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CHINA'S EXCHANGE RATE POLICY AND TRADE IMBALANCES

HEARING

BEFORE THE

SUBCOMMITTEE ON
ECONOMIC POLICY

OF THE

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

ONE HUNDRED ELEVENTH CONGRESS

SECOND SESSION

ON

EXAMINING THE EFFECT THAT CHINA'S EXCHANGE RATE POLICY HAS ON TRADE FLOW, U.S. MANUFACTURERS, AND WORKERS

APRIL 22, 2010

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CHINA'S EXCHANGE RATE POLICY AND TRADE IMBALANCES

THURSDAY, APRIL 22, 2010

U.S. SENATE,
SUBCOMMITTEE ON ECONOMIC POLICY,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Subcommittee met at 10:11 a.m., in room SD–538, Dirksen Senate Office Building, Senator Sherrod Brown (Chairman of the Subcommittee) presiding.

OPENING STATEMENT OF CHAIRMAN SHERROD BROWN

Chairman BROWN. This hearing of the Economic Policy Subcommittee of the Banking Committee will come to order. I appreciate my friend Senator Lindsey Graham, who has been outspoken in support of manufacturing and on all of these issues that surround currency, and we will hear from Senator Graham in just a moment.

The matter before the Subcommittee is an urgent one. We are holding this hearing in the hope that our witnesses can shed light on the effect that China's exchange rate policy has on trade flow and U.S. manufacturers and our workers and on what remedies Congress should consider. Financial and trade analysts and news reports indicate we should anticipate China to begin gradually revaluating its currency, the RMB, in the coming weeks. What we hope to learn is what a meaningful appreciation of the RMB would be and what effects it will have on the U.S.–China trade relationship and on U.S. employment. We will consider remedies to address this imbalance that exists today and that we can expect to remain for some time in the future.

While it is true the journey of a thousand miles begins with a single step, it is an awfully slow way—and I know it has tried Senator Graham's patience, too—a slow way to reach our destination. But that is the path we are on today.

When I came to Congress in 1993, the RMB was valued at about 5.5 to the dollar. Then from 1995 to 2005, it was valued at about 8.28 without change. In my mind, that is one of two things: one heck of a coincidence or blatant currency manipulation.

From 2005 to the middle of 2008, we were heading in the right direction in part because of Senator Graham's and Senator Schumer's—in large part because of their efforts, but still too slowly. Beginning in 2005, the Government of the People's Republic of China managed a slight currency appreciation which allowed for a few years of modest progress. But in the summer of 2008, China

abandoned this process and once again fixed the value of their currency against the dollar. So our journey of a thousand miles has involved more steps backward than forward during the last decade and a half.

By keeping the value of their currency artificially low, China provides an incentive to foreign corporations to shift production there because it reduces the price of investing in China and makes China's exports cheaper. This continued undervaluation, which most economists agree—and we will hear from several of them today—is in the range of 25 to 40 percent, has caused serious harm to our economy and has cost American jobs.

Think about it. If a gas station is offering gas for $3 a gallon and another is selling it for $2 a gallon, how long can the first one stay in business?

According to a recent Economic Policy Institute report, since China joined the WTO in 2001, 2.4 million jobs have been lost or displaced in the U.S. as a result of the U.S.–China trade deficit. Under the Omnibus Trade Act of 1988, the Treasury Department is required to formally identify countries that manipulate their currency for the purpose of gaining an unfair competitive trade advantage. In recent years, Treasury has found that certain countries' currencies were, in fact, undervalued.

However, based on its interpretation of the law's legal standard for a finding of manipulation, Treasury refused and continued to refuse, through Presidents of both parties, to cite such countries as currency manipulators. Last month, Secretary Geithner announced the Department will delay the release of the statutorily required report to Congress. This Committee has oversight responsibility of this issue, and under Article I, Section 8 of our Constitution, it is Congress that is charged with the regulation of both foreign commerce and the value of our currency.

The Subcommittee has invited a representative of Treasury to testify today, but the Department declined due to its ongoing diplomacy, both bilaterally with the Chinese and in multilateral settings like the G–20. I disagree with the Department's decision. I care less about the exact timing of the report than I do about the Administration's willingness to be open with Congress and the American people about what it is doing and why it is doing it. And while the cat has got their tongue when it comes to testifying before Congress, I note that not one but three Treasury representatives were scheduled to speak with a group of bankers and analysts at the JPMorgan investor conference at the Madison Hotel tomorrow morning.

The American people have been patient as the Administration continues this strategy, but patience is waning as more U.S. businesses are undercut and more U.S. workers are losing their jobs. Just yesterday, Commerce said it will investigate whether Chinese aluminum products are getting unfair subsidies, but have delayed a decision as to whether currency valuation will be a factor in the case.

These delays and the Administration punts on currency decisions involving China cannot last forever. The Chinese Government follows its economic interests. The U.S. Government should do the same.

I know I can speak for Secretary Dodd in stating that the Committee looks forward to Secretary Geithner's appearance before the Committee in the coming weeks.

Today we have three distinguished panels, led off by Senator Graham, to help the Subcommittee understand not just the fact that China's currency is undervalued. That point is clear to all of us. What we hope to understand are the effects of that policy and what options are available for moving forward.

I look forward to the hearing and the testimony of each of the witnesses, and we will start with Senator Graham—and Senator Schumer we invited today, too, the two chief sponsors of the currency manipulation issue. Senator Schumer could not join us. His staff is here, and I very much appreciate Senator Graham being here and Senator Graham's work on this and many other issues. Lindsey.

STATEMENT OF LINDSEY GRAHAM, SENATOR FROM THE STATE OF SOUTH CAROLINA

Senator GRAHAM. Well, thank you, Mr. Chairman. People are dying for their Congress to work together in a bipartisan fashion to solve problems that affect their daily lives. Well, when it comes to China currency, your ship has come in. We have got new legislation with Senators Stabenow, Brown, Brownback, myself, and Senator Schumer, and, Mr. Chairman, having you on board has been great. No one has talked more about this in terms of how Chinese manipulation of their currency affects the ability of American manufacturing to survive. And American manufacturing is under siege for a lot of reasons, some of them of our own making back here. We need to do a better job of regulating, taxing, and litigation. But at the end of the day, it is the world economy, and Republicans and Democrats see the current behavior of the Chinese government of manipulating the value of the yuan against all other currencies as having a devastating effect in terms of the global economy.

The reason I know they are manipulating is that the only time it gets any adjustment or revaluation is when we put a bill in. And the moment we look the other way, it stops.

Now, this is a bipartisan team to fix the problem, but there is a bipartisan problem associated with Chinese currency. In the Bush administration, it was impossible for us to get the Bush administration to say China manipulated their currency, which everybody knows they do. The Obama administration ran—music to my ears. Now here we are having the same trouble with them. We cannot get them to do the things that would change this policy. And I think the reason is that when you get in the White House, you realize that we are borrowing so much of our money to run the Government and pay our bills from China, it just makes it very difficult to engage China. And that is an unhealthy relationship.

I want a good partnership with China. I want it to be mutually beneficial. But this one issue of where the currency of China is kept artificially low has a devastating effect—and I am not an economist, but I am looking at it through the eyes of a manufacturer in Ohio and South Carolina. You are producing a product to be sold on the world market. One of your biggest competitors is China. If they can beat us because they do a better job, so be it.

That is just the way the world is and will always be. If the other person outworks you and has a better business model that is more efficient and they are smarter at what they are doing and they work harder and you lose, so be it. But our companies in Ohio and South Carolina are losing market share not because they are being outworked. They are being out manipulated.

It is one thing to compete against cheap labor, and the Chinese communist capitalist model is unique. They are capitalist as long as the government allows you to be a capitalist. They literally recruit millions of workers, put them in high-rise apartment buildings and set their wages, in a way that could never happen here, and provide that labor to any company that would come over. The company has to agree to a Chinese partner at 51 percent, and if you do a business for a long time over there and you have got technology, there will be a Chinese company opened across the street from where you are doing business that is using your technology. That is just the way it is with China, and instead of complaining, we ought to do something about it.

When it comes to their currency, based on economics, as I understand it, the more you export, if you become an export economy, well, the value of your money should change based on the way you are doing business. If you are making all of your money by selling goods to other countries, then the value of your money ought to change based on your export-import balances.

Well, it never changes. And what does it mean if it never changes? What does it mean if they manipulate the currency? It means that the company in South Carolina and Ohio has got to compete against cheap labor, no EPA, a command-and-control communist economy. You also have to compete against artificially low money. If it is 25 to 40 percent below its true value, that means that a product produced in China, in addition to the other things I have said, direct subsidies, low wages, no environmental laws, on top of all that you are getting a reduction in the cost of producing goods in China because the money discount goes to the people making products in China at the expense of people in South Carolina and Ohio.

If China were some island nation trying to get through and just pay their bills and manipulating their currency to kind of seize a market just to stay in business for a while, that would be OK with me. They are not. They are a huge economy. They are sucking up all the excess oil there is in the world. They are going around buying natural resources. They are growing at 11 percent with no end in sight. I am glad they are doing well, but not at our expense. I want them to do well. I want them to be a partner that can buy stuff from us. But they have to adopt recognized trading policies and economic principles to be a good partner.

Our legislation is very simple. If you find that their currency is misaligned—and you do not go to intent. If it is misaligned, then we give the Treasury Department and the Commerce Department tools to address that misalignment. And it is not China specific. It is any country that has a certain economic weight that is engaging in this behavior. Our country can push back. We can now bring dumping cases based on misaligned currency. That would be a huge breakthrough.

The textile industry, which is constantly under siege from Chinese products being dumped throughout the world, would now be able to make a case that I am losing market share because the money is a form of dumping, the money manipulation.

We would get 80 or 90 votes if we could ever get this sucker on the floor, and it is a shame, quite frankly, that we are having to do this legislation given all the efforts by the Bush administration and the Obama administration to find a better glide path. But in 2008—the Chairman is absolutely right—their marginal efforts at currency adjustment stopped because the political pressure stopped.

So this time around, we have got a chance to institute reforms that will be WTO compliant. And if it hurts our relationship with China, then that says a lot about the relationship. It is not healthy that you have to ignore someone's cheating to keep them as a friend. I have nothing against the Chinese people. I do not like their form of government, but they do not like ours. We will just deal with that. I cannot sit by and watch people in my State, Ohio, or anywhere else lose their job because the Congress is allowing someone as big as China to cheat.

Stop cheating is all we are asking. Allow the currency to float in a reasonable way. I understand you have an immature banking system. I am willing to be flexible and reasonable. You need to increase the basket of items that go into valuating the yuan. You need to change your banking system so it will accommodate a floating currency. I do not expect that it would happen overnight, but I expect a system to be in place to replace adjustments based on political pressure.

I cannot live with small changes in the yuan directly related to how much time and attention the two of us spend on China currency. I need to go back to South Carolina and you need to go back to Ohio and tell folks change is coming. It is going to take a while for the Chinese economy to float their currency, but we now have them on a path where over time we will have a better trading relationship. The Chinese people save way too much. We save way too little. They need to open up their markets to financial services so their people can have a way to invest their money. We are good at that. And where they are better than us because of the way they do business fairly and we lose, so be it. But they are beating us not because they are better, but because they are manipulating their currency. And if we do not do something about that, then the public is going to be very disappointed in their Congress beyond what they are today.

One last thought. We borrow most of our money from China to pay our bills, and one of the biggest bills we pay is buying oil from overseas. This is a lousy spot for America to find herself in 2010. And I am working with you, Mr. Chairman, to do something about both things. I am working with you to find a way to get a better trading relationship with China so that we will have an honest trading relationship. And I am working with you to find a way to reduce our dependency on foreign oil. If the next generation of Americans inherits a world economy where China continues to manipulate their currency given their growth, it is going to destroy American manufacturing. If we continue to never change our poli-

cies here at home about finding oil that we own and consuming less and investing in technology to break our oil dependency, they are going to be more dependent on Mideast oil, and that is not what either one of us wants to do for the next generation of Americans.

So I hope the Congress, the Democratic and Republican leadership, will get behind this bill because the time is long overdue to act. Thank you very much.

Chairman BROWN. Thank you, Senator Graham. Thanks for joining us, and I appreciate your comments and especially your work on all of those issues, from climate change to the currency issue, so thank you again.

I will call the first panel up, if they would join us. Thank you, all of you, for joining us. I will introduce each of you briefly. Then I am going to do something a little different. Mr. Prestowitz has a flight, because of a cancellation has to get out earlier. So after his testimony, I will ask him a couple questions. Then the rest of you can do your statements, and I will then focus on the three of you, if that is OK with people.

Clyde Prestowitz has played key roles in achieving congressional passage of NAFTA and in shaping the final content of the Uruguay Rounds, as well as providing an intellectual basis for current U.S. trade policies, and was the lead negotiator, as most of you know, for the Commerce Department in the Reagan years in our Japan negotiations. I just finished over the weekend reading the galleys of his new book which is coming out, "The Betrayal of American Prosperity," and his role in how America can address these issues.

Nicholas Lardy, Senior Fellow for the Peterson Institute for International Economics, was a Senior Fellow at Brookings for about a decade and the Director of the Henry Jackson School of International Studies prior to that at the University of Washington. His writings I have been a fan of for many years and learned a great deal about trade and economic policy.

Charles Blum is Executive Director of the Fair Currency Coalition, for 30 years focused on trade and manufacturing while serving in various capacities in the Government and the private sector, and he has been a very important advocate as part of the Domestic Manufacturing Group and part of the National Association of Manufacturers and all that he has done that way that has been so important to us.

Daniel Ikenson is the Associate Director of Cato Institute's Center for Trade Policy Studies. Cato, as you know, speaks articulately and forcefully on behalf of issues that are important in this country and I think has a perspective that is important for all of us to address also. So, Mr. Ikenson, welcome to you.

I will start, if Mr. Prestowitz would do his testimony, and then as I said, I will ask him a couple questions and then move to the rest of the panel. Thank you.

STATEMENT OF CLYDE PRESTOWITZ, PRESIDENT, ECONOMIC STRATEGY INSTITUTE

Mr. PRESTOWITZ. Thank you very much, Mr. Chairman. I appreciate your courtesy.

First, I think it is important to recognize that in the tensions between the U.S. and China—the trade deficit, the nature of the

trade between the U.S. and China, questions of employment and unemployment—the currency is only one factor. There are a number of other factors—savings and investment, consumption policies, economic growth, and so forth. So currency is only one factor, but it is an important factor. And as Senator Graham said, there is no doubt that China is managing its currency to maintain it an undervalued rate. The evidence of that is the daily intervention by China in currency markets and the huge accumulation of dollar reserves by China.

You have my written testimony. I wanted to hit just four quick points. One of them is the argument that is often heard that the exchange rate does not matter, the argument being that even if China revalued, it would not make any difference in the U.S. trade deficit or U.S. employment; and, moreover, that the driver of these imbalances is not the exchange rate but it is consumption and investment and savings. Two points there:

One is that the equation that calculates the impacts of these factors is a mathematical identity, and so by definition, in a mathematical identity, the action in the equation can be either way. So, of course, savings and investment has an impact, but so also do currency rates. And in this case, we know that the currency rates are being distorted. Again, not the only influence but a very important influence.

The second point is when we say it does not matter, that is almost like saying prices do not matter. And if prices do not matter, then I am not sure economics matters. The point is that there are, of course, a number of factors that determine trade balances, but certainly the rate of currency is one of them.

