows along the lines of comparative advantage. China's share is very much an outgrowth of this framework — both as a supplier of surplus saving and as a source of low-cost, increasingly high-quality goods. I do not believe a stronger RMB will force Americans to save more. The best you in Washington can hope for if you rely on such a "remedy" is to shift the China piece of the US multilateral imbalance somewhere else. Yet that alternative source could easily be a higher-cost producer — thereby imposing the functional equivalent of a tax hike on the American consumer.

There's another element of the "RMB fix" that bears noting insofar as the US is concerned. America's trade problem is one of excess imports — not insufficient exports. As of 4Q06, goods imports were running 73% higher than goods exports. The import surge, in my view, is very much an outgrowth of an extraordinary period of excess personal consumption — with the consumer spending share of US GDP rising to 70% over the past five years from an average of 65% over the 1975 to 2000 period. With labor income growth unusually weak over the current economic recovery cycle — private sector compensation tracking over $400 billion (in real terms) below the norm of previous cycles — US consumers have drawn increasingly from the wealth effects of asset appreciation to finance both consumption and saving. With the income-based personal saving rate falling into negative territory for the first time since the early 1930s, the excess consumption and the outsize import surge it has spawned is a major source of America's macro saving imbalance.

I do not believe that a stronger RMB-dollar cross rate will temper this dimension of America's imbalance in any way whatsoever. The excesses of asset-driven consumption are best addressed through asset markets themselves — a development that could now be under way as the US property bubble bursts. Moreover, given the sheer size of the imbalance between imports and exports, an equilibrating realignment of the dollar would have to be so huge that it would be politically unacceptable to the rest of the world — not just to the Chinese but also to the Europeans, the Japanese, and America's other Asian trading partners.

The macro context is absolutely key in setting the stage for the China debate and in underscoring America's own role in fostering saving and trade imbalances. All too often, however, China bashers barely pay lip-service to this aspect of the debate before launching in to a full-scale broadside attack on the "unfair Chinese competitive advantage." That ducks the responsibility that you in the Congress must accept in creating the so-called China problem. By running policies that discourage saving — namely, large budget deficits and incentives for excess private consumption — you are setting up the US economy for an era of

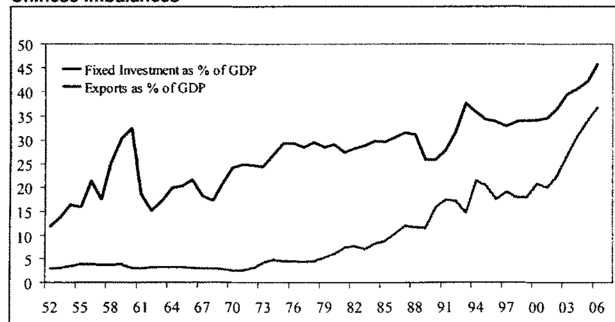
chronic trade deficits. China, largely through no fault of its own, fits all too neatly into that aspect of America's macro equation.

China's Daunting Challenge

It is all too easy for us in the United States to view China as an equal in the increasingly challenging arena of global competition. But China is very different than America's other main trading partners — it is not like Japan, Germany, or Canada. Despite nearly three decades of extraordinary progress on the road to economic development, China is still a very poor country, with a per capita GDP of just $2,000 in 2006 — literally one-twentieth of that in the United States. China is only just now reaching income levels that would put it in the middle range of what the World Bank calls lower-middle income economies.

Over the nearly 30 years of China's remarkable development, it has adopted a unique recipe for growth very much dominated by a recycling of a massive reservoir of domestic saving into surging investment and exports — sectors that now collectively account for more than 80% of Chinese GDP (see Exhibit 2). This model is now nearing the end of its useful existence. China knows that and is now making a major effort to change its approach to economic growth and development. None other than China's Premier, Wen Jiabao, admitted that on March 15 on the occasion of his annual press conference following the conclusion of the National People's Congress. In uncharacteristically blunt language, he sent a very clear message about the worrisome state of the Chinese economy, characterizing macro conditions as "unstable, unbalanced, uncoordinated, and unsustainable." I have never known a senior policy maker or political leader anywhere to leave it like that without rising to meet his own self-imposed challenge. Premier Wen has put his reputation firmly on the line. China, in my view, now has no choice but to now bring its rapidly growing and unbalanced economy under control. You in the Congress need to encourage this transition for it offers much in the way of opportunity for improvements on the US trade front.

Exhibit 2
Chinese Imbalances



Source: China Statistics Bureau, Morgan Stanley Research

Nor is China standing still in addressing the challenge of macro control. The ink was barely dry on the Premier's recent observations when China's central bank followed the very next day with a rare Saturday announcement of a monetary tightening — the third interest rate hike in 11 months, which reinforces five increases in bank reserve ratios implemented over the past nine months. The latest 27 basis point hike in the policy lending rate came only a day after Zhou Xiaochuan, Governor of the People's Bank of China, sent a crystal-clear warning, "...(F)rom a macro perspective, after serious study, we decided to place further controls." In central banking circles, it doesn't get any more direct than that. Suddenly, China's once opaque policy authorities are amazingly transparent — owning up to the seriousness of their macro control problems and setting in motion what I believe will ultimately be a much more determined shift to policy restraint than has been evident in a long time.

To some extent, this shift has been data driven. While China's January-February statistics are always hard to read because of Lunar New Year's distortions, there can be no mistaking the reacceleration of economic and financial activity in early 2007. There were marked overshoots of exports, industrial output, bank lending, while, at the same time, the long-awaited investment slowdown failed to materialize. Moreover, on the heels of the spike in export growth, the trade surplus ballooned to nearly $24 billion in February — fully nine times levels hit a year earlier; that signals what most senior Beijing officials believe to be a very rapid accumulation of foreign exchange reserves in early 2007, which only further complicates China's already daunting liquidity management challenge.

In short, the data flow in early 2007 depicts a Chinese economy that is once again defying the efforts of a three-year tightening campaign. Beijing has long talked tough on the macro control front, but this talk has not achieved satisfactory results. Persistent excess liquidity, in conjunction with a still highly fragmented banking system and an investment decision-making process that is driven mainly by provincial and local considerations, have undermined policy traction. As Premier Wen Jiabao indicated at the conclusion of the National People's Congress, this is a major challenge to the Chinese leadership. He stressed, this is "...not the time for complacency with respect to the economy.

These concerns were very much the focus of the just-completed China Development Forum — an annual gathering in Beijing that follows immediately on the heels of the National People's Congress and provides official China with an opportunity to clarify and expand its message. I have been privileged to attend all but one of these Forums since its inception in 2000 and find it to be invaluable in getting a read on the Beijing agenda. This year's theme said it all — "China: Towards New Models of Economic Growth." It is a clear recognition by the State Council — China's cabinet, whose Development Research Center is the official sponsor of the event — that the Chinese economy is at a critical juncture. The Old Model — dominated by a recycling of massive domestic saving into an equally massive investment boom that then supports an all-powerful export machine — has outlived its usefulness. Official China not only concedes the twin perils of excess capacity and a protectionist backlash to open-ended exports but also worries increasingly about the negative externalities of the current model — namely, excess resource consumption, environmental degradation, and widening income disparities.

The Beijing Consensus is clear on the broad outlines of the New Model. As underscored by the 11th Five-Year Plan enacted a year ago, the goal is a more balanced economy that draws increasing support from private consumption and a more rational market-based allocation of saving and investment. The emphasis on the shift from the quantity to the quality of the growth experience permeated the discussions at this year's China Development Forum. Resource conservation and environmental concerns were at the top of the agenda as defining characteristics of the coming regime change. Senior Chinese officials were quite open in expressing major disappointment over the failure to hit the energy conservation and emission-reduction targets that were announced with great fanfare a year ago. This was ascribed to what the Chinese leadership now refers to as "structural pollution" — the environmental degradation that is a painfully natural outgrowth of the structural disequilibrium of the old manufacturing-intensive growth model.

The give and take with senior Chinese policy makers is always the highlight of the China Development Forum. Minister Ma Kai, Chairman of the National Development and Reform Commission (NDRC) and the nation's leading macro manager, acknowledged in response to a question that I raised that Premier Wen has "...increased our awareness of China's problems." While he hinted at more administrative measure to come — underscoring likely increases in the area of land control and higher project-approval hurdle rates with respect to environmental impacts and energy consumption requirements — he did not pound the table in favor of restraint. His confident, but generally relaxed, demeanor over the state of the Chinese economy stood in sharp contrast with the far more determined tone expressed by China's Premier. I suspect Minister Ma is about to change his tune. To the extent Chinese authorities are likely to up the ante on tightening, and to the extent that monetary policy traction remains very much in doubt, the burden of restraint should fall increasingly on the central planners at the NDRC.

This conclusion became all the more evident at the closing session of the China Development Forum — the annual audience with the Premier. I have watched Wen Jiabao grow into his job over the past four years. Today, he speaks with much greater conviction and confidence than he did several years ago in framing the

China macro debate. It's not just the way he states the problems but it is also a new sense of command over the challenge and solutions. He welcomed the opportunity to elaborate on his worried characterization of the state of the Chinese economy. By *unstable*, he was referring to overheated investment, excess liquidity, and a sharply widening current-account surplus. By *unbalanced*, he was voicing concerns over urban-rural and east-west disparities. By *uncoordinated*, he was drawing attention to the regional fragmentation of the macro economy, to the sharp contrasts between excess manufacturing and an undeveloped services sector, and to the disparities between excess investment and deficient consumption. And by *unsustainable*, he was highlighting the twin perils of environmental degradation and excess resource absorption, as well as persistent tensions in the income distribution. Collectively, the "four uns" — as they became known in our recent discussions in Beijing — made a compelling case for the growth-model change that was the theme of this year's China Development Forum. As Columbia Professor and Nobel Laureate Joseph Stiglitz put it in our discussions, "China always adopts new models at key transition points in its development journey. This is one of those times."

As I sit back and reflect over the message from this year's Forum and try to benchmark the discussions to those I have heard in each of the previous six years, I am struck by one major shift — that there is greater determination than ever to get on with the transition to the new model. There is a clear sense that time is growing short. Official China's frank admission of failure in hitting its energy conservation and environmental remediation objectives in 2006 only underscores the sense of urgency. So does the renewed spurt of rapid growth in early 2007. Premier Wen left no room to mistake the significance of this new focus. He went out of his way to stress, "This is a strategic shift for China." It doesn't get much clearer than that.

For those of us in the West, this is a strong signal we need to update our perceptions of China. Think less of open-ended unbalanced growth and more of a somewhat slower and better-balanced expansion. Think less of an industrial-production dominated model with increasingly destabilizing implications for natural resource consumption and the environment. Think more of a shift to consumption, services, and "greener" growth. Think also of macro stabilization policies — not just those of the central bank but especially those of the central planners at the NDRC — that will be used increasingly to up the ante on the tightening required to achieve these objectives. But don't think for a moment that China will back down on the reforms that have driven nearly three decades of its extraordinary transformation.

The Heavy Lifting of Chinese Rebalancing

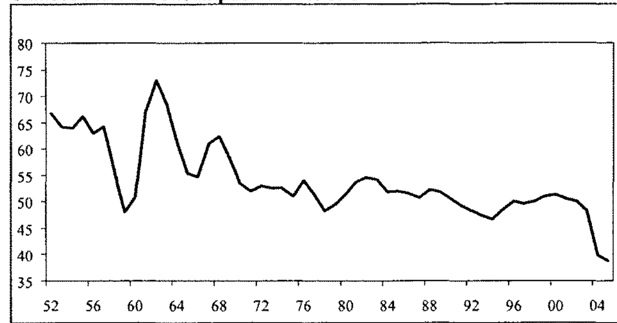
The rebalancing of any economy is never easy. Nor is there a boilerplate recipe for such a daunting transformation. For a state-directed Chinese economy, the challenges are very different from those in a market-based economy like the United States. China is now taking an important step on the road to rebalancing — moving to rein in the excesses of an investment boom and a stock market bubble. A key question is, What comes next?

Most believe the answer lies with the Chinese consumer. The numbers are compelling: Private consumption in the world's most populous nation currently accounts for only about 35% of its GDP — half the elevated share in the US, well below portions elsewhere in the developing world, and quite possibly the lowest consumption share of any major economy in modern history (see Exhibit 3 on the following page). There's obviously nothing but upside to the case for the Chinese consumer. It is widely billed as one of the great hopes and opportunities of China's rebalancing — able to fill the void left by any slowing in investment or exports.

I wish it were that easy. Centrally-planned or not, China can't simply push a button to bring its vast consumer sector immediately into play. Consumer cultures, in many respects, are the DNA of market-based capitalism. China has taken only small steps in that direction. With over 60 million layoffs traceable to the state-owned enterprise reforms of the past decade, job and income insecurity is rife amongst the Chinese workforce. The lack of a nationwide social safety net — especially social security, pensions, and unemployment insurance — only compounds that problem. As such, Chinese households, motivated by fear of uncertain economic prospects, are predisposed toward an inordinate amount of precautionary

saving. Reflecting this penchant for personal thrift, China's national saving rate is now close to 50%, the highest for any major economy in the world and a major stumbling block to the development of a more vibrant consumer culture.

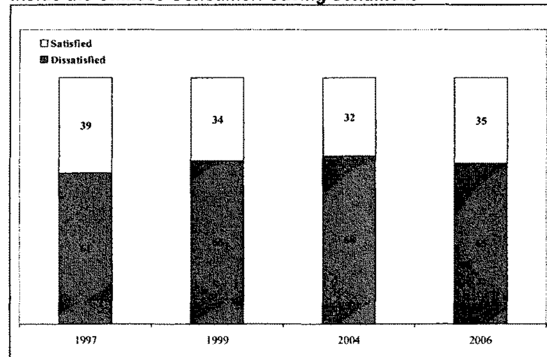
Exhibit 3
Chinese Private Consumption as a % of GDP



* Data for 2004 and 2005 reflect revised national accounts.
Source: China National Bureau of Statistics, Morgan Stanley Research

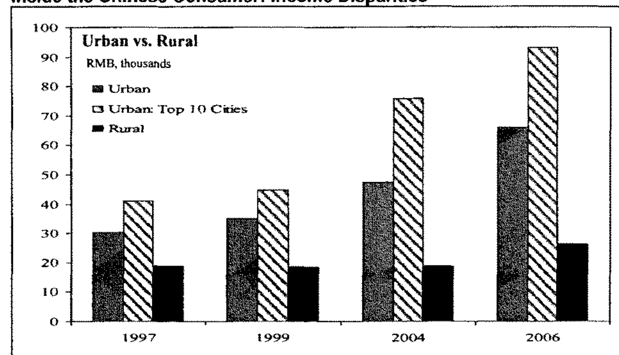
The just-released results of the 2006 Gallup Poll of China underscore three key obstacles that the consumer still presents to a rebalancing of the Chinese economy: (1) Fully 65% of Chinese households remain dissatisfied with their saving positions, up from a 61% dissatisfaction reading in 1997. Consistent with a powerful precautionary saving motive, the Gallup Poll found that worries about an adequate safety net were the major reasons behind such dissatisfaction — especially in the areas of retirement funding, healthcare, and children's education (see Exhibit 4). (2) Widening income disparities are also inhibiting the expansion of a broader base to Chinese consumption. This is evident in both urban and rural areas, where the Gallup tally shows that the difference between the upper and lower quintiles of household incomes increased by about 40% in 2006 relative to 2004; this is the largest increase in income inequality in the 10-year history of Gallup's China Poll. (3) The lifestyle benefits of urbanization are concentrated in China's "Top 10" cities; by contrast, citizens in "Middle China" — medium-size urban centers — remain on the outside looking in. With income disparities increasing much more in medium-size cities than in large ones, China's urban consumption base remains disappointingly narrow (see Exhibit 5 on the following page).

Exhibit 4
Inside the Chinese Consumer: Saving Sentiment



Source: The Gallup Poll of China: Nationwide Polling, 1997-2006

Exhibit 5
Inside the Chinese Consumer: Income Disparities



Source: The Gallup Poll of China: Nationwide Polling, 1997-2006

These findings are not lost on Chinese policymakers, who are very focused on a pro-consumption rebalancing of the Chinese economy. The 11th Five-Year Plan enacted by the National People's Congress a year ago addressed two of these issues head-on: the need for a national safety net and the imperatives of tempering rising income inequalities. Greater priority was placed on support for the woefully under-funded National Social Security Fund, which currently holds just RMB 300 billion, or roughly US$30 per capita. Emphasis was also directed at rural income support, especially tax incentives and improved medical and educational allowances. In addition, the latest Five-Year Plan is explicit in identifying China's relatively undeveloped service sector as a new and important source of job creation in the future. Chinese leaders recognize the need to draw increased support from labor-intensive tertiary industries, especially those involved in distribution and delivery, like wholesale, retail, and trans-national shipping. On balance, the 11th Five-Year Plan is probably the most pro-consumer effort ever put forth by the Chinese leadership. But it underscores how far China needs to go in removing the obstacles that currently inhibit the development of a flourishing nationwide consumer culture — a challenge I expect will be actively debated at this year's National People's Congress.

Equally serious constraints are evident in China's saving and capital allocation mechanism — and in the financial-sector reforms that such breakthroughs would require. China has made major progress in the areas of banking and capital markets reforms in the past five years. But these initiatives have effectively started from "ground zero." The public listing of three of China's largest banks was a very important step in the creation of a new financial system, especially in instilling the shareholder-value culture that will ultimately drive profitability and discourage lax lending practices. But, here as well, this is a long and arduous road for China — especially the transformation of legions of former government bureaucrats into discriminating bank lending officers. In the end, the integrity of a prudential lending function is the essence of a market-based credit culture for any economy. Through strategic alliances with several major foreign banks, China is making progress in this area, but the heavy lifting in the personnel, systems, and risk management areas of Chinese banking reforms has only just begun.