It is often said that between 2005 and 2008 China did allow its currency to float up about 20 percent, and yet the U.S. trade deficit increased, and this is cited as evidence that the currency rate does not have any effect. But one has to remember two things—three things. One is that this was a period of a bubble in the United States, enormous growth in U.S. demand. One has to ask the question: If they had not allowed the currency to float up, would the deficit have been bigger?

And the final point, I think, is that while China's currency appreciated nominally by 20 percent, in fact, because its rate of productivity growth was very high, the appreciation in real terms was actually less. In fact, it may even have depreciated in real terms over that period of time. So just to make the point that currency rates do matter and we should not ignore them.

The second point is that while we talk about this issue in terms of deficits, imbalances, and particularly unemployment in the U.S., I think there is another very important element, perhaps more important, that we do not discuss very much, and that is, the distortion of trade. In other words, we could have a situation, as we do with Saudi Arabia, where we have a huge trade deficit with Saudi Arabia, but our trade with Saudi Arabia is not being distorted. What we make in the United States, what we sell in export is not being distorted by our trade deficit with Saudi Arabia. On the other hand, in our trade with countries that—and China is not the only one. Let us keep this in mind. But our trade with countries that do manage their currencies to be undervalued, it changes the

structure of our trade. And in a way, that is more important than the question of deficits and employment because while other factors impact deficits and employment, the structure of the trade is very much impacted by the currency rates.

The third point I would like to make is that in this discussion, we are frequently warned that any effort by the U.S. to offset the impact of the currency distortions would be protectionist and would risk setting off a trade war. I think it is important for us to understand that when countries manage their exchange rates to be undervalued as a matter of policy, that is a protectionist policy. And so in this debate or in this confrontation, it is not the United States that is being protectionist. We are already in a situation in which others are being protectionist.

The last point I would make is this: China has said, and understandably, that it manages its exchange rate in the interest of its economy. It has unemployment; it has huge structural problems. It is a country that needs to have rapid growth. We want it to have rapid growth. We want it to be successful, and China has said, look, you know, we are not doing this to hurt you guys; we are doing this because this is in the best interest of our economy. And I think we can understand that.

I think that sometimes rather than pointing the finger at China, we should take a similar position, namely, that, OK, we understand you have unemployment, we understand you need to hit growth targets. We have unemployment, too; we have growth targets we need to hit as well; and, therefore, we need to manage our currency in the best interest of our economy.

We can do that. We have countervailing duty laws. There are clauses in the WTO that suggest that currency manipulation is really illegal under WTO rules. We have balance-of-payments issues that could be adduced to justify measures by the U.S. to counter the impact of currency management. I think particularly our countervailing duty laws and the ability of the Secretary of Commerce to self-initiate countervailing duty cases is something that should be pursued more aggressively than it has been. But my point is that rather than constantly beating up on China, perhaps we should be looking to our own interests and thinking about what we can do to protect our interests.

The final point I would make is that in the debate about competitiveness and the question of what is causing decline of U.S. competitiveness, certainly China's currency policies are one factor that contributes to a decline in U.S. competitiveness. But we should not forget that there are man factors that we contribute ourselves. We are low savers. We do have a *de facto* industrial policy that makes no sense. And so as well as dealing with the currency issue, we should be dealing with that in the context of a broad strategy to revitalize the U.S. productive base.

Thank you.

Chairman BROWN. Thank you, Mr. Prestowitz, and I will ask a couple questions, then move on to Mr. Lardy.

This week, Brazil and India joined the call for China to appreciate its currency. Since those are two countries that are part of the developing emerging economy BRIC group—Brazil, Russia, India, and China—what does this suggest to you that they have made

that call? And what opportunities does it present to us to work with them rather than trying to address this unilaterally?

Mr. PRESTOWITZ. Well, I think it is very important that they made that call because what it tells us is that while we tend to think of this question in bilateral terms, in fact, China's policies are having a negative impact on many countries. And that suggests that it should be possible to address this in a multilateral setting, in a multilateral framework, rather than just a U.S. beating up on China framework. And so I think that the Administration would be well advised to try to rally support from others who are being negatively impacted.

Chairman BROWN. In your book, you mentioned—thank you for that. You talked about U.S. company—I mean, the framework of—I often heard in my time in the House working on trade issues that trade brings democracy and the wealthier a country gets, the more it interacts with Western democratic countries like ours, the more democratic it becomes and the more it shares our values.

You point out in your book and other times I have heard you that, in fact, U.S. companies sometimes prefer manufacturing and development and location of plants, if you will, in countries that are less than democratic and countries that are authoritarian. If that, in fact, is true—and I think it is, too. But if that, in fact, is true, how do we change that direction a little bit so that it is not more of a pull to do business in China for an American company because of the authoritarian structure that might make their lives a little bit easier?

Mr. PRESTOWITZ. Well, I think it is, as you have said, we are in a situation in which global companies are major political players in Washington, DC, and in other democratic capitals. In authoritarian capitals, they are supplicants, just like everybody else. And so the balance of influence is kind of asymmetric.

But more than that, I think a major issue that needs to be discussed in tandem with the currency question is the question of investment incentives, because right now, if you look at the structure or the dynamics of a global economy, all of the incentives are really such as to move the production of tradable goods and the provision of tradable services out of the U.S.

What are those dynamics or those incentives? One of them is currency. Currency is being undervalued in a number of countries, China lead among them but not the only one.

The second one is financial investment incentives. Put your factory in my country and we will give you the land. We will give you the infrastructure. We will put in a capital grant. You won't pay taxes for 30 years. So on a $5 or $6 billion investment, those incentives can amount to as much as half of the capital invested, and what they serve to do is to distort the actual market dynamics.

So, for example, you can produce widgets more economically in the U.S., let us say, than in China on a normal operating cost basis. But if the capital is subsidized, then you move that production to China. And so the location of production is not being determined by market forces. It is being determined by capital investment incentives.

This is something that the U.S. does at the State level, but the States don't have many chips to play with in the U.S. We don't do

it at the Federal level. I think we should. I think we should have a fund. My proposal is that we propose globally to negotiate an agreement like we have in the WTO on export subsidies. We proposed to negotiate disciplines on the use of investment incentives, but at the same time, while negotiating that, we create a fund that would match the incentives of others to offset that distortion of the market forces.

Chairman BROWN. Thank you, Mr. Prestowitz. Thank you for joining us.

Mr. Lardy, your testimony, please. Thanks.

STATEMENT OF NICHOLAS LARDY, ANTHONY SOLOMON, SENIOR FELLOW, PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS

Mr. LARDY. Thank you very much, Senator Brown, for inviting me to appear before the committee this morning. I did submit a statement for the record and I would just like to take my limited time to draw out some points from that. I am going to focus on four key points from the prepared statement.

The first is that although China's external surplus on a global basis has fallen extremely sharply, from 11 percent in 2007, 11 percent of GDP, to only 1 percent of GDP in the first quarter of this year, I think this decline was caused primarily by factors that have already been reversed or are likely to be transitory. But the sharp and unexpected reduction in China's external surplus does suggest that there is a substantial uncertainty about the precise degree of undervaluation.

In other words, this surplus has fallen much, much more rapidly than anybody expected. However, despite this, I do believe that China's currency on a fundamental basis remains significantly undervalued and it is quite likely that the external surplus will rise in the second half of this year as compared to the second half of 2008.

The second point in my prepared statement is that the virtual disappearance of China's external surplus means that within China, it will be politically difficult for the central government to resume a policy of appreciation *vis-a-vis* the dollar. It will be strongly resisted by provincial and other local political leaders along China's coast, where upwards of 50 million people are employed in export-oriented manufacturing. They simply won't understand why appreciation is called for in a period when China's surplus has disappeared. If appreciation does resume, I expect it would be relatively modest, at least until the global recovery strengthens further and China's external surplus widens significantly, for example, as a result of the resumption of growth in Europe.

The third point in my prepared statement is that even if the undervaluation of the RMB remains very large, a rapid correction of this undervaluation is not optimal from either the U.S. or the global perspective. A rapid appreciation would likely lead to a deceleration of China's economic growth and thus both impede global recovery and lead actually to a loss of jobs in the United States.

This is very straightforward. If China's growth decelerates, their imports will decelerate and will have negative implication for jobs

in the United States. So the optimal path is to rather eliminate the undervaluation over a period of years. This would add modestly to the growth of employment in the United States as our economic recovery continues. I think the problem is, as one reads estimates about the number of jobs that might be created as a result of China's appreciation, it is frequently not qualified by any discussion about the timeframe over which that would be either likely to occur or optimally should occur.

The fourth point is that, again, and Clyde mentioned this, I think U.S. policy should not focus exclusively on the Chinese exchange rate. Rather, policy should be set on a broader framework that recognizes that reducing China's and keeping China's external surplus small requires not only a more flexible exchange rate, but also structural reforms within China that would lead to more consumption-driven growth.

This is the savings-investment imbalance. This is essentially, I think, the economic rebalancing agenda that has been taken up in the economic component of the strategic and economic dialog with China that is led by Treasury Secretary Geithner. It is also a very important part of the G–20 process that has emerged over the last year or so. In my judgment, it is this more comprehensive approach that is most likely to reduce global economic imbalances and thus contribute to a more sustainable global economic recovery.

Thank you.

Chairman BROWN. Thank you very much, Mr. Lardy.

Mr. Blum.

STATEMENT OF CHARLES H. BLUM, EXECUTIVE DIRECTOR, FAIR CURRENCY COALITION

Mr. BLUM. Thank you, Mr. Chairman. The Fair Currency Coalition appreciates this opportunity to testify on what action can and should be taken to remedy currency undervaluation by China and others.

Almost 6 years ago, we sought a solution through multilateral dispute settlement by filing a well researched and argued Section 301 petition. It was summarily rejected by the last Administration. Only then did we turn to legislation, developing and refining what is now known as the Currency Reform for Fair Trade Act, introduced by Senators Stabenow and Bunning and by Representatives Tim Ryan and Tim Murphy. We intend to continue to work on this problem until it has been resolved on an effective and lasting basis.

Had the government acted on the Section 301 complaint in 2004, or had any version of our legislation passed the Congress, the damage to American workers and industries would have been reduced. Had the IMF or the WTO been up to their task, the problem we face today would be less difficult to manage. Unfortunately, none of that has happened.

Instead, China's trade surplus with the United States and with the world, as well as its foreign exchange reserves, have mushroomed over these last 10 years while U.S. manufacturing employment has plummeted by one-third. A remedy delayed is a remedy denied. The longer it is denied, the greater the injustice.

The logical approach, as Mr. Prestowitz already has mentioned, the logical approach is to deal with currency undervaluation as a

subsidy, using the WTO sanctioned remedies, countervailing duties, to offset the unfair advantage on an industry-by-industry basis. Undervalued currencies meet the three legal tests for a subsidy finding.

The government established exchange rate, which is price fixing on a broad scale, forces banks to pay the seller of an internationally traded good or service extra units of the home currency compared to its fair market value. That is a government mandated financial contribution. The extra units of currency constitute the benefit to the exporter. That benefit creates an incentive to export. Currency undervaluation thus seems to be a classic example of an export subsidy, a practice that has been from the beginning prohibited under GATT rules.

Passage of legislation, such as S. 1027, the Stabenow-Bunning bill, would distinguish actionable from nonactionable forms of currency undervaluation. That is an important point. Currency undervaluation is not a *per se* issue. It has to be defined. There need to be conditions and terms. The legislation does that.

S. 1027 would also provide clarity regarding the method of calculating the subsidy, the source of data to be used in that calculation, and other procedural matters. Clear guidance from the Congress would facilitate the application of existing law to a new area of economic activity, reduce the scope for controversy, strengthen the hand of the government in the ensuing litigation and negotiations, and provide helpful guidance to trade practitioners, importers, exporters, and foreign governments about the rules that will govern their trade.

A new bill, the Currency Exchange Rate Oversight Act of 2010, S. 3134, has 18 cosponsors today, including the Chairman and Senator Graham. It seeks to strengthen the Treasury's negotiating leverage in its oversight of foreign government currency practices, in part by explicitly authorizing the use of trade law remedies in response to currency undervaluation. The FCC welcomes this legislation and is working with the chief cosponsors, Senators Schumer and Stabenow, to strengthen it as much as possible.

In closing, let me invoke no less a free trader than Ronald Reagan, for whom I worked in the 1980s. In the wake of the 1985–1986 realignment of currencies following the Plaza Accord, he explained his trade policy in a radio address in three simple concepts. First, he said, trade must be reciprocal. Free and fair trade with free and fair traders is exactly what he said. He didn't say free trade with the world. He didn't say free trade with free traders. He said free and fair trade with free and fair traders. A strict reciprocity is the first principle. The second is that trade must be based on a mutual respect for the rules. And third, policy must produce results.

Persistent currency undervaluation surely is a protectionist practice. Tolerating such protectionism undermines the global economy. Confronting it cannot be deemed as protectionism so long as that is done within agreed rules.

Martin Wolf recently wrote in his column in the *Financial Times,* "The U.S. was right to give talking a chance. But talk must lead to action." A sound trade remedy is the best approach to action. It provides negotiating leverage without overkill. Once it has accom-

plished its objective, each countervailing duty remedy can be adjusted according to the degree of revaluation, all the way down to zero. It is a carrot as well as a stick.

In our view, legislation is the right thing to do. It is the only thing we can do. It is the one thing we must do. It is high time for the Congress to act by passing S. 1027 or equivalent legislation.

Thank you very much.

Chairman BROWN. Thank you, Mr. Blum.

Mr. Ikenson, welcome.

STATEMENT OF DANIEL J. IKENSON, ASSOCIATE DIRECTOR, CENTER FOR TRADE POLICY STUDIES, CATO INSTITUTE

Mr. IKENSON. Thank you, Chairman Brown. I very much appreciate the opportunity to be here with you today.

Many economists believe the Chinese currency is undervalued, and I have no reason to disagree with that. But the broad range of estimates of undervaluation, 10 percent to 40 percent, approximately, should remind us that the true value of the Renminbi can only be determined if the currency is allowed to float and the capital account is fully liberalized. The world would probably be much better off if China did that, as it would lead to more optimal resource allocations, although a stronger RMB presents its own set of challenges to U.S. producers and consumers.

A stronger RMB, for example, would lead to increased demand in China for commodities and raw materials, which would bid up the prices, increasing the cost of production to U.S. producers, some of which would be passed on to U.S. consumers, exacerbating the stress on their own budgets already felt by the relative decline of their dollars against the RMB.

For many in Washington, though, it seems the issue is not the Chinese currency *per se* but that the United States has a large bilateral trade deficit with China, which is often attributed to the undervalued RMB. A currency revaluation for many policymakers is just a proxy for reducing the trade deficit, which itself is seen as a proxy for creating jobs in the U.S. economy.

But the relationship between currency values and trade is not as straightforward as might have been the case before globalization took hold. Because of the proliferation of transnational production sharing arrangements, the effects of currency value changes cut in many different ways. The last period of RMB appreciation is instructive. As you heard earlier, between July 2005 and 2008, the RMB appreciated by 21 percent against the dollar, from a value of 12.08 cents to 14.64 cents, but during that period, contrary to what the textbooks predict, the U.S. trade deficit with China increased from $202 to $268 billion, or by 33 percent.

U.S. exports to China increased, as predicted, and by $28 billion, or 69 percent. But there is a strong case to be made that Chinese currency appreciation wasn't the most important determinant of that export growth, and I refer you to the chart in my submitted written testimony.

During that same period, U.S. imports from China increased by $94 billion, or 39 percent. One reason for continued U.S. consumption of Chinese goods, despite the relative price increase, is that there may be a shortage of substitutes in the U.S. market for Chi-

nese-made goods. If that is the case, RMB appreciation reduces Americans' real incomes, and any trade sanctions imposed to approximate or compel that appreciation can be seen as a regressive tax.

But the fact that a 21 percent increase in the value of the RMB was met with a 39 percent increase in import value means that the quantity of imports demanded after the price change increased by nearly 15 percent. Higher prices met with greater demand would seem to defy the law of demand, so something else must have happened.

I think Chinese exporters must have lowered their RMB-denominated prices to keep their export prices steady. That would have been a completely rational response, enabled by the fact that RMB appreciation reduces the cost of production for Chinese exporters who rely on imported raw materials and components. According to a growing body of research, somewhere between one-third and one-half of the value of U.S. imports from China is actually Chinese value added. The other half to two-thirds reflects the costs of materials, labor, and overhead from other countries, including the United States. China's operations still tend to be low-value manufacturing and assembly operations. Thus, much or most of the value of Chinese exports was first imported into China.

RMB appreciation not only bolsters the buying power of Chinese consumers, but it makes Chinese-based producers and assemblers even more competitive because the relative prices of their imported inputs fall. That reduction in cost can be passed on to foreign consumers in the form of lower export prices, which could mitigate entirely the effect desired by many in Congress, which is to reduce U.S. imports from China.

That process might very well explain what happened between 2005 and 2008 and is probably a reasonable indication of what to expect going forward. Factors such as income, savings propensities, the availability of substitutes, and monetary and fiscal policies have greater influence than currency movements over trade flows, particularly when exporters are willing to absorb the costs of those currency changes.

As to the claims that imports kill jobs, I would note that U.S. producers themselves account for a majority of import value year after year. The figure was 55 percent in 2008. Fifty-five percent of U.S. importer value was imports conducted by U.S. producers. Imports from China and elsewhere really, therefore, support countless jobs up the value chain in the United States.

During the quarter-century between 1983 and 2008, as the value of U.S. trade increased more than fivefold in real terms, U.S. employers added 46 million jobs to payrolls and real GDP more than doubled to $14.5 trillion. That is 1.8 million net new jobs per year, even as U.S. import value increased by 8 percent per year over that period.

Finally, yesterday, the U.S.–China Business Council released a compilation of State-by-State export data which revealed, among other findings, that in 2009, 19 U.S. States exported more than $1 billion worth of goods to China, which is our third-largest export market; that U.S. exports to China were off by only 0.2 percent in 2009, while exports to the rest of the world tanked by 19 percent;

that 47 States have experienced triple-digit export growth to China since 2000; and that exports to China from Ohio grew from $292 million in 2000 to $1.9 billion in 2009. The undervalued RMB is apparently not an insurmountable barrier to exports, as some have suggested.

Thank you for your time and attention.

Chairman BROWN. Interesting. Thank you, Mr. Ikenson.

Mr. Lardy, you in some sense agreed, in some sense contrasted your views with Mr. Prestowitz. One place where they were more or less coincident was that it should be part of whatever we do with adjusting currency. I think you wanted to move probably more slowly than he would on adjusting currency, but since he is not here to speak for himself, I won't do that debate.

But you both talked about making this part of a larger plan. He mentioned manufacturing policy and other things. You mentioned using the talks, the strategic talks to urge some kind of restructuring of China's relationship with us, economic relationship with us. Would you talk that through a little more, about what those talks should be and what you would suggest we try to accomplish within China's economy and, I assume, ours to deal with these disadvantages of currency and, I assume, to deal with the trade deficit overall and our economic relationship.

Mr. LARDY. Yes. I think the talks through the strategic economic dialog deal with this broad rebalancing agenda, and I think for China, that means several areas where there is room for policy change beyond the currency. I am not minimizing the currency.

Chairman BROWN. I understand.

Mr. LARDY. The currency is a key part of it, but there are other things that need to be done. Price reforms, for example, are extremely important. China has tended to have undervalued prices for energy, still has significantly undervalued prices for electricity, for example. That provides a very substantial advantage to producers of tradable goods, that is, exports and import-competing goods. These are the firms that use most of the electricity in China. So appropriate pricing of electricity, water, a lot of other natural resource products.

I think Senator Graham also mentioned the environmental protection. They need to introduce appropriate environmental charges and fees. Again, that would tend to raise the cost of producing exports. It would not impinge so much on the production of services. A very big part of this rebalancing is to get away from a totally manufacturing-driven growth process and have the service sector play a larger role in growth.

Financial reform is another important part of this reform of the banking system, which I believe is very important. Primarily, the step that is needed is interest rate liberalization. There has been a massive tax on the household sector by very low deposit rates. That means households' income growth has been inhibited compared to what it would have been on a more liberalized interest rate environment.

The central government in China and the local governments, as well, need to continue to build out the social safety net. They have done a reasonably good job of accelerating that process over the last few years, but more, much more needs to be done. That would

tend to reduce the household savings rate and help to alleviate the saving-investment imbalance that Clyde spoke of.

So there are some things in the pricing domain, the financial sector, particularly interest rate reform, and environmental charges and fees, and more of a social safety net, which would affect individual choices on consumption *versus* savings. All of those things would tend to reduce China's very large—traditionally, over the last few years, very large external surplus.

So, as I said, not just the currency. Other things need to be addressed, as well. But the currency certainly should be part of it.

Chairman BROWN. What would you consider—and this is for both Mr. Lardy and Mr. Blum—what would you consider a meaningful step by the Chinese government? Forget our legislation in terms of enactment. Think of it in terms of a prodding, for instance, for now. What would you—and you have said—I don't want to put words back in your mouth. What would each of the two of you, and then I will get to Mr. Ikenson, consider a meaningful step by the Chinese voluntarily on currency? At what rate of appreciation? What step over time, and what kind of timeframe?

Mr. LARDY. Well, my answer to that would have to be conditional on some of the factors I alluded to earlier. That is whether or not the U.S. growth continues to gain traction, whether Europe joins in the recovery process sometime this year.

I certainly agree with what the Central Bank Governor said a number of weeks ago, that repegging to the dollar in the summer of 2008 was a temporary measure undertaken with the stress of the financial crisis and that it would be the—the policy would be changed. I think there is enough evidence now that global recovery is reasonably strong. I think they should go back to allowing their currency to appreciate.

When their external surplus, though, has almost disappeared, I would be very surprised if they would be willing to appreciate more than three or 4 percent. Let us say, over the balance of this year unless we get—if we got strong European recovery and their surplus started to go up again—then I would expect and hope that they would appreciate more than that, maybe 5 percent or 10 percent. But I do think it has to be somewhat—our expectations have to be somewhat conditioned on what happens to the global recovery, the pace, and also what happens to their own trade position, their global trade position.

Chairman BROWN. Mr. Blum, same question to you with the addendum, do you agree with Mr. Prestowitz's contention—I don't believe he said it today, but he has other times—that increase in Chinese productivity basically canceled out the appreciation of the Yuan in that 2- or 3-year period. So address that, if you would.

Mr. BLUM. Let me address that first.

Chairman BROWN. Sure.

Mr. BLUM. It is obviously true. The productivity of Chinese workers is escalating rapidly. People are being taken off the farm and being put in factories, and after a certain amount of training, they become highly productive compared to what they used to be. There is no question about that.

But there is something else, and it gets me to a comment I wanted to make to Mr. Lardy's earlier point. A big part of the problem,

which I don't think, Nick, I heard you say, is that the government is lavishing—the Chinese government is lavishing cheap, even zero interest, effectively, zero interest money on favored enterprises. They are almost always state-owned enterprises.

So one reason—another reason, let us say—why the appreciation during those 37 months didn't add up is that the people who were investing for export were being given free money. That nullified a big part of the effect of the appreciation.

And in that connection, I think it is important to recognize, Mr. Lardy has talked correctly about the thriftiness of Chinese households. I know many Chinese people, how careful they are with their money. They hate credit cards. They save and pool their money to buy things. This is all true. But in the last few years, the corporate savings have outpaced the household savings. It is now a bigger factor. The latest numbers I have, which are Chinese numbers, are that in 2007, corporate savings reached the level of 22.9 percent of Chinese GDP, while household savings, while still rising—well, actually while fairly stagnant over a 15-year period, were at 20 percent.

So a big part of the consequence of the currency policy is to put a lot of money in the hands of and at the control of these state-controlled enterprises. They are the guys who invest for export, sometimes nullifying the currency policy.

To answer your question directly, I will tell you honestly what we have told the Treasury Department is, we don't have a specific number of set of numbers, but we have told them that the initial revaluation needs to be higher than the last time, 2.1 percent. The pace at which appreciation proceeds needs to be faster than the last time, which produced—again, there are two ways to measure it. So we get 17.5 percent if you use the Renminbi to the dollar. You get a higher number if you use cents per Renminbi.

Third, it has got to be sustained. I mean, last time, the Chinese stopped when they found it convenient to stop, before we had actually gotten any benefits. Part of the reason is it was not backed up by all of the rest of the policies, and we certainly endorse Treasury's effort to have a full-scale understanding with the Chinese about what needs to be done on their side and on our side to rebalance the economy.

So it is not an easy issue. It is not a magic number. It is not a stable number. Forty percent happens to be a recurring number, but a lot of things have changed. This will change with both economies.

So what we need, I think, is a serious, sustained process that will actually bring us reliably to some kind of equilibrium.

Chairman BROWN. Give me, if you would, a real short answer on a pretty simple question, the two of you, Mr. Blum and Mr. Lardy. Is Congressional pressure a necessary ingredient to begin to fix this? Mr. Blum.

Mr. BLUM. Yes.

Chairman BROWN. Mr. Lardy.

Mr. LARDY. I used to be agnostic on this question, but in the current environment, I think pressure either from the Congress or from the executive branch is probably counterproductive. This has become politically a very contentious issue within China and I

think the more external pressure there is, the harder it is for them to change off the peg.

Chairman BROWN. OK. I understand that.

Mr. LARDY. I would—let me, just in response to your earlier question, I would say it is very important to recognize this productivity gain is very important, and this is one of the things that I don't think is fully understood or adequately understood in China. That is, the appropriate exchange rate is a moving target. China has much higher productivity growth in the export sector than its trading partners. Even if they moved magically to an exchange rate that we would all agree on was the right number within a relatively short period of time, their competitiveness would have improved *vis-a-vis* their trading partners and they would be heading back into a surplus. So they need to have a steady pace of appreciation in order to offset that productivity gain and not have larger and larger imbalances.

Chairman BROWN. Mr. Ikenson, listening to your comments and looking at your testimony, I was going to ask you if the size of the trade deficit with China, our bilateral trade deficit, was of concern to you, but I guess I want to frame it in a different way as I am listening to the comments of others.

A lot of us are concerned that, you know, as we wean ourselves off foreign oil—and we all kind of think we should do that in various degrees and various paths—that we do not want to see us losing the opportunity to build a domestic clean energy manufacturing capability. It is a concern particularly of mine. I was critical of the Administration on the stimulus dollars—regardless of what you thought about the stimulus package, but the stimulus dollars going to build wind turbines abroad and used in the United States. And I was critical of the Administration, but I also was understanding in that we do not necessarily have the industrial capacity to succeed, at least in the short term, on doing that.

One, is that a major concern of yours? And, second, if it is, what do we do to build this manufacturing capacity to lead the world in at least—not lead the world, if we do not lead the world, which we should do, but at least be a major player in solar panels, wind turbines, biomass, fuel cells, all of that?

Mr. IKENSON. Well, let me just back up and address what I think is a myth that has been lingering for quite some time, and that is, this myth of manufacturing decline. There is this presumption that the Chinese have eaten our lunch, that we have de-industrialized, that we do not produce anything anymore. U.S. producers, U.S. manufacturers are still the world's most prolific. We measure manufacturing output by value, not by volume. In fact, about 22 percent of the world's manufacturing value-added comes out of the U.S. factories; about 13 or 14 percent comes out of Chinese factories. We are not producing the products that you see in retail stores anymore. We are not producing baseball bats and sporting goods and hand tools and clothes. We are producing pharmaceuticals and chemicals and airplanes and technical textiles.

So we have moved up the value chain, and it seems to me that these industries that you speak of are in the U.S. manufacturing's bailiwick. We are occupying the higher value-added portion of the value chain. China is still at the lower value-added stages. It wants

to get to where we are. It might get to where we are. We can stay where we are and stay at the top if we have the right policies, and I think those policies are policies that attract investment, that attract human capital, liberal immigration policies. And we need to recognize that—you know, we used to talk about comparative advantage in terms of one industry against another. Ricardo spoke of the Portuguese wine maker and he English cloth maker producing and exchanging surpluses. Today I think that applies to—comparative advantage applies to functions on the supply chain, and we need to maintain our position at the upper end.

If you speak to people at the National Association of Manufacturers, they say their biggest problem is the dearth of skills. People do not have the skills to take some of the jobs that could lead these industries into the future. I think that we should come up with some sort of an idea where manufacturers subsidize or pay for workers to get these skills in exchange for a commitment from workers to stick with them for a number of years. I think manufacturers do not want to invest in these skills knowing that people might take off.

So if there is some sort of an arrangement that can be worked out like that, I think we could create the skill set and the labor force necessary to excel in those industries.

Chairman BROWN. Thank you. I would argue that Ricardo would be perhaps surprised that both wool and wine would have very possibly moved to Portugal, but that is a whole other issue.

I hear your arguments, and I have heard those before, and I think there is great credence to major parts of it. It is clear that we are a much more productive manufacturing sector. It is clear that we produce more than we ever did, and our lost jobs surely are ascribed in part to efficiency. But I also represent a State—and I have looked at what has happened to my hometown and so many others. Much of this manufacturing for a lot of reasons has gone elsewhere.

Also, most disturbingly to me that 30 years ago manufacturing was about a third of our GDP and finance was about half that, and today it is almost the reverse of that, and, you know, look where that got us. But that is, again, another issue.

Let me ask a brief question. I hope you can give me a brief answer on this. A bit off the subject, but not. Senator Graham talked about the climate change legislation peripherally. Putting aside your position on climate change itself, on whether it exists, who is responsible if it does, and whether and how we should address it, should we do a border adjustment? Would you support some kind of border adjustment to apply to those countries that do not follow significant environmental rules that we would impose on our Government, on our industries and utilities and transportation and homes, if you will? Would you support some kind of a border adjustment which would be the shape of a tariff or a payment or something like that? Mr. Lardy.

Mr. LARDY. Well, I——

Chairman BROWN. Fairly short if you can, but if you cannot, I understand.

Mr. LARDY. I would support that if it was consistent with the WTO.

Chairman BROWN. OK. Mr. Blum.

Mr. BLUM. Yes, well, I can say that the Fair Currency Coalition has no position on that, but if you will allow me a personal observation—and, again, I would hark back to Ronald Reagan's reciprocity. If we play by one set of rules and our trading partners play by another, we are going to hurt ourselves.

Chairman BROWN. OK. Mr. Ikenson.

Mr. IKENSON. No.

Chairman BROWN. OK. That was a pretty short answer. That was even shorter than "yes" by one letter.