Two other obstacles compound the capital allocation problem in China: the currency regime and a lack of progress on broader capital market reforms. I don't buy the notion that China's currency policy is a threat to global trade. I feel, instead, that many in the developed world — especially the saving-short United States — are treating RMB-related issues as scapegoats for their own macro shortcomings. I worry more about China's quasi-fixed currency regime as a source of its own domestic instability — largely in fostering massive speculative capital inflows and a build-up of foreign exchange reserves. China's currency policy requires these inflows to be recycled into dollar-based assets and neutralized through a massive "sterilization" exercise. To the extent that China's undeveloped domestic debt market makes such sterilization difficult, excess liquidity undoubtedly spills over into its banking system. The latest trends in

bank lending underscore this problem: Despite a series of recent hikes in bank reserve ratios, RMB loan growth accelerated from 13% y-o-y in June 2006 to 16% in December. With China's policymakers trying to clamp down on excessive investment, curtail an equity bubble, and limit a new wave of nonperforming bank loans, the persistent excesses of bank lending growth complicate the macro control problem.

As US Treasury Secretary Henry Paulson noted in a recent speech in Shanghai, an equally glaring shortcoming is China's lack of capital market development, especially the low level of activity in its corporate bond market (see Secretary Paulson's 8 March speech, "The Growth and Future of China's Financial Markets"). In 2006, China's domestic capital markets — equity and bonds, combined — accounted for only about 18% of total funds raised by the business sector; equities made up the bulk of that total, whereas corporate bond issuance was only about 3% of overall funding. By contrast, banks accounted for fully 82% of total credit intermediation. That underscores yet another obstacle on the road to rebalancing: China's still fragmented banking system has long been tied to the funding of a vast network of inefficient and largely unprofitable state-owned enterprises. In the past, this has led to a massive surge of nonperforming loans, a problem that could well resurface once the dust settles on the current bank-funded investment boom. Over-reliance on still inefficient banks, in conjunction with a lack of capital-markets-based discipline, underscore the serious risks of a misallocation of Chinese saving and investment.

China is at a critical juncture. Over the past 15 years, its powerful investment- and export-led growth model has been driven by bank-directed recycling of a massive pool of domestic saving. Coupled with aggressive and unprecedented reforms of its state-owned enterprises, China's transition to "market-based socialism" has been nothing short of spectacular. But this strategy is now in danger of outliving its usefulness. The investment sector has gone to excess and the export dynamic is at risk of triggering a protectionist backlash. The lack of a vibrant consumer sector, in conjunction with the legacy effects of state- and bank-directed capital allocation, are critical obstacles that must be overcome if the Chinese economy is to move to the next level.

China's unbalanced macro structure also presents its leadership with major cyclical control problems. Lacking in well-developed market-based systems, China recently upped the ante in opting for "administrative controls" to cope with its mounting imbalances. The latest such actions — state-directed equity selling, a clampdown of short-term foreign borrowing by domestic Chinese banks, and new rules that prevent companies from purchasing equities with proceeds from share sales — underscore China's willingness to stick with this non-market approach to policy formulation. In my view, they were not one-off developments. Based on Premier Wen Jiabao's opening speech to this year's National People's Congress, these actions may only be the first salvo in a broader tightening campaign. Yet this approach is not without its own shortcomings. Administrative actions not only underscore the state-dominated mindset that still pervades the China model, but they also are stop-gap measures that circumvent more robust market-driven solutions. In my view, the only viable answer is an acceleration of reforms, focusing both on the nascent consumer as well as on an embryonic financial system. A successful rebalancing of the Chinese economy is essential to avoid the boom-bust cycles that were so prevalent in the past. Yet until the obstacles to rebalancing are removed, China's overheated investment sector and over-extended export machine pose increasingly serious risks to sustainable and stable growth.

China's Environmental Challenge

As China rises to meet the challenges posed by Premier Wen Jiabao, one of the most urgent items on its agenda pertains to pollution and environmental damage. In my recent meetings in Beijing, I sensed that awareness of this problem has taken on a new level of urgency. And with good reason. Pollution is invariably one of the first impressions visitors form of China. From bicycles to cars in 25 years, urban China rarely sees much in the way of blue sky anymore. Rapid and large-scale industrialization only compounds the problem. The Chinese government knows full well it must take prompt and forceful actions to avoid an environmental crisis. There are encouraging signs it is now rising to the occasion. Can China pull it off while, at the same time, staying the course of its remarkable economic development strategy?

On a per capita basis, China's pollution problem hardly jumps off the page. Its ratio of carbon emissions per person is less than half the global average and less than one-tenth that of the world's biggest polluter,

the United States. China's enormous population, of course, distorts those comparisons. On an absolute basis, it's a different story altogether. China's total carbon emissions are more than double those of Japan and Russia, fractionally behind the European Union, and a little more than half those of the US. The essence of the Chinese environmental degradation problem is both its scale and growth. Over the 1992–2002 period, CO_2 emissions in China have expanded at a 3.7% average annual rate, more than two and a half times the global average of 1.4%. At that rate, according to a recent report issued by the International Energy Agency, China will surpass the United States as the global leader in carbon emissions by 2009.

In terms of sulfur dioxide, China's current rate of discharge is already double its so-called environmental capacity — responsible for an acid rain that now covers about one-third of China's total land mass. According to SO_2-based measures of air pollution, seven of the ten most polluted cities in the world are in China. With respect to emissions of organic water pollutants, China leads the world by more than three times the number two polluter, the United States. Moreover, fully 90% of China's urban rivers are polluted, and 90% of its grassland has been degraded. (Note: Data cited above are from Al Gore's *Inconvenient Truth* [2006], Nicholas Stern's *The Economics of Climate Change* [2007], and a recent paper prepared by the Development Research Center of China's State Council, "China: Accelerating Structural Adjustment and Growth Pattern Change" [2007]).

Exhibit 6

Environmental Degradation Ratings

Sulfur Dioxide *(mcg per cubic meter)*	
1. Guiyang, China	**424**
2. Chongquing, China	**340**
3. Taiyuan, China	**211**
4. Tehran, Iran	209
5. Zibo, China	**198**
6. Quingdao, China	**190**
7. Jihan, China	**132**
8. Rio de Janeiro, Brazil	129
9. Istanbul, Turkey	120
10. Anshow, China	**115**
Emissions of Organic Water Pollutants *(kg per day, million units)*	
1. China	**6.09**
2. US	1.90
3. Russia	1.52
4. India	1.52
5. Japan	1.28
6. Germany	1.02
7. Indonesia	0.72
8. Brazil	0.63
9. UK	0.61
10. Italy	0.50

Source: World Bank

China's environmental moment of truth is now at hand. The problem is twofold, in my view: It is not just an issue of moving from dirty to clean technologies, but also a matter of shifting the macro structure of the Chinese economy from a pollution-intensive to an environmentally-friendly mix. This latter point is a key and often overlooked aspect of China's environmental challenge. It is also a crucial element of the rebalancing challenge that shapes China's macro debate. The issue, in a nutshell, is that the Chinese economy is heavily skewed toward exports and fixed investment, which now collectively make up over 80% of China's GDP. This concentration represents the most lopsided mix of a major economy in modern history. It is not sustainable from a macro point of view in that it threatens the twin possibilities of a

deflationary overhang of excess capacity and a protectionist backlash to open-ended exports. And it is not sustainable from an environmental point of view because the industrial-production-dominated growth model has a natural bias toward excessive carbon emissions.

The paucity of data on the carbon intensity of the various sectors of the Chinese economy makes it difficult to quantify the environmental implications of the mix of its GDP. The carbon intensity of the UK experience illustrates what China is up against. Nor surprisingly, according to The Stern Review, services are at the low end of the UK spectrum, averaging around 0.3 on the carbon intensity scale; for manufacturing industries, the range is wide — motor vehicles (0.5) and sporting goods/toys (0.8) are at the low end while the paper (2.4) and steel (2.7) industries are at the high end. A comparable dispersion is evident in the energy share of UK business costs, with non-transportation services at the low end of the spectrum and manufacturing at the high end.

OK, China is not exactly England. But I strongly suspect that the relative dispersion of the carbon- and energy-intensity of the major sectors of the Chinese economy is comparable to that of the UK. Under that presumption, consider the following: The latest data put China's industrial sector at around 52% of its GDP, well in excess of the 32% share of the average developed economy and considerably higher than the 37% average of the low- and middle-income countries of the developing world. That implies the manufacturing-intensive Chinese economy is highly skewed toward a pollution- and energy-intensive model of economic activity — the same "structural pollution" problem noted by the Chinese leadership at this year's China Development Forum.