Mr. Ikenson, at the risk of making an assumption where you work and whom you might consider your personal and your think-tank heroes might be, do you come down on the same place as Mr. Blum in your interpretation of what Ronald Reagan would say about this?

Mr. IKENSON. I think reciprocity is not necessary. I think we can improve our lot through unilateral measures. We do not need—if our trade partners want to engage in protectionism, if they want to subsidize their producers, we can still improve our lot and maximize our position by reducing our trade barriers or eliminating them. Ronald Reagan is thought to have been a free trader, but he engaged in a lot of protectionism as well. But I would say we do not need reciprocity; we do not need trade agreements. We can follow in the footsteps of the countries that are leading us in this continent—Mexico and Canada—by eliminating tariffs as a way to reduce costs for U.S. producers. The Canadians and the Mexicans have cut tariffs on a whole slew of products, industrial inputs. That is one way to reduce costs for U.S. producers. We can do that unilaterally.

Chairman BROWN. Thank you. Great discussion, and all three of you defended your positions articulately and very well, with passion. Thank you to the three of you. Thanks.

I will call up the next panel, please. Thank you.

Jack Shilling is Executive Vice President of Corporate Development and Chief Technical Officer (retired) of Alleghany Technologies. He earned his Ph.D. in metallurgical engineering from the University of Pittsburgh and for more than 30 years oversaw the manufacture of high-technology specialty metals for aerospace and defense markets and energy generation markets. We need more people studying what you studied these days. Thank you for joining us.

Mark Suwyn, Chairman of NewPage in Miamisburg, Ohio, his previous positions with NewPage included Chairman and Chief Executive Officer and Executive Chairman of the Board. He was Chairman and Chief Executive Officer of the Louisiana Pacific Corporation for 8 years, and as I said, NewPage is located in Miamisburg, Ohio. That is the largest coated paper manufacturer in North America with $3.1 billion in net sales.

Derek Scissors is a Research Fellow of the Heritage Foundation. He focuses his studies on the economies of China and India as Research Fellow for Economics in Heritage's Asian Studies Center, and he has written extensively in *Foreign Affairs,* the *New York Times,* and other publications.

Dr. Shilling, if you would begin. Thank you.

STATEMENT OF JACK W. SHILLING, RETIRED EXECUTIVE VICE PRESIDENT AND CHIEF TECHNICAL OFFICER, ALLEGHANY TECHNOLOGIES INCORPORATED, AND CHAIRMAN, SPECIALTY STEEL INDUSTRY OF NORTH AMERICA

Mr. SHILLING. Well, thanks so much for asking me to be here.

My conviction, from all of my previous experience, some of which was in China, actually, is that it is vitally important for job creation, the overall economy, and national security—particularly important for national security—that the United States strengthen and extend its manufacturing base. An integral part of this effort must be an international system of exchange rates that reflect market fundamentals and that adjust as those fundamentals fluctuate.

China's enforced undervaluation of its currency by pegging the RMB to the dollar dates from 1994. Most estimates are that the RMB remains misaligned by about 40 percent relative to the U.S. dollar on a bilateral, real exchange rate basis, as large today as the RMB undervaluation was before the Chinese Government allowed the RMB to appreciate nominally by 17.5 percent between 2005 and 2008. Other countries have similarly undervalued their currencies in an attempt to remain competitive with China.

This sort of competitive currency depreciation is protectionist in nature, as others have said this morning, and a significant factor in the weakening of our U.S. manufacturing base and in the increasing loss of skilled jobs and investment in the United States. The RMB's protracted undervaluation also facilitates exports from China into the U.S. and impedes exports from the U.S. to China. The U.S. trade deficits with China and China's hoard of foreign reserves will continue to grow as long as the RMB remains undervalued.

In my written statement, I have discussed how the RMB's 40-percent undervaluation affects purchasing decisions and the prices of items traded between the U.S. and China. I have also described what likely would happen if the RMB were effectively revalued by 40 percent on a bilateral, real exchange rate basis relative to the dollar. All other things being equal, price becomes the dominant issue where exchange rates have a direct and obvious impact.

I believe there are at least two principal lessons to be drawn from this review. First, in my opinion, the primary benefit of a meaningful 40-percent revaluation of the RMB would be to have a positive impact on reducing imports into the U.S. of subsidized products from China. This shift in turn would mean that U.S. producers would have a greater ability to supply a wide range of segments in the U.S. domestic market with a broader range of products and in larger volumes than is presently the case. There would be, in other words, a very beneficial effect on the U.S. economy, U.S. jobs, investment, and, again, national security.

Second, the effect of revaluation on exports from the U.S. to China likely would be somewhat helpful, but not as much so because it seems likely the Chinese Government would intervene in the future in some manner other than an undervalued RMB to prevent a significant disruption to the ability of Chinese producers and labor to supply their own market.

I would emphasize that the 40-percent revaluation of the RMB must be on a real exchange rate basis in accordance with inflation-

adjusted, trade-weighted exchange rates. The RMB's appreciation between 2005 and 2008 was a nominal 17.5-percent appreciation. And during that time, China's economy and ability to supply the U.S. market grew rapidly and dramatically.

It seems clear that China is very unlikely to revalue meaningfully on its own initiative, nor is the IMF in a position to impose and enforce a solution. In the meantime, if not countered, China's protectionist currency policy will increasingly drain the United States of knowledge and expertise, contribute to the demise of U.S. manufacturing, and siphon off U.S. jobs, technology, and investment. That is not a winning formula for the U.S. economy and national security.

It is critically important that we act now before the situation deteriorates further. Competitive currency depreciation on the unprecedented scale practiced by China is a very destabilizing mercantilist monetary measure with far-reaching and damaging effects on international trade. A first step that can be taken by Congress and the executive branch is legislatively confirming the legal right of U.S. industries to countervailing and antidumping duties as a means of offsetting injury caused by imports from any country with a fundamentally undervalued currency. This approach would be a reasonable implementation in U.S. domestic law of the WTO's provisions, would timely help U.S. companies and workers, would act as a deterrent, and would underscore that protracted currency depreciation will not be tolerated.

Thank you.

Chairman BROWN. Thank you very much, Dr. Shilling.

Mr. Suwyn, welcome.

STATEMENT OF MARK A. SUWYN, EXECUTIVE CHAIRMAN OF THE BOARD, NEWPAGE CORPORATION, MIAMISBURG, OHIO

Mr. SUWYN. Thank you, Mr. Chairman. I appreciate the opportunity to appear to discuss China's exchange rate policy and imbalances. As you indicated, NewPage produces printing and writing papers, including coated and uncoated free sheet and groundwood papers. While headquartered in Miamisburg, we have production facilities in Kentucky, Maine, Maryland, Michigan, Minnesota, and Wisconsin, employing about 7,500 people. Production of these papers is a multibillion-dollar industry in the United States.

China's undervalued currency is a very significant problem for the United States paper producers. The U.S. has a significant competitive advantage over China in the production of paper and paperboard used domestically for printing and writing, a fact that has been confirmed regularly in various market research studies. Paper producers in this country have access to abundant, renewable, responsibly managed fiber sources, and we have a plentiful supply of water required for paper processing. We have a highly skilled workforce with generations of experience producing paper and state-of-the-art equipment. We have also the advantage of being close to the bulk of our customers in the U.S. market since paper is a low-margin, high—very heavy product that has very high, expensive shipping charges.

Now, by contrast, the Chinese producers have to import the vast majority of the fiber that they use. Most of that comes from Latin

America. They also lack an adequate water supply. Wage rates are lower in China than they are in the U.S., but paper manufacturing is pretty much automated so that the wages are only about 10 percent of the total costs of producing the product. Therefore, they do not gain a real significant advantage from those lower wage rates.

They have state-of-the-art production equipment, such as we do. But, finally, their producers are an entire ocean and half a continent away from our customers in the Midwest, and paper is very heavy and expensive to ship, and something has to cover that.

Nonetheless, despite those disadvantages, Chinese paper producers have been able to lower prices, increase exports, and gain significant market share in the United States, all because of the large subsidies provided by the Chinese Government, their willingness to dump product in the U.S. market, and the biggest subsidy of all, the 40-percent undervaluation of the Chinese currency.

In September of last year, NewPage, along with other members of the domestic industry and the United Steelworkers Union, filed antidumping and countervailing duty petitions covering certain types of coated paper from China and Indonesia. In the countervailing duty petition covering Chinese subsidies, we listed a host of subsidy programs that benefit Chinese paper producers, including allegations covering China's undervalued currency.

Now, as it has been pointed out earlier and in my written testimony, we provided currency information that demonstrated that there were legal requirements—all three legal requirements for finding the existence of a countervailable subsidy were met: the Chinese Government had provided a financial contribution, it resulted in a benefit, and which was specific to a particular industry in China.

Much to our disappointment, the Commerce Department did not initiate an investigation into our allegation when we first made it in September of last year, claiming that we had failed to sufficiently allege that the receipt of the excess yuan is contingent on export or export performance—in other words, exactly how the subsidy was specific. But in January of this year, we submitted a revised allegation, shown here, that gave all kinds of details by a third-party economist, an independent economist, that demonstrated that, based on the Chinese Government's own data, 70 percent of China's foreign exchange earnings were derived from the export of goods. Because Chinese exporters garner the overwhelming share of benefits from the undervaluation of the RMB, the subsidy benefit is *de facto* specific to the exporters as a group.

As of today, the Department of Commerce has still not announced whether it will initiate an investigation into whether China's undervaluation of its currency confers a countervailable subsidy. We believe, as do many Members of Congress, that Commerce has a legal obligation to investigate this practice. We hope an initiation occurs soon so that Commerce will have sufficient time to fully analyze this allegation.

China's undervalued currency, as well as the other subsidies from which Chinese coated paper producers benefit, has had a very significant impact on NewPage and other members of the coated paper industry. The consequences are documented in the preliminary unanimous injury determination by the International Trade

Commission, which was issued in November of last year. They cited a number of things, but I will just summarize that during this time period the increase in the U.S. market share of imports from China—and Indonesia—rose from 15 percent to 26 percent during the first half of 2009. This came by because of significant underselling by Chinese producers that led to price depression across the whole industry. These steps and these actions contributed to the closure by NewPage and other coated paper producers of several mills over the past several years, including two of our mills at Kimberly and Niagara, Wisconsin; a mill in Muskegon, Maine; and in Columbus, Mississippi, just a month or so ago. And we had also a converting facility in Chillicothe, Ohio.

I estimate that about 2,500 direct jobs were lost, with another 5,000 indirect jobs as suppliers, contractors, and shippers lost business.

So what is the appropriate response to their undervalued currency? We believe the best outcome, of course, would be for China to allow its currency to float freely and reflect market forces. However, we cannot wait 4, 5, 6, 8, 10 years for that to occur. Whatever may be accomplished through long-term negotiation, we believe that the Department of Commerce needs to investigate China's undervalued currency as a countervailable subsidy to the Chinese coated paper producers and to ultimately impose countervailing duties to offset the level of undervaluation. We believe this is required by the U.S. countervailing duty law and is critical to prevent material damage to the U.S. paper industry and the jobs and local communities that rely on our industry.

Again, I appreciate the opportunity to appear before you today and would welcome any questions that you have.

Chairman BROWN. Thank you very much, Mr. Suwyn.

Dr. Scissors.

STATEMENT OF DEREK SCISSORS, RESEARCH FELLOW, ASIAN STUDIES CENTER, THE HERITAGE FOUNDATION

Mr. SCISSORS. Thank you, Mr. Chairman, for the opportunity to speak today. I am going to embrace two seemingly contradictory themes. One is that China is, in fact, a mercantilist trading state but, nonetheless, revaluation of the yuan will not benefit the U.S.

The first step in reconciling those two themes is a reminder of something that we tend to forget, and I have not actually heard mentioned at this panel so far. The U.S. has a much bigger economy than China. I do not mean that as a reason for complacency. I mean that our policies and our behavior have necessarily far more influence on the U.S.–China economic relationship than China's policies and behavior. We are the 800-pound gorilla here, not them. That is the main reason that there is no conventional relationship between the exchange rate, whether measured in real or nominal terms, and the bilateral trade gap—and, again, not just from 2005 to 2008, but from 1994 to 2009.

When the U.S. economy expands, we pull in more Chinese goods, regardless of the exchange rate, and when the U.S. economy contracts, as it has in the financial crisis, we pull in fewer Chinese goods, regardless of the exchange rate.

Putting it in rough terms, all Chinese policy and behavior only explains about a fourth to a third of U.S.–China economic relations. The weight is concentrated on our side, not theirs. Our policies, I realize, are not the focus of this hearing, but they are vital, and I can summarize a way to reduce the trade gap, create jobs, and, as mentioned earlier, strengthen national security in four words: Cut the budget deficit.

Back to the topical theme of Chinese mercantilism. There have been multiple pieces of legislation in Congress calling China a nonmarket economy. These are exactly correct. In fact, it almost seems as if some members have forgotten how right they are about China.

Why does that matter? If you pick a policy to change from a nonmarket economy, it is not going to do any good. Even if the exchange rate is important in influencing Chinese trade, Beijing will just intervene in some other way to compensate, because that is what happens in nonmarket economies.

As it happens, Beijing did not need new intervention the last time the yuan appreciated against the dollar, and it will not need it this time because the peg is really a minor factor in Chinese trade. Much more important is that China heavily subsidizes its state-owned enterprises. Mr. Blum in the last round mentioned one of these subsidies, and he and I completely disagree on the larger point, and we agree on this. China provides basically free money to most of its state-owned enterprises, and that is not the only subsidy. In the trading hubs, where one-third of China trade goes through Shanghai, Shenzhen, Xuzhou—three cities, one-third of the trade—land is very expensive for understandable reasons. But all land is owned by the state, so state firms can acquire land in the trading hubs freely and quickly whenever it is necessary.

The biggest subsidy I want to point to, however, is regulatory. State firms are sheltered from competition at the national level for the big state firms and competition at the local level for small state firms. The central government has formally and explicitly reserved most of the economy for state economic leadership and is formally and explicitly working to consolidate major sectors, and by consolidate, they mean using government intervention to create a small number of very large firms, all of which are state owned.

The result is that relatively few state firms are guaranteed the bulk of many major sectors in the economy. This creates economies of scale, which makes state enterprises more competitive in exports even though they are otherwise inefficient. But the real harm to open trade and to the U.S. in particular comes in imports. All imports from any country, all nonstate domestic production, whether by local firms or foreign firms based in China, are competing for a minority stake of many sectors. Imports of goods and services are, thus, capped regardless of the exchange rate.

I want to stress that. Whatever the exchange rate is, you are still not capturing larger shares of the Chinese market because they are reserved for the state.

The bottom line is, when you consider all the factors involved, there is little role left in U.S.–PRC trade for the value of the renminbi. China has a nonmarket economy, as Congress has noted, and the U.S. has more weight in the relationship and our policies matter more than theirs. The stories you hear, as my fellow panel-

ists have told, about the RMB mattering works when you put the more important factors on the sidelines, in particular, when you act as if China will not adopt another policy to countervail a change in exchange rate when we know China will because it is a mercantilist trading state, as Congress has pointed out.

So I am not here to say the U.S. should do nothing. I am here to say that real improvement in U.S.–China economic relationships will require more difficult work than a renminbi revaluation. We need to go after those subsidies. We are not going to get rid of them entirely, and it will not be as simple as saying, OK, let us have an exchange rate revaluation. But it will actually work.