In the case of China, there is an added complication — it is the heaviest consumer of coal of all the major economies in the world today. According to China's Development Research Center, coal-driven power accounted for fully 79% of total electricity generated in 2003, eight percentage points higher than in 1990 and essentially double the 40% share of coal-powered electricity for the world as a whole. The adverse environmental implications of coal power are well known; according to the Stern Review, the CO_2 emissions of coal per unit of energy generation are twice as much as those associated with natural gas and about 50% more than those generated by oil-burning technologies. Inasmuch as UK coal consumption — fueling 34% of the country's total energy generation — is less than half the share in China, there is good reason to believe that the pollution implications for the Chinese economy per unit of GDP would be a good deal worse than those implied by the British results cited above.

The bottom line for China is a GDP that is far more predisposed toward environmental degradation than any other major economy in the world today. For an economy that is growing at 10% per year, that spells an endgame of environmental crisis — sooner rather than later — if it stays its present course. And for the planet, even though China currently lags behind the big polluters of the developed world, it only compounds the perils of global climate change. The principles of global remediation, as put forth in international agreements such as the Kyoto Protocol, have always recognized a progressivity of burden sharing — that rich developed economies should fund a greater share of the mitigation than poor developing economies. Yet the Chinese environment is now nearing a critical tipping point that demands urgent action on its own merits rather than special dispensation because of its status as a low-income developing country.

China has a rare and important opportunity to kill two birds with one stone. A successful rebalancing of the Chinese economy — moving away from excess reliance on investment and exports and embracing more of a pro-consumption growth model — would be a huge plus in dealing with two key issues: On the one hand, it would enable China to avoid the capacity excesses and protectionist risks that might arise from a continued expansion of a severely unbalanced real economy. But it would also tilt the mix of Chinese output away from pollution- and energy-intensive growth. Don't get me wrong: Macro rebalancing should not be seen as a substitute for major environmental policy initiatives — the development and implementation of new technologies and incentives that would lead to a cleaner GDP. But rebalancing could well be an important down-payment. By shifting the mix of economic growth away from emissions-intensive activities, China would not only avoid serious macro imbalances but it would also buy some important time on the environmental front.

The latest statements from official Beijing are quite encouraging in addressing this conjoined problem. Premier Wen Jiabao's "Work Report" to the recently concluded National People's Congress strongly endorsed a strategy of macro rebalancing, energy conservation, and environmental remediation. But the time for talk is over. Just as China has had the will and determination to deliver on the reform front over the past 28 years, I am hopeful that it will rise to the occasion and finally deliver on the rebalancing front. In the end, there is no other choice. Time is growing short — for China and for the planet.

Unprepared for Globalization

Motives are not my specialty. Nevertheless, I constantly ask myself why the world is having such a strong visceral reaction to such a remarkably successful Chinese development story. Ironically, the answer may have less to do with China and more to do with how we see ourselves. It may well be that the rich countries of the developed world are simply unprepared for the stunning successes of an IT-enabled globalization. Lacking in preparation, the developed world is now on the defensive — and, unfortunately, ripe for a politically-driven backlash.

A key element in all this is speed. Unlike the slowly evolving pace of the globalization of a century ago, the current strain is unfolding at lightening speed. A major difference is the technology of the distribution system. In Globalization I, it took ships, rail, and eventually motor vehicles to facilitate the cross-border exchange and delivery of manufactured goods. It also required the time-intensive construction of ports, rail systems, and roads. Globalization II built on this earlier infrastructure but then added a new twist of its own — the revolutionary connectivity of the rapidly growing Internet. Where it took at least 30 years for the cross border network to reach a critical mass in the first globalization, this time around it all came together in less than a decade.

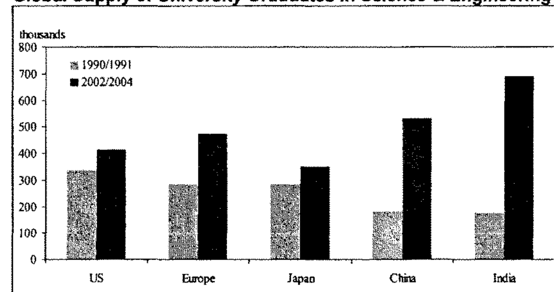
There is, of course, nothing new about the accelerated rate of technology absorption that underpins both globalizations. Over time, each major wave of innovation has hit its critical mass of penetration considerably faster than the wave that preceded it. For example, it took 38 years for radio to reach 50 million US households; similar levels of penetration for television were hit in 13 years, for cable-TV in 10 years, and for the Internet in only 5 years. While this is the norm in the long continuum of technological breakthroughs, in my view, it has played a critical role in the current build-up of tensions in the global economy. It has pushed this globalization ahead at hyper-speed — in effect, not giving many workers the luxury of time to ponder what hit them.

Nor can there be any doubt of the unusual breadth of the current globalization. Unlike the first episode, which was all about the cross-border exchange of tradable manufactured goods, the IT-enabled second globalization opens up a similar possibility for many once non-tradable services. This was not supposed to happen, according to the two-sector Ricardian models of economic theory. For high-wage economies, it was fine to trade away market share in manufactured products. Displaced workers could then seek refuge in non-tradable services — incurring steep retraining and other transition costs but eventually drawing security from performing knowledge-intensive tasks (such as software programming, engineering, medical advice, and consulting) that played to the natural endowment of their unique skill-sets. The Internet all but obliterated that sense of job security in an increasingly knowledge-based industrial world. With the click of a mouse, the output of a wide range of knowledge workers residing in low-wage developing countries can now be exported to desktops on a real-time basis from anywhere in the world. This has led to an unprecedented wave of white-collar shock, as once sheltered knowledge workers in the rich countries face the tough pressures of international competition for the first time ever.

Both the speed and breadth of this globalization has caught the developed world by surprise. While the world's leading economies have long been preaching the gospel of trade liberalization and international opportunities, they have done little to prepare for the sudden arrival of new competitive threats. But the hyper-speed of an IT-enabled globalization should not be seen as an excuse. In many respects, the rich countries of the developed world took job and income security for granted — failing or unwilling to see the challenge that was rapidly building halfway around the world. That's especially the case on the human capital side of the equation — the essence of competitive advantage in the Information Age. As can be

seen in the accompanying chart, back in the pre-Internet days of the early 1990s, the US, Europe, and Japan were well in the lead in turning out newly-minted science and engineering graduates from their colleges and universities. A decade later, China and India had surged to the lead — at precisely the time when IT-enabled connectivity gave these low-wage knowledge workers the opportunity to compete head-on with their high-wage counterparts in the developed world (see Figure 7). Lagging educational reform in the industrial world only compounded the problem. Workers in ever-complacent developed economies were, in effect, blindsided by the new globalization.

Exhibit 7
Global Supply of University Graduates in Science & Engineering



* Includes first university degrees in S&E. Data is for the latest year available (i.e., 2002 to 2004).
Source: US National Science Foundation, NASSCOM, Morgan Stanley Research

The United States was even more reckless in its approach to dealing with intensified international competition. As noted above, in drawing down its income-based saving rate to record lows, America had no choice other than to run massive current-account and trade deficits to attract surplus foreign saving. This bias toward ever-widening trade deficits left the US exposed to the comparative advantages of the main beneficiary of the new globalization — China. Unprepared on two counts — under-saving and under-investing in human capital — America is feeling the heat from the pressures of international competition as never before.

Unfortunately, all this was a lethal combination — a lack of preparation by the developed world, rapid development in the emerging economies, and a new IT-enabled cross-border connectivity. Out of this lethal combination, a new fear has arisen — job and income security in the developed world. Add in widening disparities in the income distribution and record returns to the owners of capital, the fear becomes all the more palpable for middle-class workers in industrial economies.

Globalization, of course, is a two-way street. The poor countries of the developing world are finally making extraordinary progress in lifting their standard of living and offering opportunity for hundreds of millions of people to escape the ravages of poverty. It has taken courage and determination on the part of the developing world to push ahead on reforms and open itself to the rest of the world — a strategy that is very much in keeping with that long suggested by the developed world. And yet just when the poor countries begin to reap the benefits of this approach, an unprepared developed world risks turning the tables and threatens to put up new walls of its own. Such hypocrisy could well be the ultimate tragedy of this globalization. Both rich and poor countries, alike, need to own up to the shared responsibilities of defusing these tensions — before it's too late. Trade frictions and protectionism could put the world in a very treacherous place. As the most powerful economy in the world, America can do better. You in the Congress need to take the lead in finding the high ground in this critical debate.

Striking a Different Bargain

Trade policy is a very important item on both America's and China's policy agendas. Yet there is an important disconnect between Washington's currency-centric demands and China's concerns over financial

stability. It is critical, however, that both sides find a common ground. In the end, I would hope that the US political debate will shift away from the single-minded fixation on the currency and, instead, push more for Chinese progress on the equally important matters of financial sector reforms and protection of intellectual property rights (IPR).