We have a couple of things in our favor. One thing was mentioned by the Chairman in the last round. The U.S.–China Strategic and Economic Dialogue should exist for just this purpose. It is not for conventional trade discussions. That is for the JCCT. It is so senior leadership can hash out major change, which is what we are talking about right now.

Nick Lardy mentioned some changes on the Chinese side. I want to focus my suggestions on changes that will directly affect U.S.–China trade rather than fundamental reform within China itself.

We should call for less harmful Chinese bank lending. Their bank lending subsidizes their state firms. It is a distortion of global economic trade and investment. There should be less of it. We have something to do on our side that has exactly the same effect. It is less of a U.S. budget deficit. Or we could just cut the budget deficit from our own reasons and support Chinese market reform. This was also mentioned in the last panel.

The PRC has claimed for over a decade that it was going to liberalize capital controls. They have not. Their lack of progress is inconsistent with pledges to the U.S. And if they liberalize capital controls, it will be much harder for them to use bank loans to subsidize their firms.

The best thing we could do in the S&ED would be invoke WTO principles concerning state dominance of all these sectors. First of all, the lack of transparency, China will not tell us exactly what state dominance means and what policies are to be used to encourage state dominance. They will not commit to anything. And the lack of transparency violates WTO principles. It hampers market access and it hampers our negotiations over market access.

If the WTO is insufficient as a tool to get the Chinese to move on state dominance, we have the possibility of a bilateral investment treaty, which we should not extend to China unless we get progress on this issue, as well as the S&ED.

In sum, RMB revaluation is not going to accomplish much of anything. When proponents are pressed, they understandably—and you have heard repeatedly—point to additional issues that need to be resolved, and they are right. But we would be much better off skipping over RMB revaluation and going to what really matters, which is state dominance of the economy in China and the budget deficit in the U.S.

Thank you.

Chairman BROWN. Thank you, Dr. Scissors. I appreciate that.

Dr. Shilling, my staff pointed out, I guess the humor writers behind me, that if Dr. Shilling were more in geology than metallurgy, we would have rock, paper, and scissors here, but——

[Laughter.]

Chairman BROWN. I know you have always heard jokes about your name, Dr. Scissors, so this is the best we can do. Since you laughed, that was actually my line. It wasn't theirs.

[Laughter.]

Chairman BROWN. Dr. Shilling, you had said the IMF is not in the position to, perhaps, to do anything here. Is there a case to be made for bringing this dispute—dispute in my words, Dr. Scissors might not call it that—but is there a case to be made for bringing this dispute to the WTO in your mind?

Mr. SHILLING. Well, I don't consider myself an expert in that particular area. We have lots of other folks here who are. I am a manufacturing guy and a technology guy. There is a case for doing anything and everything we can do to reverse the trend of lost U.S. manufacturing and technology. And if we thought we could win a WTO case on any basis that Dr. Scissors was talking about or Clyde talked about or anybody else, I am all for doing it.

The country has got to get tough here because time is running out. Every year that goes by that we don't do what we need to do to create a level playing field for U.S. manufacturers is a year lost. So whether there legally is a case that we would win, that could be presented and won at the WTO, I am not knowledgeable enough to answer it.

Chairman BROWN. OK.

Mr. SHILLING. I hope there is, and if there is, we should definitely pursue it.

Chairman BROWN. What would you do if—well, I mentioned the wind turbines when I asked Mr. Ikenson earlier. The Administration will say, and I think rightly, although I didn't exactly agree with their emphasis and their focus on this issue, they will say that we don't have the industrial capacity to begin the scaling up of wind turbine production and some other clean energy, and some other industrial capacity generally. But your field is metals and you understand a lot of this.

What should we be doing in terms of building the supply chain, converting from other things, perhaps, so that we really can benefit from this revolution, if you will, in clean energy? I mean, granted, there are other issues. There is nuclear and there are other things that we will likely pursue. But especially in these new energy alternatives, where do we go? How do we do this?

Mr. SHILLING. Yes, that is a big question. Let me try to give—I have worked on this for so long and think about it so much, I will try to give you a real simple—because it is a relatively simple—answer.

First of all, there are things we need to do besides address currency misalignment, as has been pointed out by others, to create a level playing field for investment in the United States.

The next thing we should do is tax reform, because the U.S. has a noncompetitive tax structure from a corporation standpoint compared with the rest of the world, both in terms of income tax and

VAT tax, *et cetera.* We have got to look at that and make that competitive.

We have got to look at our energy policies and how they affect the costs of manufacturing. Energy is a big factor in manufacturing costs and they have to be competitive, and we have to look at regulatory issues and make sure we are competitive there in a general sense.

But if we were to create a level playing field for investment, I have always believed that the private sector can handle picking winners and losers, and gradually, over time, bring the manufacturing base back to this country. One of the things that is very frustrating to me is to read statements that "those jobs are lost forever," that "those industries are lost forever," and that "the U.S. can't compete in that."

We have to be innovative manufacturers of wind turbines. I am all for alternative energy. I am all for doing everything we can in those areas. But we have 300 million-plus people here. We need to create employment opportunities across a large segment of manufacturing and we should set very high expectations in terms of what can be done. Labor costs are, as has been pointed out, a small percentage of costs of many U.S. manufacturers, particularly highly productive U.S. manufacturers. But we are disadvantaging our U.S. manufacturers, we are discouraging investment in U.S. manufacturing because the playing field isn't level.

So I don't think the solution is to subsidize a particularly bright idea like wind turbine manufacturing. That will work temporarily, but it won't solve the bigger picture of this tremendous loss of both manufacturing and technology. I will stop there.

Chairman BROWN. That is helpful.

Mr. Suwyn, why the resistance to petitions like yours from our Government? It is not a political partisan thing. The Bush administration was not particularly aggressive on these. The Obama administration on some narrow issues has been a little more aggressive, but generally has not been where a lot of us think they should be. What is the resistance? Do you understand this?

Mr. SUWYN. I don't, because we have been pushing on this now for several years, particularly in this most recent petition. I am not sure. I assume it is a political hot potato and people are worried about that. It is obviously caught up in the whole issue of our relationships with China, Senator.

But to me, it is—and I am a simple person—it is very clear. They are subsidizing their operations significantly by both the things that Mr. Scissors indicated, and we are seeing all of that, and those things, we can go after. We are going after those subsidies.

But one of the biggest ones, we can't go after, which is the currency. And so we have asked, we have requested, we have submitted documents like this to articulate why it is, in fact, meets all the requirements. And what we have gotten so far is nothing. It is like it is a blank wall. So we are not even getting told why they won't. We are simply getting no response at all on that. So I don't have an answer as to why.

Chairman BROWN. Well, I am as perplexed as you are. I mean, certainly the geopolitical issues of we need China's help with Iran and North Korea, but it has puzzled me for a decade-and-a-half.

Mr. SUWYN. Yes.

Chairman BROWN. Your outspokenness and aggressiveness as a major Ohio manufacturer is important to continue to weigh in.

Dr. Scissors, a last question, and then we are kind of running out of time. Is the *status quo* on exchange rate acceptable to you?

Mr. SCISSORS. Yes, and not because I am in love with the *status quo* on the exchange rate but it is because it doesn't matter. It is just not to where I would put U.S. energy in negotiations with China. We just mentioned that there are these political issues. I am an economics person. I think economics is more important than politics. But even on economic issues, I just wouldn't go with the exchange rate.

If somebody said, we are not going to do anything else, then I would say, fine. Let us work on the exchange rate. If we are not going to do anything else, then an exchange rate change might be helpful. But it is not where I would put my first priority, my second priority, or my third priority. So if someone said, let us sit on the exchange rate and do other things, I would say I would rather do that.

Chairman BROWN. I thank you. I think there is agreement from the three of you and the four on the previous panel that it is bigger than exchange rate, that there are many things to do. I mean, many of us agree with Mr. Suwyn that the exchange rate should be a central focus of this, though.

Well, thank you all. The record will be open for an additional 7 days. If you have other answers that you wish you had given or if you have another rock, scissors, and paper joke, you could expand on that, or if you have anything else that you want to submit to the Subcommittee, we would appreciate that.

The testimony of all seven of you was very, very helpful today. So thank you, and the Subcommittee is adjourned.

[Whereupon, at 11:47 a.m., the hearing was adjourned.]

[Prepared statements, responses to written questions, and additional material supplied for the record follow:]

PREPARED STATEMENT OF CLYDE PRESTOWITZ

PRESIDENT, ECONOMIC STRATEGY INSTITUTE

APRIL 22, 2010

Chairman Dodd, Ranking Member Shelby, and Members of the Subcommittee on Economic Policy, thank you for the opportunity to speak to you this morning. My name is Clyde Prestowitz, President of the Economic Strategy Institute.

The Subcommittee has asked for answers to specific questions with respect to China's currency policy. I would like to address these questions in brief now, and then go into greater detail as to the scope of this issue and what we must do to address it.

To What Extent Is China's Currency Misaligned?

Estimates of this misalignment range from 10 to 50 percent. The majority of analysts put the undervaluation of the Chinese RMB at 25–40 percent.

What Is the Effect of This on the U.S. Trade Deficit and on U.S. Employment?

The undervaluation of the RMB tends to increase both the U.S. trade deficit and U.S. unemployment. Nobel Prize winning economist Paul Krugman has estimated that proper RMB valuation could result in an increase of as many as 1.4 million U.S. jobs. That suggests a trade deficit reduction of over $100 billion using standard estimating parameters.

But these are only representative figures because many factors other than exchange rates influence both the trade deficit and the level of employment. No one can say for sure at any particular moment exactly what amount of trade deficit or unemployment is due to currency undervaluation. But neither can anyone deny that such undervaluation distorts trade and ways that are negative both for the undervaluing country and its trading partners.

Moreover, the impact is not only on trade. It is also on investment. If global companies anticipate that a major country's currency will be chronically undervalued, they will tend to move investment and production to that country and away from other locations which might be better suited for the production in terms of their actual factor endowments. Thus the market distortion is not only of trade, but of the whole composition of production and structure of the economy. For instance, the fact that China undervalues the RMB is displacing production not only from the United States, but also from Mexico, Indonesia, the EU and other locations. The whole global economy is being distorted, in other words.

What Sectors of the Economy Would Increase Employment in the Wake of an RMB Revaluation?

Again, we must note that many factors in addition to exchange rates influence employment levels. But certainly an RMB revaluation would push in the direction of higher U.S. employment. This would be in a wide variety of sectors ranging from furniture production to textiles, semiconductors, machine tools, aircraft parts, tires, and many, many other sectors. Actually, it would be more or less across the board because a rise in one sector tends to stimulate a rise in others.

What Happened When China Allowed RMB Appreciation in 2005–2007 and Why Did the Trade Deficit Not Decline Then?

First, the appreciation was quite small in nominal terms being only about 20 percent over 2 to 3 years. Since China' productivity was growing very rapidly and at a greater rate than the currency appreciation during that period, in real terms, the RMB was actually depreciating. So a much greater appreciation over a shorter period of time would have been necessary to have significant impact on trade deficits and surpluses.

Second, many other things were occurring at this time in addition to the change in currency values. The U.S. economy was in the midst of its real estate bubble and China's exports were being subsidized in a number of ways in addition to currency undervaluation. So these factors acted to compensate for the effect of the currency revaluation.

What Is the Appropriate Appreciation for the RMB at This Point?

The question is appropriate for whom. For China, a slow gradual appreciation of 4–5 percent a year is advantageous. For the United States a revaluation of 15 percent annually over 2 to 3 years would be helpful.

What Are the Options?

A negotiated deal between the G-20 countries for a wide reaching set of currency adjustments would be the most preferable solution. Indeed, ultimately, it is the necessary solution. Ideally, such a solution would not only adjust currencies but would also begin a process of creating a new global financial framework in which the role of the dollar would be reduced and that of other currencies increased and in which eventually there would evolve one global currency. To drive toward this goal, it might be necessary for the United States to invoke the clauses of the WTO and to take necessary measures to offset the damage being done to its economy.

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

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

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

The problem, however, is far bigger than China's currency, and let's be clear that China is not the only one in this game. Many of the East Asian countries are managing their currencies to facilitate their export competitiveness into the U.S. market. But currency is just the tip of the iceberg. We've all been engaging in a huge charade. We in the United States have been acting on the basis of the presumption that in a world of globalization, with a majority of countries being IMF and WTO members, that all countries are playing the same globalization game. And that it is a game of win-win free trade. This has never been true and is increasingly less true. In fact, the world is divided—some important countries (the U.S., the U.K., a few others) are more or less free traders, but many other countries are neo-mercantilists pursuing export-led growth strategies guided by elaborate industrial policies. We've seen this movie before. We've seen Japan pioneer the export-led growth

strategy, followed by the Asian Tigers, and now we're seeing the last tiger, or perhaps the first dragon, perfecting the model. A model, it should be noted, that is not unique to Asia. Indeed, we see Germany pursuing accumulation of chronic trade current account surpluses and insisting that it can never buy more of the products of its partners in the EU.

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

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

Rather than making this a bilateral issue, it is clearly preferable that some multilaterally negotiated arrangement be achieved, perhaps in the G-20 or in the WTO or even in the IMF. Another option is negotiating with China in a multilateral context, such as the G-20 or the WTO. But if that can't be achieved in some reasonable period of time, countries, including the United States, will be obliged to defend their interests in whatever way they deem appropriate, unilaterally or as a coalition of concerned countries. A difficulty is that the global institutions and many of their key underlying concepts such as most favored nation and national treatment are not cognizant of the present structural realities and not adequate to deal with the problems of a world that is half neo-mercantilist/strategic trade and half free trade. How laughable is it that countries put enormous effort into the WTO to lower tariffs while ignoring exchange rates which can easily move by a magnitude greater than the value of the tariffs the WTO system has reduced, or that the IMF can discuss currency values and exchange rates without reference to trade and investment? Yet they do. We should recognize and use this opportunity to begin establishing 21st century institutions for the 21st century. The first step is to recognize the realities.

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

Negotiations similar to those of the Plaza Agreement of 1985 should be launched immediately to coordinate a substantial (40 to 50 percent) revaluation of a number of managed Asian currencies *versus* the dollar and the euro over the next 2 to 3 years. This would also have to entail an agreement to halt strategic currency management activities. A second longer term objective of the deal would be a reversal of savings and consumption patterns in the United States and Asia. Once the current recession is behind us, Washington would promise to balance the Federal budg-

et over the business cycle and to reform poorly targeted consumption incentives like the tax deductibility of interest on home equity loans, while key Asian and oil producing countries and Germany would undertake to increase domestic consumption. China could upgrade its social safety net, and a true liberalization of Japan's housing and consumer credit markets might do wonders. The oil countries also need to improve social safety nets and greatly upgrade their infrastructure.

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

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

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

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

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

Attachment 1

TIME TO COOL CHINA, U.S. TEMPERS

Business Times, Saturday, March 20, 2010

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

By Leon Hadar, Washington Correspondent

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

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

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

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

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

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

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

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

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

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

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

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

But since the Chinese do not allow their currency to float freely, the same economists also disagree over the degree to which the Chinese undervalue their currency.

Economists also differ in estimating the extent to which the appreciation of the Chinese currency will lead to the narrowing of the U.S. trade deficit with China. After all, reducing that deficit seems to be the main rationale for the proposed legislation on Capitol Hill.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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PREPARED STATEMENT OF NICHOLAS LARDY

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APRIL 22, 2010

China and the United States each contributed massively to the large global economic imbalances that emerged in the middle of the last decade. China was far and away the largest global surplus country by the middle of the decade. Its current account surplus reached an astonishing 11.0 percent of GOP in 2007 and for the 4 years from 2005 through 2008 China accounted for about a fifth of the total global surplus. China's emergence as a large surplus country reflects the rise of domestic savings relative to investment over this period.