What I found in recent discussions in Beijing is that the Chinese may well be willing to move more aggressively on the Intellectual Property Rights issue than has been the case in the past. There is a key reason for this shift: Inasmuch as China's economic prowess has moved rapidly up the value chain in recent years — from low-value-added items such as toys and textiles to increasingly high-value-added technology products — there is a growing consensus forming within the Chinese leadership that IPR protection is now in its best interest, as well. As one senior official recently put it to me, "Since the China of tomorrow will be more about innovation and knowledge-based breakthroughs, we need to protect our own IPR." This speaks of a China that is now putting increasing value on the quality of its intellectual capital rather than on the quantity potential of its mass-production platform. OECD data underscore how far China has come in investing in the basic research underpinnings of intellectual property: In 2006, it overtook Japan and stood second only to the United States in the global research and development spending sweepstakes. Little wonder China now wants to protect its own proprietary knowledge base.

Interestingly enough, I recently saw a real-time example of what China can do on the IPR front when it puts its mind to the effort. Like most airports these days, Beijing International Airport has become something of an indoor shopping mall. Notwithstanding opportunities to make last-minute purchases of Chinese arts and crafts, the crowds were biggest at the Beijing 2008 kiosk, where travelers were fighting over newly minted souvenirs from the upcoming Olympics. What I found most interesting in these products is that they are all "officially licensed" — in many cases, complete with a numbered and holograph-tagged authentication certificate designed to foil counterfeiting. The Chinese have long complained how difficult it is to enforce IPR protection in a nation where factories and distribution facilities can spring up overnight. Try finding official Beijing 2008 souvenirs in China's fabled open-air markets that contain knock-offs of a wide range of Western products. Let me assure you — you can't. When the Chinese put themselves to the enforcement task, they can accomplish almost anything. A recent anti-piracy effort — the so-called "100-Day Campaign," running from July 15 to October 25, 2006 — is a high-profile example of China upping the ante in this area.

Ironically, Smokestack America continues to play a very powerful role in shaping US trade policy. While the concerns of manufacturing companies and their blue-collar workers are understandable, factory sector employment is now down to just 10.5% of the total US nonfarm workforce. Yet the decibel level of its voice in shaping the debate is well in excess of its role in driving the US economy. By contrast, knowledge workers are not only the overwhelmingly dominant segment of the US labor force, but, courtesy of IT-enabled connectivity, they are increasingly on the leading edge of feeling the new pressures of global competition. Protecting the intellectual capital of these highly skilled workers, could well be the essence of the competitive challenge faced by the US and China, alike. It is in the interest of both nations to shift the debate in this direction rather than fixating on legacy disputes in the manufacturing arena.

Policy Agenda

You in the Congress have an awesome responsibility in preparing the United States for the new competition of an increasingly powerful globalization. We can face this competitive challenge head-on only if we are honest is assessing our own responsibilities for trade imbalances, while at the same time, holding our trading partners accountable for their role in putting unfair pressure on American workers.

First and foremost, the US needs a pro-saving agenda — setting fiscal policy on a path to bring structural budget deficits under control and pushing ahead with tax reforms would alter the relative price between personal saving and current consumption. A national sales tax or some form of a VAT tax should be given consideration in that latter regard. Only by boosting domestic saving, can the US wean itself from a dangerous addiction to foreign saving that biases America toward a steady stream of trade deficits — if not with China, with many other lower cost producers around the world. At the same time, the United States

must do a much better job in preparing its workforce for the new competition — investing in human capital, educational reform, and basic research. A revamping of the Trade Adjustment Assistance program to deal with new pressures bearing down on white-collar knowledge workers would be especially timely and important.

All this is not to say that the US shouldn't push hard in its trade negotiations with China. WTO compliance is critical to monitor and enforce — especially in the still contentious areas of insurance, telecommunications services, agriculture, distribution, and construction. As stressed above, the protection of intellectual property rights should get special attention under the WTO compliance umbrella — especially in the areas of movies, audio-visual products, software, and Internet-related piracy. I am not optimistic that the currency angle is a productive area for future US-Sino trade negotiations. For reasons that pertain mainly to financial stability, China has sent a strong signal that it wishes to go slow and steady of the RMB appreciation front. US politicians seeking a prompt and more aggressive remedy are likely to be disappointed. That doesn't mean another avenue can't be pursued.

Getting China right could well be one of the greatest challenges of the current era of globalization. China has one of the most "open" development models in history — more than willing to open its economy up to imports and foreign direct investment, while at the same time going full-throttle down the path of an export-led expansion. China knows full well that it can't stay its present course. A rebalancing of the Chinese economy is now under way that poses great opportunity for China and the broader global economy. A China that makes meaningful progress on the road to rebalancing, will also offer the United States expanded benefits for two-way trade. Getting bogged down in a contentious currency issue without offering an alternative agenda raises the risks of trade frictions and protectionism. Once the world goes down that path, it's a very slippery slope. You in the Congress must resist that temptation at all costs.

****

SENATOR CHARLES E. SCHUMER STATEMENT

SENATE FINANCE COMMITTEE HEARING ON CHINA CURRENCY POLICY

MARCH 28, 2007

Chairman Baucus and Ranking Member Grassley, thank you for holding these two days of hearings on our economic relationship with China, and for allowing Senator Graham and I to make a statement as a team.

I know it is unusual for a member of the Finance Committee to address the Committee as a witness, but I felt it was important for me to sit here with my policy partner on this issue for almost five years now. We have been a trade tag-team for a long time, and we look forward to developing a new currency bill with both of you over the next two months.

Last Congress, as you know, Senator Graham and I ruffled a few feathers with our tariff bill, which we set aside at the very end of the Congressional session because we wanted to work with the Chairman and Ranking Member on a new currency bill that was WTO compliant. Senator Graham and I were both surprised when our bill received 67 votes on the Senate floor in April of 2005 – yet we are convinced that the support for strong legislation on Chinese currency manipulation and other illegal trade practices has grown significantly in the two years since.

We never intended for that bill to become law. It was a shot across the bow. But now the possibility for legislation in the 110th Congress is real, because the number of people who will vote for strong legislation exceeds the number of people who would have voted for a tariff. In other words, well-crafted legislation – WTO compliant and strong and effective – is likely to pass with a veto-proof margin during this Congress.

That's the message I hope that the Chinese and the Bush Administration take away from these hearings: The desire to pass tough legislation that is WTO compliant is very strong on this Committee and in this Congress. Our goal in the 110th Congress should be to find a tough but fair bill that can pass the House and Senate and be presented to the president. Senators Baucus and Grassley, we look forward to working with you to craft such a bill.

Let me say that there is no doubt that China is making some progress in various areas. China has recently decided to permit foreign banks greater access to its domestic market for credit cards and other everyday services. Also, China is making efforts to administratively reduce the trade deficit; for example, by changing export tax incentives.

What the Chinese should recognize, however, is that taking these steps only reinforces the notion that the pace of currency appreciation could be faster without harming their domestic economy. In other words, the same economic effect that these government policies are designed to achieve could be attained by merely revaluing the yuan. Why they refuse to do so is beyond me.

Although the pace of appreciation quickened slightly at the end of 2006, it has frozen to a standstill over the past month or so. Nearly all experts still agree that the Chi-

nese yuan remains significantly undervalued; that this undervaluation is the result of deliberate intervention by the Chinese government in world currency markets; and that this policy gives Chinese products a tremendous advantage in the United States market.

In fact, even though the currency has appreciated by about 6.6 percent since Senator Graham and I started our crusade, some would argue that the currency is even more undervalued now than it was when we started, since the Chinese economy has grown so quickly over that time, and our trade deficit with them continues to explode – over $232 billion in 2006 alone.

The Treasury Department has repeatedly used a technical and legalistic dodge to determine that China does not manipulate its currency. We all know that they intervene on the order of $200 billion a year to keep the yuan's value artificially low, yet our government can't call a spade a spade. And the President wonders why the bipartisan consensus for free trade has eroded.

But let's leave aside for a moment what word we want to use to describe what the Chinese are doing, and focus instead on its effects. In a few minutes, I will be chairing a Joint Economic Committee hearing with Fed Chairman Ben Bernanke. He has said that Chinese currency practices amount to an export subsidy. I think there is an emerging consensus that this is simply a fact, regardless of what our official government reports may say, and regardless of how Administration officials and other China apologists might parse their words to dance around the real issue. The Chinese continue to flout the rules, and all we do is talk.

I know that Secretary Paulson and others are trying hard, but there have not been enough tangible results after several years of tough talk – and we have not been willing to really push or threaten serious action.

Let me be perfectly clear: The real protectionists in the debate over China's trade practices are those who argue that we should do nothing, or that we should continue to wait, or that rapid change would upset their so-called "harmonious society." These apologists are protectionists in a different sense: They are protecting China. Those of us that care deeply about American workers, who care about upward mobility for middle-class families, who care about our economic future, who understand that free trade benefits Americans when our major trading partners follow the rules – we know that pushing China is the right thing to do.

When I talk about this issue now, I feel a little bit like former Vice President Gore must feel when he talks about global climate change: When he first started, he was regarded as a little bit out of the mainstream – but over time, public opinion has evolved, and now the overwhelming majority of the public is with him. The currency issue is very similar. Senator Graham and I were focused on it before most other people thought it was a real issue. Nearly five years later, every senator might not agree on how to address it, but I think there is an overwhelming consensus that something needs to be done, and soon.

To those who argue for more patience, my response is: How much longer can we wait? According to many experts, allowing the yuan to rise more quickly would require some adjustments by Chinese state-owned enterprises and further stress the balance sheets of Chinese banks. However, these adjustments will only be larger if the yuan is revalued years from now. During the interim, China will have to purchase ever-larger

amounts of dollars, and transfer larger amounts of what it makes to world markets. How long can that be sustained?

Some say that we should not push on currency, but rather let the current trade enforcement and diplomacy mechanisms be used more effectively. Well, in my view, the Bush Administration cannot be counted on to protect American industry and American workers from China's unfair trade practices.

Consider their track record. The President has four times rejected recommendations from the U.S. International Trade Commission under Section 421 of the Trade Act to grant import relief to U.S. industries facing market disruption from Chinese imports. USTR has three times rejected Section 302 petitions to take action against China's currency manipulation. The Treasury Secretary has refused to cite China for manipulation in Treasury's semi-annual report to Congress. Proceedings before the WTO are time consuming and expectations of impartial review are naïve at best, while IMF officials have simply looked the other way where currency is concerned. Simply put, the current options are not yielding real results.

Plus – and let's not underestimate this effect – the longer we wait, the more U.S. companies will have invested in China, and it will be in the interest of corporate America to preserve the status quo. It's not as if the political will to confront the Chinese is going to hit a sweet spot anytime soon.

Economists such as Peter Morici of the University of Maryland estimate that the trade deficit has cost the United States two million manufacturing jobs since 2000. If China stopped intervening in currency markets, or slowed it appreciably, other Asian countries would have to follow suit. This would not eliminate our trade deficit, of course – we need to make major adjustments in our domestic policies for that to happen – but it could be reduced significantly. While some may be concerned about how the price of Chinese imports might go up, our trade performance would be more balanced, U.S. R&D would increase, more jobs would be created here, and GDP would likely rise.

We all know the old jobs aren't coming back – but speeding up the pace of reform in China can help create new high-wage jobs in export industries here at home and allay some real concerns about wage stagnation among middle-class workers. What's more, if the American people see that our major trading partners are abiding by the rules of free trade, they are much more likely to support expanded trade, which is in the long term interests of our country.

Thank you again, Chairman Baucus and Ranking Member Grassley, for inviting us to testify. I now yield to my colleague from South Carolina.

COMMUNICATIONS

National **Retail** Federation
The Voice of Retail Worldwide

March 28, 2007

The Honorable Max Baucus
Chairman
Committee on Finance
U.S. Senate
219 Dirksen Senate Office Building
Washington, DC 20510

Re: The U.S.-China Trade Relationship – Comments by the National Retail Federation

Dear Chairman Baucus:

On behalf of the U.S. retail industry, the National Retail Federation is pleased to provide the following comments in response to the hearings before the Senate Finance Committee on March 27 and 28 on U.S.-China trade relationship.

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 more than 1.6 million U.S. retail establishments, more than 24 million employees - about one in five American workers - and 2006 sales of $4.7 trillion. As the industry umbrella group, NRF also represents more than 100 state, national and international retail associations.

International trade issues fundamentally impact the ability of U.S. retailers to run their businesses successfully. Every American retailer sources products from around the world in order to provide their customers the widest selection of merchandise at the best value. The commercial activities of the retail industry support good-paying, blue and white collar jobs, many of them union jobs. These millions of American workers are employed not only in the retail industry, which accounts for one-fifth of the U.S. workforce, but also in many industries that support retail operations and supply chains – *e.g.*, manufacturing, farming, ports, rail, trucking, warehousing, air delivery, and logistics. Having access to the widest selection of imported and domestic goods also keeps prices and inflation down and raises our standard of living.

Historically, commerce has provided the basis for U.S. economic prosperity. Yet today, there is a growing sentiment that blames international trade and globalization for a host of economic and competitiveness challenges facing Americans. Much of this national economic anxiety is focused on trade with China as it becomes a significant player in the global economy. Ignoring many of the more complex underlying causes, it has become easy to blame China for a variety of perceived problems – in particular our growing trade deficit and loss of manufacturing jobs. Policy makers have come under increasing pressure to take action to address these issues, often through protectionist measures under the guise of "fair trade" to limit imports from China.

Few U.S. industries have more at stake in the debate on the U.S.-China trade relationship than retailers. Consumer goods comprise 80 percent of U.S. imports from China, and China a key supplier in nearly every consumer goods category, including clothing, footwear, toys, consumer electronics, housewares, and furniture. Moreover, the demand in China for western style retail services is growing rapidly as millions of Chinese enter the middle class. This growth of the retail sector in big emerging markets like China is critical for the future of U.S. retail companies facing slowing growth in the United States and other mature retail markets.

The retail industry recognizes that there are legitimate issues with China that need to be effectively addressed, including inadequate protection of intellectual property rights, market access issues, the need to develop a more flexible currency regime, ensuring that China abides by its obligations under international trade rules, and dealing with the difficulties inherent in China's transformation from a 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 rules. For example, we fully support both the Strategic Economic Dialogue (SED) and recent actions by the U.S. Trade Representative's Office against China under the WTO dispute settlement mechanism. The SED may be a slower process than some may want, but it is most likely to yield positive results. By the same token, it is appropriate to challenge China at the WTO if it is providing prohibited subsidies and failing to adhere to international trade rules on the protection of intellectual-property rights.

On the other hand, policy makers should reject unilateral, counterproductive, and WTO illegal restrictions on imports of Chinese goods as a policy tool to compel action by China. An example of legislation that would fall in this category was the Schumer/Graham bill to impose a 27.5 percent tax on all imports from China in retaliation for China's alleged undervaluation of its currency. Had this protectionist, WTO-illegal legislation become law, it would have imposed huge costs on the U.S. economy, seriously harmed U.S. retailers, manufacturers, services providers and farmers that depend on imports used in the products they make, adversely affected millions of American consumers, and exposed U.S. exports to billions of dollars in WTO-approved trade sanctions. Just as disturbing, it would have moved the focus away from the real goal – achieving reform of China's financial sector so that the currency issue can be effectively addressed.

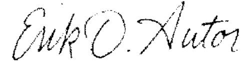
Most recently, we have seen Congress and the Administration turn to the trade remedies laws (antidumping, countervailing duty, safeguards) to restrict imports from China in an effort to deal with some of the larger trade issues with China. Again, the retail industry has much at stake as policy makers debate changes to trade remedies laws and procedures. Recently there has been a notable increase in trade remedies investigations against imported consumer products – e.g., wooden bedroom furniture, grills, etc. Based on our experience in these cases, we strongly believe that there is no need to "strengthen" current laws to make it easier for petitioning industries to obtain relief. If anything, these rules are too heavily stacked against

U.S. importers, consuming industries, and consumers – those who pay the bill for the import taxes imposed in antidumping and countervailing duty cases – to defend their interests. Therefore, we urge policy makers to oppose legislation that would further skew these rules to the detriment of U.S. retailers, consuming industries, and consumers, make trade remedies decisions more arbitrary and political, and violate international trade rules.

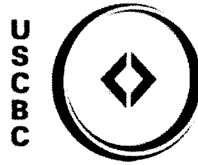
Several proposals that raise particular concern are legislation to restrict presidential discretion to consider the national economic interest in 421 safeguards cases; to circumvent WTO rules on standing in antidumping and countervailing duty cases by allowing upstream industries to file cases; to circumvent WTO subsidies rules by deeming currency imbalances to be a countervailable export subsidy.

NRF appreciates the opportunity to comment on these important issues and is available to answer any questions the committee may have.

Respectfully submitted,



Erik O. Autor
Vice President, Int'l Trade Counsel
National Retail Federation



THE US-CHINA BUSINESS COUNCIL
美中贸易全国委员会

1818 N Street, NW, Suite 200, Washington, DC 20036
Tel: 202-429-0340 | Fax: 202-775-2476 | E-mail: info@uschina.org | www.uschina.org

Statement of the US-China Business Council

to the

Senate Committee on Finance's Hearings
"Opportunities and Challenges in the US-China Economic Relationship" and
"Risk and Reform: The Role of Currency in the US-China Relationship"

March 27–28, 2007

A BALANCED APPROACH

The US-China Business Council (USCBC) is the leading organization for US companies doing business in and with China. Founded in 1973, USCBC represents its more than 250 US corporate members by providing advocacy and information services through its offices in Washington, DC, Beijing, and Shanghai.

USCBC advocates a balanced approach to trade policy toward China—one that recognizes the tremendous benefits that trade and investment with China bring to the US economy, yet at the same time focuses on eliminating market barriers and other unfair trade practices that affect US companies doing business with China. We support the rules-based resolution of trade disputes in a manner consistent with our World Trade Organization (WTO) obligations, just as we expect China to abide by its WTO commitments.