The United States was far and away the world's largest deficit country in recent years, hitting a peak of 6 percent of GOP in 2006. For the same 4-year period the United States accounted for almost 60 percent of the total global deficit. These very large U.S. deficits reflected our low national savings relative to our national investment.

The imbalances in both countries contributed to the global financial crisis, though lax financial regulation in the United States was undoubtedly a more important underlying cause.

But this situation has changed significantly over the past 2 to 3 years. The external imbalances of both the United States and China have declined dramatically. From its 2007 peak China's current account fell by almost half to 6.1 percent of GOP in 2009 and in the first quarter of this year was running at an annual rate of only 1 percent of GDP. Similarly, the pace of official intervention, which prevents the value of the renminbi from appreciating, fell by three-fifths in the first quarter of this year compared to last year. The U.S. current account imbalance also has fallen sharply; the deficit fell to only 2.9 percent of GOP last year, about half the level of 2006.

Given these developments it may appear that the renewed focus by the U.S. Congress on China's currency and its external imbalance is misplaced. In China the Ministry of Commerce now argues that the collapse of China's trade surplus shows that its currency is no longer undervalued and thus appreciation is not warranted. However, I believe that this conclusion is not well founded since the decline in China's external surplus in large part was caused by three factors that are likely to be transitory or already have been reversed.

First, China was the first globally significant economy to begin to recover from the global recession. China's growth bottomed out in the fourth quarter of 2008 and then accelerated very strongly starting in the first quarter of 2009. Thus China's recovery predates that of the United States, its largest trading partner, by half a year and predates European recovery by an even longer period. China's early growth resurgence compared to the rest of the world boosted its imports relative to its exports, cutting the external surplus. But this factor will wane if the U.S. recovery gains traction and Europe begins to recover.

Second, China's terms of trade have deteriorated dramatically over the past year, reflecting a sharp rise in commodity prices. Since China is the world's largest importer of a number of key commodities, sharply rising prices for these goods have added substantially to China's import bill, thus reducing its external surplus. This is unlikely to continue to be such a major factor going forward.

Third, the renminbi appreciated 15–20 percent in real effective terms from late 2007 through the first quarter of 2009. This was a major factor contributing to the sharp reduction in China's surplus in 2008 and 2009. But since the first quarter of 2009 the renminbi has depreciated in real effective terms by about 5 percent. This factor is likely to contribute to a rise in China's surplus, probably beginning in the second half of 2010.

Thus I disagree with those who argue that China's currency is no longer undervalued. It seems more likely that China's external surplus will turn upward and that China's contribution to global economic imbalances should continue to be a focus of U.S. policy.

However, the extraordinarily sharp and unexpected reduction in China's current account surplus over the past year surely suggests that there is substantial uncertainty surrounding most estimates of the degree of renminbi undervaluation. Moreover, we should recognize that the virtual disappearance of China's trade surplus, even if only temporary, means that within China it will be politically difficult for the government to quickly resume a policy of appreciation *vis-a-vis* the U.S. dollar. It also means that if this policy is adopted we are likely to see a slow pace of appre-

ciation, at least until the global recovery strengthens and China's external surplus widens significantly.

Furthermore, even if the degree of undervaluation of the RMB is very large, a rapid appreciation of the renminbi is not optimal from the Chinese perspective and probably not from the U.S. perspective either. With about fifty million people employed in China's export-oriented manufacturing, the Chinese government will eschew rapid appreciation since that would result in a sharp fall in the output of these industries and eliminate many of these jobs. Their optimal strategy will be a gradual appreciation that would eliminate the growth of China's trade surplus and thus tend to stabilize the output and employment of these industries. In 2008, when my colleague Morris Goldstein and I believed the renminbi was very substantially undervalued, we argued the optimal time frame for eliminating currency undervaluation would be 4 to 6 years.[1] Our colleague, Michael Mussa, points out that a very rapid elimination of China's currency undervaluation would not be desirable from the perspective of the United States since it would likely "disrupt China's economic growth in ways and to an extent that could not plausibly be offset by other policy adjustments."[2] A rapid deceleration in the growth of the world's second largest economy is not likely to enhance global economic recovery, nor would it likely contribute to the recovery of employment in the United States. Indeed, the opposite is more likely.

Ultimately reducing imbalances, whether in the United States or China, requires structural reforms that reduce the gap between national rates of savings and investment. The exchange rate is an important factor that can contribute to this process. But without supporting reform policies in both countries, the results of exchange rate adjustment alone are likely to be disappointing.

In China, some progress has been made over the last couple of years to advance this broader rebalancing agenda. This progress is spelled out in greater detail in the attached Policy Brief, which was distributed by the Peterson Institute in March. The government has taken steps to reduce some of the factor market distortions that have artificially subsidized the production of export goods and goods that compete with imports and at the same time have inhibited the output of services, which are largely consumed at home. In 2009 the government raised the prices of some important inputs, notably fuels, which are predominantly consumed in the industrial sector. This reduced the bias of investment toward manufacturing, contributing to a larger increase in investment in services than in industry in 2009. This is a reversal from the pattern that had dominated Chinese investment for many years. Similarly the government continued to accelerate its build out of the social safety net by massively increasing expenditures on health, education, and pensions. This should contribute to a reduction in households' precautionary demand for savings and thus a reduction in China's large savings surplus. Finally, bank lending to consumers grew dramatically last year, facilitating a remarkable increase in household consumption expenditures.

In addition to allowing its currency to appreciate, the Chinese government should adopt a number of other policy reforms to insure a sustained reduction in its global current account surplus and a successful transition to more consumption-driven growth. Low interest rates on bank loans continue to favor manufacturing (tradable goods) over services and thus contribute to China's external surplus. To address this problem China's central bank should end its policy of imposing a broad range of deposit and lending rates in favor of allowing supply and demand in the market to determine interest rates. Further price reforms would also contribute to sustaining the reduction in China's global current account surplus. For example, while the government last year raised the prices of gasoline and diesel fuel, electric power remains underpriced, continuing to provide an advantage to China's exports. And, after years of discussion, the government should introduce realistic environmental taxes and fees, which would help to level the playing field between industrial growth and exports *versus* services and consumption.

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[1] Morris Goldstein and Nicholas R Lardy, "China's Exchange Rate Policy: An Overview of Some Key Issues", in Morris Goldstein and Nicholas R. Lardy, editors, Debating China's Exchange Rate Policy (Peterson Institute for International Economics, 2008), pp. 54–55.

[2] Michael Mussa, "Global Economic Prospects for 2010 and 2011: Global Recovery Continues", April 8, 2010. Available at *http://www.petersoninstitute.org.*

Peterson Institute for International Economics

Policy Brief

NUMBER PB10-7 MARCH 2010

The Sustainability of China's Recovery from the Global Recession

Nicholas R. Lardy

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China's policy response to the global financial and economic crisis was early, large, and well-designed. Although Chinese financial institutions had little exposure to the toxic financial assets that brought down many large Western investment banks and other financial firms, China's leadership recognized that its dependence on exports meant that it was acutely vulnerable to a global recession. Thus they did not subscribe to the view sometimes described as "decoupling," the idea that Asian countries could passively weather the financial storm that originated in the United States and other advanced industrial economies. They understood that absent a vigorous policy response China inevitably would suffer from the backwash of a sharp economic slowdown in its largest export markets—the United States and Europe.

While it is now widely understood that China was the first globally significant economy to begin to recover from the crisis, critics nonetheless increasingly charge that the stimulus program has substantial flaws and that China's early economic recovery cannot be sustained. One prominent critic has gone so far as to suggest that the stimulus has created a debt-fueled bubble that will collapse, causing China's growth to plunge to only 2 percent.[1] But the analysis below suggests these criticisms are exaggerated.

CHINA AND THE CRISIS

In the fall of 2007, just before the global crisis, the Chinese authorities tightened monetary policy and took steps to curtail an incipient property bubble. But when the global crisis intensified in the fall of 2008 the authorities reversed economic course by launching a policy of monetary easing in order to offset the additional drag on China's growth caused by the sharp slowdown in global trade. First, they cancelled the lending quotas that had previously restricted the ability of banks to fully meet the demand for loans from their customers.[2] Second, to ensure that a sufficient supply of funds would be available to meet this demand, the government repeatedly reduced the share of deposits that banks had to place with the central bank. Banks were not necessarily forced to expand their lending in 2009, as has often been asserted. It was in their economic self-interest to do so since the interest rate that they could charge on loans was several times what they earned either on funds they were required to place with the central bank or on funds lent in the interbank market.[3] Thus, the

1. Aki Ito and Patrick Riai, "Rogoff Says China Crisis May Trigger Regional Slump," February 24, 2010, www.bloomberg.com (accessed March 5, 2010).

2. Mao Lijun and Wang Bo, "Lending Caps to Reduce Liquidity," *China Daily*, January 21, 2010, 10.

3. The central bank pays 1.62 percent on reserves and in December 2008 interbank market lending rates ranged from 1.0058 percent for loans of one-month maturity to 2.3579 percent for loans of one-year maturity. In contrast, in December 2008 the average interest rate on a one-year loan was 6.64

government's first step in monetary easing was to increase the supply of loanable funds.

The authorities simultaneously took steps to increase the real demand for loans. First, they repeatedly lowered the benchmark interest rates that guide the rates that banks charge on loans of various maturities. These cuts took the benchmark rate on a five-year loan from 7.74 percent in September 2008 to 5.76 percent at year-end. Second, they made deeper cuts in the rates for mortgage loans. Prior to the fall of 2008 the rate that applied to mortgage loans that banks made to individuals to purchase owner-occupied property was 0.85 times the benchmark rate. Beginning in September the government reduced this multiple to 0.7. So, for example, the combined effect of a reduction in the benchmark five-year loan rate and the adjustment in the mortgage factor meant that the interest rate a potential home buyer would pay on a mortgage with a term of five or more years was reduced by two-fifths, from 6.66 to 4.16 percent. This meant that the monthly payment on a 20-year mortgage was reduced by 18.6 percent.[4] For property investors the 40 percent minimum downpayment on a mortgage, introduced in the fall of 2007, was scaled back to 20 percent. And the compulsory penalty interest rate that applied to property investors, which had been set at 1.1 times the benchmark rate starting in September 2007, was eliminated.[5]

Much of the criticism that is directed at China's stimulus ignores or understates both the substantial advantages that accrue to China as a result of coming through the crisis with strong economic growth momentum and fails to appreciate the steps that the authorities already have taken that head off the potential adverse effects of the stimulus predicted by the critics.

A few months later, in January 2009, the authorities reduced to two years (from five years) the period investors must hold a property in order to avoid a sales tax when a property is sold.[6]

The result of these policy initiatives was a massive increase in bank lending, particularly in the first half of 2009, when domestic currency loans outstanding increased by RMB7.4 trillion, three times the increase in the first half of 2008. Loan growth moderated substantially in the second half, so for the year as a whole bank lending in domestic currency increased by RMB9.59 trillion, about twice the RMB4.91 trillion increase in bank lending in domestic currency in 2008.[7] Mortgage lending was a large part of the loan expansion story in 2009. Individual mortgage loans outstanding increased by RMB1.4 trillion, about five times the increase of 2008.[8]

Shortly after the authorities launched their policy of monetary easing in September 2008 they also announced a RMB4 trillion stimulus program, entirely devoted to investment expenditures. This program began immediately in the fourth quarter of 2008 and extends through 2010. In practice the stimulus program is closely linked to monetary easing since the plan from the outset was that it would be financed primarily by increased bank lending rather than through the government budget.

The results of China's stimulus program were impressive, making China the first globally significant economy to begin to recover from the global economic recession. Measured on a quarter-over-quarter basis the economy bottomed out in the fourth quarter of 2008, when economic growth slowed to only 4.3 percent. As the stimulus package began to take hold China's growth accelerated sharply to 9.5 and 11.4 percent, respectively, in the first and second quarters of 2009.[9] In January 2010 the statistical authorities placed the year-over-year GDP growth in 2009 at 8.7 percent, well above the pace that most external observers had expected a year earlier.[10]

percent; see People's Bank of China, Monetary Policy Analysis Small Group, *Report on the Implementation of Monetary Policy, Fourth Quarter 2009*, February 11, 2010, 6, 11, and 21, www.pbc.gov.cn (accessed on February 11, 2010).

4. People's Bank of China, Monetary Policy Analysis Small Group, *Report on the Implementation of Monetary Policy, Fourth Quarter 2008*, February 23, 2009, 46, www.pbc.gov.cn (accessed on February 24, 2009).

5. Banks, however, were advised that they "should appropriately raise" the downpayment ratio and the interest rate on mortgages that were not for first-time buyers, were not for owner-occupied units, and were for high-end rather than ordinary property.

6. "China Imposes Tougher Home Sale Tax to Control Bubble," *People's Daily Online*, December 10, 2010, http://english.people.com (accessed on December 10, 2009).

7. People's Bank of China, Monetary Policy Analysis Small Group, *Report on the Implementation of Monetary Policy, Fourth Quarter 2009*, 3.

8. People's Bank of China, Monetary Policy Analysis Small Group, *Report on the Implementation of Monetary Policy, Fourth Quarter 2009*, 48.

9. People's Bank of China, Statistical Investigation Office, *An Analysis of Macroeconomic Trends in the Fourth Quarter of 2009*, January 29, 2010, www.pbc.gov.cn (accessed on January 30, 2010).

10. National Bureau of Statistics of China, *National Economy: Recovery and Posing in the Good Direction in 2009*, January 21, 2010, www.stats.gov.cn (accessed on January 21, 2010).

SHORTCOMINGS OF THE STIMULUS?

China's growth in 2009 was impressive compared with the absolute downturns in economic output in the United States, Europe, Japan, and many other developed economies and was the fastest growth of any emerging market. But 2009 was the second consecutive year of slowing Chinese growth and 8.7 percent was the slowest pace of expansion recorded since 2001. Moreover, critics, both in China and abroad, argue that growth recovery in 2009 was unsustainable since it relied on a burst of investment financed largely by an unprecedented increase in bank lending.[11] According to the critics, the massive stimulus program would have several adverse consequences. First, in the short run it created bubbles in the property and equity markets as funds lent for investment leaked into these markets. Second, in the medium term the massive investment program financed with the expanded supply of credit would inevitably lead to excess industrial capacity and thus, with a slight lag, would put downward pressure on prices and firm profits.[12] That, in turn, would impair the ability of firms to amortize their bank debt and thus likely lead to a large increase in nonperforming loans. Potentially this would require the state to recapitalize the banks once again, with adverse consequences for the government's fiscal position.

Third, the critics argue that the stimulus undermines China's strong fiscal position. China's budget deficit barely topped 2 percent in 2009, a small fraction of the deficits recorded in the United States and some other advanced industrial countries. This meant China's outstanding government debt remained stable at only 20 percent of GDP, again a small fraction of most high-income economies. But, the critics charge, this obscures a massive increase in hidden government debt.

Finally, the critics charge that the stimulus program exacerbated China's structural imbalances and set back the effort to transition to growth that would rely more on the expansion of private consumption expenditure rather than the growth of investment and exports.[13]

While China's economy is marked by substantial imbalances, all of these criticisms of China's stimulus program seem exaggerated. At a minimum they do not recognize adequately that the alternative to the massive stimulus program was an even sharper drop in economic growth. Moreover, while China faces a substantial challenge in sustaining economic growth in a postcrisis world, its immediate challenge is similar to that faced by many other countries—how soon and at what pace to reduce its stimulus.

Much of the criticism that is directed at China's stimulus ignores or understates both the substantial advantages that accrue to China as a result of coming through the crisis with strong economic growth momentum and fails to appreciate the steps that the authorities already have taken that head off the potential adverse effects of the stimulus predicted by the critics. The criticism also gives short shrift to the advantages that accrue to China as a result of its long-standing very conservative fiscal and financial regulatory policies.

Excessive Lending and a Property Bubble?

The charge of excessive lending growth, for example, fails to take into account that the authorities initiated steps to slow lending growth as early as mid-2009. Increased window guidance and other initiatives slowed lending dramatically in the second half of the year. Although lending spiked upward in January 2010, the China Banking Regulatory Commission (CBRC) announced that month that it would take tougher measures to moderate the pace of lending over the balance of 2010. It reinstated mandatory lending quotas on individual banks and imposed tougher regulations to prevent banks from disbursing most of their lending quota in the first quarter or two of the year.[14] It also raised the required reserve ratio by 50 basis points in both January and February, cutting banks' excess reserves and further signaling the transition away from the "moderately loose monetary policy" of 2009 to the "moderately loose monetary policy implemented flexibly" policy of 2010.

Second, the CBRC has taken other steps to curtail the expansion of bank credit. In October 2009, in what he described as a "historic decision," Chairman Liu Mingkang ruled that banks would no longer be able to count subordinated debt and hybrid capital as part of their tier-two capital.[15]

11. Stephen Roach, "An Unbalanced World Is Again Compounding Its Imbalances," *Financial Times*, October 7, 2009, 23.

12. European Chamber, *Overcapacity in China: Causes, Impacts and Recommendations*, November 26, 2009, 20, www.europeanchamber.com.cn (accessed on March 3, 2010).

13. Michael Pettis, "Sharing the Pain: The Global Struggle Over Savings," Carnegie Policy Brief 84 (Washington: Carnegie Endowment for International Peace, November 2009); "China Has Been Misread by Bulls and Bears Alike," *Financial Times*, February 26, 2010, 11.

14. The aggregate quota for the increase in bank loans outstanding in 2010 was set at RMB7.5 trillion. Moreover, the CBRC announced that each bank should advance in each month no more than 12 percent of its annual quota and in each quarter no more than 30 percent of its annual quota. This would limit the expansion of loans outstanding to RMB900 billion per month, although the authorities acknowledged that this limit would be exceeded in January since the new regulations were not announced until the second half of January when new lending had already exceeded RMB1 trillion; see Mao Lijun and Wang Bo, "Lending Caps to Reduce Liquidity."

15. Liu Mingkang, "Chinese Bankers Carry Hopes for Future Balanced

During the lending boom of 2009 banks kept their capital adequacy ratios from falling sharply by selling large amounts of subordinated debt.[16] Raising the required reserve ratio and disallowing subordinated debt as a source of capital now requires banks to either raise more equity capital or slow down their lending and other activities that require capital backing.

Contrary to repeated criticisms, this stimulus had a substantial consumption component and focused on investment in infrastructure rather than expanding capacity in traditional industries such as steel.

Third, just as they had in the fall of 2007, the authorities focused special attention on moderating the growth of the property market. In December 2009 the government reinstated the 40 percent minimum downpayment for mortgages made to property investors and lengthened to five years the period that property investors must hold a property to avoid paying sales tax when a property is sold.[17] Both these measures cut the potential profits of property investors and disincentivized speculators. These moves dramatically cut the pace of property sales in late 2009 and early 2010 and are likely to be followed by price moderation in the housing market.

Even if the government is less successful in moderating property prices this time around than it was in 2008, it is important to recognize that even a major property price correction in China would not have the systemic implications that it had in the United States and several other major industrial countries in the current crisis. The reason is simple: There is much less leverage in China's property market than there is, for example, in the United States or the United Kingdom. This is seen most clearly in the ratio of household debt to disposable income.

The boom years in the United States and some other advanced industrial economies were fueled by a decline in the household saving rate and an increase in indebtedness, which allowed consumption to rise substantially more rapidly than household income, thus supercharging economic growth for a number of years. By the onset of the crisis, household indebtedness relative to disposable income (after-tax income) had risen to about 130 percent in the United States and even higher levels in the United Kingdom. In the United States much of this debt takes the form of mortgages, and in 2005 and 2006 an increasing share of new mortgages was underwritten on lax terms known as subprime. As long as housing prices continued to rise the increase in household leverage was manageable. But when housing prices began to correct many property investors, who had paid little or nothing down, simply walked away from their properties and defaulted on their mortgages. The value of securities backed by subprime loans plummeted, leaving major financial institutions in the United States and Europe with gaping holes in their balance sheets, which ultimately had to be plugged by massive infusions of government capital.

In contrast, Chinese households are substantially less leveraged. Just prior to the crisis at year-end 2007 loans outstanding to households, including mortgages, auto loans, credit card debt, loans to proprietorships, and seasonal working capital loans to farmers for the purchase of seeds and fertilizer, stood at RMB5.1 trillion or 34 percent of household disposable income.[18]

Not only are Chinese households much less leveraged than their counterparts in several major advanced industrial countries but also the share of their debt devoted to the purchase of property is relatively small. In part this reflects the high downpayment ratios that the CBRC requires as a precondition to qualify for a mortgage on a residential property. Moreover, the Chinese regulator has never approved the introduction of

Development," speech to the Asian Financial Forum in Hong Kong, January 20, 2010, www.cbrc.gov.cn (accessed on February 18, 2010); "China Lenders Asked to Rein in Record Loans," *People's Daily Online*, August 21, 2009, http://english.people.com (accessed on August 21, 2009). The main concern of the CBRC was that by 2009 a little over half of the subordinated bonds sold by banks had been purchased by other banks. These large cross-holdings of subordinated debt do not add any capital to the banking system as a whole, meaning that high capital adequacy ratios reported by individual banks overstate the soundness of the banking system as a whole. Fang Huilei, Zhang Man, Chen Huiying, and Feng Zhe, "New Draft Rules on Subordinated Bonds Will Lower Banks' Capital Adequacy Ratios and Reduce the Systemic Risk of Cross-Holding," *Caijing*, August 24, 2009, http://english.caijing.com.cn (accessed on August 24, 2009).

16. The CBRC starting in 2004 allowed banks to issue subordinated debt, which under certain conditions could be counted as part of their tier-two capital. The volumes issued in 2009 grew rapidly, to RMB236.7 billion in the first half of 2009 alone; see "China Lenders Asked to Rein in Record Loans," *People's Daily Online*, August 21, 2009, http://english.people.com.cn (accessed on August 21, 2009). For the year as a whole, banks issued subordinated debt valued at RMB266.9 billion; see People's Bank of China, "The Financial Market Situation in 2009," February 2, 2010, www.pbc.gov.cn (accessed on February 2, 2010). Thus once the new CBRC draft regulation was circulated in August, bank issuance of subordinated debt halted.

17. "China Imposes Tougher Home Sale Tax to Control Bubble," *People's Daily Online*, December 10, 2009.

18. People's Bank of China, "China's Stable Financial Development in 2007," January 11, 2008, www.pbc.gov.cn (accessed on January 11, 2008); National Bureau of Statistics of China, *China Statistical Yearbook 2009* (Beijing: China Statistics Press, 2009), 77.

home equity lines of credit, which inevitably increase leverage as the lines are drawn down. In part low household leverage reflects the not uncommon practice in China of buying residential property entirely with cash. Of households' total borrowing at year-end 2007, mortgage debt accounted for RMB2.7 trillion, barely over half of all household debt, an amount equivalent to 18 percent of household income. In contrast, in the United States in the same year mortgage debt accounted for three-quarters of total household debt and was the equivalent of 100 percent of household disposable income. Put differently, relative to income, household mortgage debt in the United States is five times more than in China.

The point is simple: A housing price correction in a market with a relatively small amount of leverage has implications that are quite different from a price correction in a much more highly leveraged market. In the former case defaults are likely to be few in number since property price declines would have to exceed 20 percent before any owners reached negative equity. In the latter case, as in the United States, subprime loans frequently required no money down, so even a modest price correction put many owners into negative equity positions on their property. As these subprime borrowers defaulted on their mortgages and went through foreclosure, their properties came back on to the market, reinforcing the property price correction, and thus pushing even more borrowers into a negative equity position. As a result, defaults on subprime loans rose sharply and thus the value of securities backed by subprime and eventually even higher quality tranches of mortgages, such as Alt-A, plummeted. This threatened the viability of several major financial institutions that either held large amounts of such securities or had issued guarantees on the value of such securities.

Creation of Excess Capacity?

What about the assertion that the investment boom in 2009 created excess capacity that will lead to downward pressure on prices and thus on firm profits, perhaps leading to defaults on the loans that financed the capacity expansion? This argument too seems not well founded. In a high-growth, high-investment economy, such as China's, some product sectors inevitably have at least temporary excess capacity. The issue, however, is whether this excess capacity is so widespread and enduring that it could contribute to deflation, putting downward pressure on the profits of a large number of firms across many sectors. Such a situation would not only impair the ability of individual firms to repay their loans but also potentially lead to large-scale losses in the banking system.

This does not appear to be the case in China for several reasons. First, Chinese firms historically have tended to hold on to outdated equipment, so that if demand for their product surged the firm could bring this old, higher-cost production capacity back on line. So Chinese data on excess capacity may overstate the extent of excess capacity compared with other countries. Second, there is a substantial difference between excess capacity of, say, 20 percent in a mature economy growing at 2 to 3 percent per year and 20 percent excess capacity in China, where growth has averaged about 10 percent for three decades. In the mature economy the cost of financing excess capacity for the seven or eight years it might take demand to catch up with potential supply would be substantial and probably put enormous financial pressure on the firms that had built the excess capacity. But in China 20 percent excess capacity would likely be absorbed in a year or two.

The charge of excessive lending growth fails to take into account that the authorities initiated steps to slow lending growth as early as mid-2009.

Steel is most commonly cited as an industry that has tended to excess capacity in China. A recent European Chamber report estimated that China's excess production capacity in steel at year-end 2008 was between 100 million and 200 million metric tons, which translates into excess capacity between 15 and 30 percent.[19] This estimated overcapacity alone is more than the steel output of the two next largest global steel producers—Japan and the United States.

But this analysis fails to adequately consider the pace of growth of apparent steel consumption in China, which has been over 15 percent annually between 2000 and 2008.[20] In 2009 China's apparent steel consumption soared by 107 million metric tons. In short, what appeared to outside observers to be massive excess capacity at year-end 2008 may have been mostly absorbed in 2009. If not it will likely be absorbed in 2010.

Finally, it is important to note that the stimulus-fueled investment boom of 2009 was not focused on expanding production capacity in China's traditional industries, such as steel, as is widely claimed. One important indicator of this is the sectoral allocation of medium- and long-term bank loans. These are loans of more than one year, which are used to finance

19. European Chamber, *Overcapacity in China: Causes, Impacts and Recommendations*, November 26, 2009, 20.

20. Apparent steel consumption is steel production minus net exports. This series is compiled by World Steel Dynamics.

fixed investment, as opposed to loans of a year or less, which are used to finance working capital. In 2009 medium- and long-term loans outstanding expanded by RMB4.9 trillion, accounting for almost half of the increase in renminbi lending by the banking system that year. Of these loans financing fixed investment, only 10.2 percent, or RMB502.5 billion, were extended to manufacturing firms. Fifty percent went to infrastructure projects, 13.1 percent to leasing and business services, and 10.2 percent to property.[21]

The stimulus did lead to a substantial increase in the borrowing of local investment companies...which local governments will have to repay ultimately...but the infrastructure provided through these companies likely will contribute to China's sustained economic growth and thus to increasing government tax revenues as well.

We can also examine the composition of investment, whether financed by medium- and long-term loans or by the internal cash flow of the corporate sector. Steel investment in 2009 was substantial, about RMB400 billion. But the growth of investment in the steel industry in 2009 was minimal, only 3 percent compared with an increase of investment for the economy as a whole of 30 percent. Again, this reflects the priorities of the stimulus program—more for infrastructure and less for traditional industries such as steel. Investment in the rail network, for example, rose 67.5 percent in 2009.[22]

Hidden Government Debts Threatening Fiscal Sustainability?

The third critique to examine is that China's stimulus has led to a massive increase in implicit government debt that ultimately could threaten government finances. Since the stimulus in 2009 was financed by credit rather than deficit spending, government debt remains low. But much of the medium- and long-term bank lending for infrastructure investment went to local quasi-government agencies, called local investment or platform companies.[23] Although local governments legally are not allowed to borrow or to run budget deficits, lending to these local investment companies is legal. Critics argue that these platform companies are unlikely to be able to repay these loans and that the obligation to repay will ultimately fall on local governments. The view that the repayment burden could fall on local governments is quite reasonable since in many instances local governments have provided guarantees for these loans.

How large might the debt of these platform companies be? To start with, consider medium- and long-term bank lending that the central bank specifically identifies as going to infrastructure projects. These loans amounted to RMB1.1 trillion and RMB2.5 trillion in 2008 and 2009, respectively.[24] If we assume that all of these infrastructure loans went to local investment companies and that none of the loans of this type made in the five years 2005–09 has been repaid, the bank debt of these platform companies at year-end 2009 would have been RMB5.666 trillion.[25] These firms also issue bonds, a reported RMB121.2 billion in 2009, slightly more than what they issued in the previous four years.[26] Adding bank borrowing and bond issuance brings the total debt of local investment companies to approximately RMB5.9 trillion.

An alternative to this bottom-up approach is to look for authoritative Chinese estimates of the debt. Ba Shusong, the deputy director of the Institute of Finance of the Development Research Center, a leading government think tank, placed the debt of local investment companies at mid-year 2009 at more than RMB5 trillion, up from about RMB1 trillion at the beginning of 2008.[27] Adding medium- and long-term infrastructure lending by banks in the second half of 2009

21. People's Bank of China, Monetary Policy Analysis Small Group, *Report on the Implementation of Monetary Policy, Fourth Quarter 2009*, 3.

22. These are increases in what the Chinese statistical authorities call fixed asset investment, a measure that overstates the growth of capital formation. While the data on fixed asset investment are biased upward the relative rates of expansion of fixed asset investment in steel compared with the economy as a whole is likely to be a good indicator of the modest growth of capital formation in the steel industry in 2009. National Bureau of Statistics of China, "Main Statistical Data in 2009," January 21, 2010, www.stats.gov.cn (accessed on January 21, 2010).

23. These are also sometimes referred to in secondary sources as conduit companies or urban development and construction companies.

24. People's Bank of China, Monetary Policy Analysis Small Group, *Report on the Implementation of Monetary Policy, Fourth Quarter 2008*, 4; *Report on the Implementation of Monetary Policy, Fourth Quarter 2009*, 3.

25. Medium- and long-term infrastructure lending in 2005, 2006, and 2007 was RMB617.50 billion, RMB650.48 billion, and RMB 798.36 billion, respectively.