The most obvious benefit of trade with China is the rapidly growing exports of US companies. In 2006, China and Hong Kong combined ranked as the third-largest US export market, with exports of goods totaling more than $73 billion.[1] US exporters sold more only to Canada and Mexico—neighboring countries with which the United States has a free-trade agreement. Furthermore, exports to China are growing far more rapidly than exports to any other major market. US exports to China in 2006 were 240 percent higher than in 2000, the last full year before China's WTO entry. Of the top 10 US export markets in 2006, the second-fastest-growing market for US goods during this time was the Netherlands, with cumulative growth of 42 percent.

The prospects for increased exports of services to China is also encouraging. In 2005, the United States enjoyed a services trade surplus with China of $2.6 billion—small, of course, when

[1] Individually, China is the United States' fourth largest export market at $55 billion, and Hong Kong is the 15th largest at $18 billion.

compared with the large goods deficit. As US companies take advantage of service sector openings mandated by China's WTO entry agreement, however, the US services trade surplus is projected to grow to $15 billion by 2015, according to *The Prospects for US-China Services Trade and Investment*, a report by Oxford Economics, published in 2006 by the China Business Forum.[2] If China were to open its service sectors fully to foreign participation, Oxford Economics projects that the US services trade surplus could be as much as $60 billion.

More broadly, according to research conducted in 2005 by Oxford Economics for the China Business Forum study *The China Effect: Assessing the Impact on the US Economy of Trade and Investment with China*,[3] US trade and investment with China will, by 2010, result in a 0.7 percent increase in US gross domestic product and a 0.8 percent decrease in US prices—the combined effect of which will be an annual increase of up to $1,000 in real disposable income per US household. Furthermore, by 2010, trade and investment with China will boost the productivity of US workers by 0.7 percent and that of the manufacturing sector by 0.3 percent annually. The commercial relationship with China clearly benefits the US economy as a whole.

PRIMARY CONCERNS OF US COMPANIES

National treatment

Since China joined the WTO in 2001, phased-in market openings have provided new opportunities for international businesses. Nonetheless, USCBC member company executives report departures from the WTO's national treatment principle, which requires non-discrimination against foreign companies exporting to or operating in, WTO member economies. These examples can generally be grouped into three areas.

- ***Administrative licenses and business approvals*** In the 2006 USCBC member survey, executives at USCBC member companies ranked problems encountered when applying for business and product licenses and other forms of government approval as the top hindrance to US companies operating in China.[4] In some cases, these problems simply result from resource and coordination challenges faced by PRC regulators that slow the processing of applications.

But in other cases, executives at US firms believe PRC officials may be using their regulatory authority to prevent or delay the entry of foreign competition into a market to protect domestic companies. Examples of sectors that have reported such practices include agriculture, banking, chemicals, construction, express delivery, insurance, retail, and telecoms. In these sectors and others, China appears to meet the letter of WTO-mandated market openings in certain sectors but establishes new barriers that, in effect, prevent foreign companies from participating in the sector—while at the same time facilitating domestic competitors.

- ***Discriminatory laws and policies*** Recent public policy debates in China have indicated a dampening of enthusiasm in some quarters for foreign participation in the economy. Some in China also appear to want to expand the government's role in directing the economy and in

[2] See www.chinabusinessforum.org/pdf/us-china-services-trade.pdf
[3] See www.chinabusinessforum.org/pdf/the-china-effect.pdf
[4] See www.uschina.org/public/documents/2006/08/member-priorities-survey.pdf

developing internationally competitive Chinese enterprises, while also restricting the role of international companies in certain sectors.

Protectionist sentiments were evident in a series of policy notices China's State Council issued in 2006 regarding China's technological development through 2020. Separately, the State Council Opinion on the Revitalization of the Equipment Manufacturing Industry, issued in June 2006, envisions greater state intervention in a number of economic sectors and could create new hurdles for foreign acquisitions of domestic enterprises that build engines, power generating equipment, integrated circuits, shipping equipment, and in several other industries. In August 2006, the Ministry of Commerce released new regulations on mergers and acquisitions that would submit for government approval foreign acquisitions of "well-known" Chinese companies and brands, and give the ministry a broad authority to block transactions that adversely affect "national economic security," a term left undefined in the regulations. Statements in early 2007 from the head of China's State Asset Supervision and Administration Commission further echoed these themes.

- ***Unequal enforcement*** US businesses operating in China continue to describe an unequal enforcement environment that places them at a disadvantage to their Chinese competitors. For example, while US companies generally hold themselves to the highest environmental, health, workplace safety, and other standards—often going beyond what is required by PRC law—many Chinese competitors appear to fall short of PRC law in these areas, enabling them to minimize investment and other costs associated with full compliance. Enforcement authorities, mainly at the local and provincial levels, appear to focus more of their attention on US and other foreign companies. Similarly, while US companies in China typically comply with their PRC tax obligations, domestic enterprises appear to be able to avoid full compliance without repercussions. Looking ahead, a key concern of US companies regarding China's forthcoming Antimonopoly Law is that PRC regulators will target foreign companies that meet the law's criteria for market dominance more aggressively than domestic firms of similar size in China. Although it is difficult to establish with certainty the presence of a policy of unequal enforcement, the need exists to impress upon China the importance of equal enforcement of business regulations.

Intellectual property rights
Like all WTO members, China is required to provide legal protection against intellectual property infringement and to provide penalties for enforcement that are sufficient to deter future violations. Despite this obligation, inadequate protection for intellectual property continues to impede US companies in China.

It is important to point out that the term "intellectual property rights" (IPR) encompasses several distinct areas, including copyrights, trademarks, patents, and trade secrets. In each of these areas the nature and severity of the problem are different, as are the policy needs and protection measures available to companies. Accordingly, companies view the IPR problem differently depending on their industry. For some companies, particularly in the media sectors, IPR problems are aggravated by market-access restrictions that limit the availability of legitimate products to Chinese consumers. A differentiated approach to the IPR problem in China—one that

accounts for the unique problems and solutions in the various areas—is the most productive way to achieve advances for US companies on this issue.

The ineffectiveness of China's IPR enforcement regime stems in part from China's primary reliance on administrative authorities, which are able to impose only very low penalties to enforce IPR laws, instead of the court system, in which civil suits and criminal prosecutions could lead to higher penalties on IPR infringers. While government agencies are generally responsive to the requests of IPR holders to take administrative actions against infringers, the low penalties these government bodies can impose without court authorization serve as only a minimal deterrent to future infringements.

China's central government has taken a number of steps in an attempt to address these and other issues in order to improve the effectiveness of its IPR enforcement. These steps generally have been in response to the US government's persistent pursuit of improving IPR protection via the Joint Commission on Commerce and Trade (JCCT) process. In March 2006, China's National IPR Working Group, an interagency body under the State Council that is chaired by Vice Premier Wu Yi, issued its 2006 IPR Protection Action Plan. Though much of the plan focuses on ways to promote innovation, it also expresses an intention to boost enforcement activities.

Stemming from the action plan, China's Supreme People's Procuratorate, the Ministry of Public Security (MPS), the Ministry of Supervision, and the Leading Group on National Rectification and Standardization of Market Order jointly issued an opinion in March 2006 to facilitate the transfer of IPR cases from administrative agencies to public security bureaus for criminal investigations. MPS and the General Administration of Customs in March 2006 also jointly issued rules to boost coordination in IPR cases involving products scheduled for export. The Ministry of Culture issued in November 2006 regulations giving local culture authorities more tools to address piracy of recorded music and cinema products. In December, the Beijing Number One Intermediate People's Court ruled that Pfizer, Inc.'s patent on the drug Viagra is valid, thereby reversing an early ruling that had revoked the patent and had allowed Chinese producers to legally manufacture what were, in essence, counterfeit pills. In early 2007, China's Supreme People's Court issued an opinion that could streamline judicial proceedings on IPR cases and make them more accessible and cost effective for companies that seek to protect their rights.

These are welcome steps, but China's legal capacity to effectively protect IPR remains limited. China's use of value thresholds to determine whether IPR infringers may face criminal charges reduces the efficacy of Beijing's recent steps to facilitate criminal prosecutions of IPR violators. These thresholds, although lowered in China's Supreme People's Court December 2004 judicial interpretation, provide a loophole for IPR infringers to escape criminal prosecution by, for example, keeping the value of inventory stored at any one location below the threshold level. Moreover, calculations to determine whether the thresholds have been met are based on the price of the counterfeit product rather than that of the legitimate—and higher priced—product it imitates. China's use of numerical value thresholds appears to be inconsistent with its commitments as a signatory of the WTO Agreement on Trade Related Aspects of Intellectual Property (TRIPS), which calls for criminal sanctions in all cases of IPR violations on a "commercial scale."

For its part, USCBC has urged the PRC government to take this course. In numerous meetings in 2006 with Vice Premier Wu Yi and other senior and working-level PRC officials in various agencies, USCBC advocated the abandonment of thresholds and the adoption of the "commercial scale" criteria. USCBC complemented these meetings with a written submission to several PRC government bodies suggesting detailed changes to PRC laws that would provide for an enhanced legal framework for enforcing IPR protection.[5] Adopting the "commercial scale" criteria and other changes to its laws governing IPR enforcement are important steps the PRC government can take to benefit companies in a broad array of sectors.

Transparency

Limited legislative and regulatory transparency creates uncertainty and confusion for US companies in China. There can be no question that China's legislative and regulatory processes are today far more transparent than ever before. Nevertheless, as US companies expand their business operations in China, the need to have a clear understanding of China's legal and regulatory environment has substantially increased.

Most of the problems in obtaining licenses noted above are exacerbated by the opacity of China's regulatory bodies. In addition, regulations affecting US companies sometimes come into force without the government seeking input. For example, in July 2006, the Ministry of Information Industry imposed without advance notice new rules for the value-added telecom service sector. The China Insurance Regulatory Commission issued in July 2006 qualification requirements for senior managers of insurance companies without soliciting public comment. In addition, the Ministry of Commerce imposed in August 2006 without prior notice requirements regarding the training and recruitment of direct sales agents.

There were some important instances of increased transparency in 2006. China's National People's Congress (NPC) solicited comments in March 2006 on the proposed Labor Contract Law and in June 2006 on the proposed Antimonopoly Law (although in the latter case only from members of the China Association of Enterprises with Foreign Investment, or CAEFI). In addition to the request for comments via CAEFI, the NPC has held an ongoing dialogue with foreign companies and experts on the Antimonopoly Law. China's government ministries and agencies also at times sought comments from international companies.

In a move that may in time help institutionalize the instances of transparency cited above, in April 2006, China's State Council issued a decree requiring all government bodies to report any regulations affecting trade to the Ministry of Commerce for publication in its official gazette. This is a welcome step toward a more transparent regulatory regime, but its immediate effects should not be exaggerated. First, the decree makes no stipulation regarding when government agencies must report their regulations. Second, the decree does not give the Ministry of Commerce the authority to ensure that other agencies are submitting regulations. To date, the gazette's scope appears far from complete. Finally, the gazette is intended for final regulations and not for drafts, so this development will not necessarily increase the opportunity for companies to provide input on policies that affect their operations.

---

[5] See www.uschina.org/public/documents/2006/08/irp-law-chnages-english.pdf

Standards
China's technical, safety, and product standards, as well as the procedures for establishing these standards and ensuring a product's compliance with them, continue to concern US companies.

China is seeking to encourage the development of domestically owned technical standards in an effort to reduce its reliance on foreign technology. It is natural that China as a large producer of and market for a wide range of goods should take an increased role in establishing new international technical standards. In doing so, however, China should abide by its obligations under the WTO Agreement on Technical Barriers to Trade to adopt standards based solely on scientific criteria and not as a tool of trade or industrial policy.

In some instances, China's "homegrown" technical standards appear designed to assist domestic companies at the expense of international competitors. The most prominent example of this has been China's attempt in 2004 to impose the wireless local area network authentication and privacy infrastructure (WAPI) standard as a mandatory national standard. Although this issue was resolved at the 2004 session of the JCCT, WAPI reemerged in December 2005 when Beijing announced that products using WAPI technology should be given preference in government procurement. The effect of this policy so far appears limited, however. China's designation in February 2006 of TD-SCDMA as the "national standard" for third-generation mobile telecom technology raises concerns that Chinese mobile telecom operators will face government pressure when deciding what technology to employ in their networks. China agreed at the 2004 session of the JCCT to adhere to "technology neutrality" and to allow mobile operators to choose independently which type of third-generation technology they would adopt. Unlike WAPI, however, the TD-SCDMA standard enjoys support from some international companies. China's interest in developing a native technology for radio frequency identification devices could also create significant challenges for US businesses producing in, exporting from, and importing to China if Beijing makes it difficult for companies to use the existing—and widely adopted—international standard for these devices.

Related to but separate from these issues surrounding the development of technical standards are concerns regarding safety and product standards and the means by which products are tested for compliance. China is implementing new standards governing hazardous substances in electronic products, energy efficiency, and others. Most concerns in this regard focus on limited transparency in the process of drafting standards and possible uneven enforcement for domestic and international companies. Medical device manufactures are particularly concerned about testing requirements. China partly addressed this issue in the wake of the 2006 JCCT, declaring that devices would be subject to just one test rather than two. But concerns remain, since two regulators will still need to certify a device's compliance. Raising more explicit concerns regarding China's adherence to WTO requirements, international companies may not participate in a program the Standards Administration of China announced in May 2006 to recruit a group of domestic companies to help draft new standards for household appliances.

Finally, US companies interested in obtaining the China Compulsory Certification (CCC) mark for their products continue to face delays, in part because of restrictions China places on foreign standards organizations to conduct CCC inspections and audits.

CHINA'S EXCHANGE RATE POLICY

One issue more than any other has captured the attention of Congress and much of the US public: the exchange rate between the US dollar and the Chinese yuan. Many say that China's government keeps the value of its currency artificially low in order to boost its exports and that this is the main cause of the bilateral trade deficit between China and the United States.

China should indeed adopt a market-determined exchange rate. Toward this end, the focus of the United States should be on encouraging China to undertake the broad financial sector reforms that will allow market forces to determine fully the value of its currency. These include opening the financial sector to more competition, introducing more financial market products, requiring greater commercial accountability from existing financial sector companies, and, of course, allowing more foreign participation in China's capital and credit markets. USCBC understands that the Treasury Department has made these reforms a central part of its engagement with China's government through the Strategic Economic Dialogue (SED). USCBC fully supports these efforts.

In the meantime, China should move more quickly to allow market influences from trade flows to be reflected in the exchange rate between the dollar and the yuan. The change in July 2005 in China's currency policy was a welcomed step. The movement of the yuan against the dollar since then has generally been consistent, albeit at a more tightly controlled pace than most would like to see.

It should be noted, however, that the effect of China's exchange rate policy on bilateral trade is likely overstated. USCBC member companies generally do not cite the exchange rate as a key business issue affecting their competitiveness in China. Many are concerned, however, about potential repercussions should the political dispute between the two countries over the exchange rate worsen. *The China Effect* study cited above indicates that even a 25 percent appreciation of the yuan against the dollar—far greater than expected—would decrease the total US trade deficit, which was more than $800 billion in 2006, by $20 billion.[6]

Even so, any benefit China gains from an undervalued currency—even if its actual impact on the US economy is not great—should be addressed. The best way to eliminate any such unfair advantage is to continue to push for greater market influences to be reflected in the exchange rate now, for broader financial reforms that will lead to the removal of capital controls at the appropriate time, and for a truly market-based currency in the future.

THE SED, JCCT & WTO

USCBC supports the administration's three-pronged approach to the commercial relationship with China through high-level exchanges at the SED, concrete negotiations to reach solutions to specific problems via bilateral mechanisms such as the JCCT, and the use of the WTO's dispute settlement mechanism to enforce US trade rights when solutions cannot be found through dialogue. USCBC believes this to be the most effective way to lower the market access barriers

---

[6] See www.chinabusinessforum.org/pdf/the-china-effect.pdf

that US companies face in China, leveling the playing field between US and Chinese companies competing around the globe, and ensuring that China abides by its obligations as a WTO member.

The principal value of the SED is to provide a framework to guide the development of the most important economic and commercial relationship in the world. The United States and China will soon be two largest global economies and will remain that way for our lifetimes. Our two economies are already greatly intertwined. This is a relationship that both governments need to get right—and, for our government, a relationship that needs to keep moving forward in a way that meets US interests. This is especially true because the schedule for most of China's WTO market opening requirements reached its end last year, a schedule which in essence provided a roadmap for reforms and openings of China's economy. The SED can pick up where that roadmap ended and continue to propel the reform process and trade relationship forward. If done right, the SED framework should also provide positive momentum or "tailwind" for solving specific problems through existing forums such as the JCCT.

The first session of the SED, held in Beijing in December 2006, laid the foundation for frequent and wide-ranging, high-level exchanges between senior economic policy makers from China and the United States. The dialogue has the support and involvement of the presidents of both countries. The next session is scheduled for May 23-24 in Washington, DC. USCBC has encouraged both governments to find opportunities for members of Congress to engage with the unprecedented number of top PRC officials that will be in Washington for the SED. Such interaction would lead to a better understanding among PRC leaders of the role of Congress in US trade policy and among US lawmakers of the economic concerns and priorities of China's government.

At times, Beijing and Washington will be confronted with issues for which a mutually satisfactory solution cannot be reached through dialogue. Disputes are a normal part of a trading relationship, and the growth and complexity of the US-China commercial relationship means that such disputes will naturally increase in frequency. The WTO provides a nonpolitical mechanism for solving such disputes when dialogue fails. In these instances, USCBC supports the enforcement of US trade rights through the WTO dispute settlement mechanism, but urges our government to ensure that such cases are well-defined and focused on clear WTO violations.

CONCLUSION

US trade and investment with China clearly benefit the US economy, both through exports and through broader effects such as lower prices and higher productivity. Nevertheless, market access barriers and other problems exist in the bilateral economic relationship. USCBC supports efforts to find solutions to these issues that are focused and do not threaten the tremendous gains to the US economy that come from trade and investment with China.