26. Andrew Batson, "China's Localities Feel Pinch of Tighter Credit," *Wall Street Journal*, February 25, 2010, http://online.wsj.com (accessed on February 25, 2010). The issuance of bonds in the first 11 months of 2009 almost equaled bond issuance by these companies in the previous four years. Xu Lin, "Taming 'Local Government Inc.,'" *China Reform* 316, January 15, 2010, http://englishcaing.com.cn (accessed on March 12, 2010).

27. Wang Bo, "Systematic Risks Warning," *China Daily*, November 9, 2009, 7.

and bond issuance by these firms in the second half to Ba's mid-year figure of more than RMB5 trillion brings the total debt to RMB6 trillion, very close to the bottom-up estimate just laid out.[28]

RMB6 trillion is equal to almost a fifth of China's GDP, roughly equal to the outstanding government debt issued by the Ministry of Finance and equal to 15 percent of all the loans outstanding from the banking system.[29] In short, by almost any standard the borrowing of local platform companies is large.

Judging the platform companies' ability to service their debt is difficult. One concern is that some services provided by these quasi-government agencies are substantially underpriced. Despite increases in tariffs over the last decade or more, most local water companies have lost money every year since the mid-1990s.[30] Similarly, the fares on subway systems in China are so low that fare box revenue probably does not even cover operating costs. Thus the underpricing of these services impairs the ability of these quasi-government agencies to repay their loans. To the extent to which platform companies invest in activities that do not generate revenue, their ability to repay is even more impaired.

While the financial returns to some of the investments undertaken by platform companies may be modest, it is likely that the real economic returns of these investments to the economy as a whole on average will be high. China is in the midst of the largest rural-to-urban migration in global history. Thus the demand for services in urban areas is rising rapidly and the real economic returns to infrastructure investment are likely to be high. Indeed, unlike India, where insufficient infrastructure investment has been a brake on economic growth, rapid infrastructure development in China has facilitated and stimulated superior growth performance.

Moreover, while some local investment companies may have weak cash flow, they nevertheless have substantial assets. At year-end 2009 their assets amounted to RMB8 trillion, about one-third more than our estimate of their outstanding debt.[31] Thus lending to these companies is not likely to have the same adverse consequences as did large-scale bank lending to chronic money-losing state-owned companies in the mid-1990s. At that time many of these state-owned borrowers had liabilities far exceeding their assets so when they were ultimately closed and liquidated banks recovered little or nothing.[32] Ultimately, the government had to inject about RMB3.4 trillion into the banking system to facilitate its restructuring.[33]

In short, local investment companies may be unable to repay a substantial portion of their borrowings. Ultimately, municipalities and other local governments will probably have to assume the responsibility for repaying much of the borrowing of the quasi-government agencies in their jurisdiction. But the infrastructure provided through local investment companies likely will contribute to China's sustained economic growth and thus to increasing government tax revenues as well. Moreover, local governments are likely to continue to enjoy substantial income from the leasing of land, revenue that is not reflected in local government budgets. Needless to say, if borrowing by local investment companies were to continue at the pace observed in 2008 and 2009 the outlook would be much less sanguine.

Neglect of Consumption?

The charge that the stimulus program focused excessively on expanding investment demand and has set back China's efforts to achieve more balanced growth by encouraging private consumption seems wrong. Consumption growth in 2009 was actually quite robust; indeed on the basis of preliminary data it appears that 2009 was the first year since 2000 that the growth of consumption outstripped the growth of GDP. Thus the long-term decline in the consumption share of GDP probably ended, at least temporarily, in 2009.

During a year in which GDP expansion was the slowest in almost a decade, how could consumption growth have been so strong in relative terms? In the early months of 2009 employment in export-oriented industries was collapsing, with a reported loss of 20 million jobs in export manufacturing centers along the southeast coast, most notably in Guangdong Province.[34]

28. In the second half of 2009 banks extended RMB900 billion of medium- and long-term loans for infrastructure and local investment companies issued RMB55.2 billion in bonds. See Xu Lin, "Taming 'Local Government Inc.'"

29. This is substantially below Victor Shih's estimate of RMB11 trillion; see Victor Shih, "China's 8,000 Credit Risks," *Asian Wall Street Journal*, February 8, 2010, http://online.wsj.com (accessed on February 12, 2010). It is above a figure of RMB5 trillion given by the People's Daily, an agency of the Chinese Communist Party; see "China on High Alert for Large-Scale Bad Loans," *People's Daily Online*, February 25, 2010.

30. "High Price for Water Reform?" *People's Daily Online*, October 29, 2009, http://english.people.com.cn (accessed on October 29, 2009).

31. "China on High Alert for Large-Scale Bad Loans," *People's Daily Online*, February 25, 2010.

32. Nicholas R. Lardy, *China's Unfinished Economic Revolution* (Washington: Brookings Institution, 1998), 43,142–43.

33. Ma Guonan, "Who Pays China's Bank Restructuring Bill?" CEPII Working Paper No. 2006-4 (Centre D'etudes Prospective et D'informations Internationales, February 2006), 22.

34. "20 Million Migrants Lost Jobs: Survey," *China Daily*, February 3, 2009, www.chinadaily.com.cn (accessed on March 15, 2010).

Several factors explain this unexpectedly strong growth of consumption in 2009. First, the boom in investment, particularly in construction activities, appears to have offset a large portion of the job losses in the export sector. Thus employment of rural migrant workers, largely in construction as well as in coastal export industries, quickly recovered. And in the more formal labor market in urban areas, by year-end 2009 11.02 million jobs were created, very nearly matching the 11.13 million jobs created in 2008.[35]

Second, the government continued to raise transfer payments to China's lowest income residents and to increase payments to those drawing pensions. Transfer payments to about 70 million of China's lowest income citizens rose by a third or RMB20 billion in 2009.[36] Monthly pension payments for enterprise retirees increased by RMB120 or 10 percent in January 2009, almost double the 5.9 percent increase in consumer prices in 2008.[37] This raised payments to retirees by about RMB75 billion.[38] The increases in employment, transfer payments, and pension income contributed to a 9.8 percent increase in the disposable income of urban residents and an increase of 8.5 percent in the net income of rural residents in 2009.[39]

Third, the government, recognizing it could not rely entirely on increased investment to offset the drag on growth from shrinking exports, adopted several additional specific measures to encourage consumption as part of its stimulus program. In 2009 the government cut by half the 10 percent tax on vehicles with small-displacement engines. In addition the government allocated RMB45 billion in subsidies to rural residents trading in old vehicles and home appliances. These subsidies alone probably boosted rural consumption by more than 1 percent.[40] These incentives contributed to an almost 50 percent increase in vehicle sales nationally and a massive increase in the sale of consumer durables in rural areas.

35. Wen Jiabao, *Report on Work of the Government*, March 5, 2009, www.npc.gov.cn (accessed on April 13, 2009); *Report on Work of the Government*, March 5, 2010, www.npc.gov.cn (accessed on March 24, 2010).

36. Ministry of Civil Affairs, "Statistical Communiqué on Program Development," March 5, 2010, http://files.mca.gov.cn (accessed on March 12, 2010).

37. This was the fifth consecutive year in which retirees from enterprises received increases in their monthly pensions; "China to Raise Pensions from 2010," *People's Daily Online*, December 23, 2009, http://english.people.com.cn (accessed on December 23, 2009).

38. Calculated based on an average of 51 million enterprise retirees in 2009.

39. National Bureau of Statistics of China, "Main Statistical Data in 2009," January 21, 2010.

40. RMB45 billion is equal to 1.7 percent of rural consumption expenditures in 2008. If rural consumption grew by as much as 10 percent in 2009 the subsidy would be equal to 1.5 percent of consumption in 2009.

Fourth, substantial increases in household borrowing bolstered consumption in 2009. Loans outstanding to households grew by RMB2.5 trillion, almost four times the increase of 2008.[41] RMB1.4 trillion of this was used to finance the purchase of housing. The remainder, RMB1.1 trillion, might be considered an upward bound estimate of the amount of this increased borrowing that was devoted to financing consumption expenditures. This is a substantial amount, in excess of 3 percent of GDP.

These factors combined boosted urban consumption, which accounts for three-quarters of private consumption expenditures, by 10.1 percent in real terms, well ahead of the pace of GDP growth.

SUMMARY

China faces major challenges in sustaining its economic growth in a period of weak global recovery, particularly in Europe. In 2009 China's net exports of goods and services dropped precipitously, resulting in a substantial drag on economic growth.[42] To overcome this drag China launched a massive stimulus program, financed largely with bank credit. Contrary to repeated criticisms, this stimulus had a substantial consumption component and directed investment primarily toward infrastructure rather than expanding capacity in traditional industries such as steel.

But the stimulus did come at a cost insofar as it led to a substantial increase in the implicit debt of local governments. The authorities recognize flooding the economy with more credit is not the way forward and that they will have to take strong additional policy initiatives to sustain economic growth. These include raising the prices of inputs such as water, electricity, and other resource products as well as introducing realistic environmental taxes and fees. These reforms, as well as a more flexible exchange rate, would reduce the distortions that for much of the past decade have favored industrial growth and exports over services and consumption and would contribute to sustaining China's impressive long-term economic growth.

41. The increase in lending to households is a comprehensive measure that includes mortgages, credit card debt, auto loans, seasonal working capital loans to farmers to finance seed and fertilizer purchases, and loans to proprietorships and other unincorporated businesses. When farmers and proprietors have improved access to working capital from banks, they can devote more of the income from their farms and small businesses to personal consumption.

42. The drag was calculated at 3.9 percentage points by China's statistical authority. That means to achieve growth of 8.7 percent domestic demand increased by 12.6 percent, which is the fastest pace of increase in domestic demand in more than a decade.

The views expressed in this publication are those of the author. This publication is part of the overall programs of the Institute, as endorsed by its Board of Directors, but does not necessarily reflect the views of individual members of the Board or the Advisory Committee.

PREPARED STATEMENT OF CHARLES H. BLUM

EXECUTIVE DIRECTOR, FAIR CURRENCY COALITION

APRIL 22, 2010

On behalf of the members of the Fair Currency Coalition (FCC),[1] I thank the Subcommittee for this opportunity to testify on what action the United States can and should take to remedy the persistent problem of currency undervaluation by China and other countries. The FCC and its antecedents have worked on this problem continuously for 7 years. In 2003–4, we developed a well researched and argued petition filed under Section 301 of the Trade Act of 1974 that was summarily rejected by the last Administration.

Only then did we turn to a legislative solution, developing and refining the legislation currently known as the Currency Reform for Fair Trade Act, introduced by Senators Stabenow and Bunning in the Senate (S. 1027) and by Reps. Tim Ryan and Tim Murphy in the House (H.R. 2378).[2] We will continue to work on this problem until it has been resolved on an effective and lasting basis.

A Remedy Delayed Is a Remedy Denied

Currency misalignment is not a new problem, nor is it limited to the Chinese renminbi (RMB). On the contrary, it is a perennial problem for reasons that we will address in this testimony and one that continues to grow in severity.

Consider the data contained in Attachment 2. They show that over the 10 years since China's accession to the World Trade Organization (WTO), the U.S. trade deficit with China has mushroomed, as have China's global trade surplus and its stockpile of official foreign exchange reserves. At the same time, U.S. manufacturing employment has plummeted by one-third.

We do not suggest that the undervalued RMB is the sole cause of the loss of American manufacturing jobs, though the two clearly are related. Our point is simply that the long delay in our response to this persistent problem has allowed it to grow to the detriment of American workers and industries. Moreover, what would have been a more easily managed problem—had we acted on the Section 301 complaint in 2004, the first version of our legislation in 2005, the improved version in 2007, or even the latest version introduced last year—has become an enormous problem.

A remedy delayed is a remedy denied. The longer it is denied, the greater the injustice. History suggests that the currency problem will become even larger and harder to manage in the future unless we act now.

Let's look at the options for near-term solutions.

Multilateral Rules Provide No Solution to Currency Misalignment

For understandable reasons, many would prefer to find a solution in the multilateral rules and institutions that are supposed to provide a framework for settling monetary disputes among nations. Indeed, repeated attempts have been made to address the problem through these channels. By now it should be clear that existing multilateral rules and institutions are woefully inadequate to deal with the problem of currency misalignment *per se.* The problem lies not in the degree of effort by our government but rather in the weakness and imprecision of the rules themselves and the excessive length of multilateral dispute resolution processes.

Consider the following the sorry performance of the International Monetary Fund:

- International Monetary Fund Article IV—the most relevant international law on exchange rate practices—obligates members to "avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members."[3] The overriding aim of Article IV is "sound economic growth" and the correction of imbalances that threaten it.
- As part of its exchange rate surveillance mandate, the IMF holds annual consultations with each of its members under Article IV. Repeatedly, the IMF has in careful, diplomatic language suggested that China should revalue the renminbi. Such moral suasion is the only tool the IMF has, and it has never been enough to persuade China to end its mercantilist currency policy. Indeed, China has taken the extraordinary step of blocking the release of the IMF's reports for 2007, 2008 and 2009, presumably because it does not like the conclusions.

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[1] *See,* Attachment 1 for the FCC's list of members.

[2] As of April 20, 2010, S. 1027 has eight cosponsors, and H.R. 2378 has 102 cosponsors.

[3] IMF, Article IV, Section (1).

- The weakness of its rules and the lack of any credible enforcement power makes the IMF useless for all practical purposes in addressing the problem of currency misalignment.

Consider next the problem of addressing currency misalignment through the rules of the World Trade Organization:

- Article XV provides that WTO members "shall not, by exchange action, frustrate the intent of the provisions of this Agreement nor, by trade action, the intent of the provisions of the Articles of Agreement of the International Monetary Fund."[4]
- Such broad language might conceivably form the basis for action under WTO rules. A legal argument clearly exists that undervalued misalignment of a currency constitutes an export subsidy, a practice prohibited on manufactured goods by GATT Article VI. In addition, it can be argued that undervaluation constitutes a *de facto* additional levy on imports, nullifying and impairing the tariff bindings under GATT Article II. Indeed, such allegations were among those made by the Coalition's Section 301 complaint in 2004, and we continue to believe that they have legal and economic merit.
- While there is little question that an undervalued currency has those deleterious effects on key elements of the basic trade contract among WTO members, it is far less clear what action the WTO might take in response to a complaint brought by the United States or a group of countries.
- Novel issues pose substantial problems for the WTO's *ad hoc* dispute settlement panels and the standing Appellate Body. Panelists are drawn from the trade policy establishment around the world. Their knowledge and experience vary, of course, but few of them have any grounding in monetary affairs. As a consequence, it is difficult to anticipate how they would analyze, much less resolve, disputes centering on IMF standards and concepts.
- Most importantly, the WTO arguably lacks a clear mandate to deal with these issues on its own. Instead, GATT Article XV, paragraph 2 requires the WTO to "consult fully with the International Monetary Fund" in cases dealing with "monetary reserves, balances of payments or foreign exchange arrangements." Worse yet, the WTO is obligated by that same paragraph of Article XV to "accept the determination of the Fund as to whether action by a contracting party in exchange matters is in accordance with the Articles of Agreement of the International Monetary Fund."
- Thus, the WTO must rely on the impotent IMF to decide the issue, that same IMF that can't even find a way to convince the Chinese to agree to the release of three annual consultation reports that have no legal or practical consequences.
- In addition, the filing of a case by the U.S. government under the WTO has other potential pitfalls. First, as the plaintiff in the case, the burden of proof would be on the United States to prove that action on currency manipulation falls within the ambit of WTO rules. Thus, the United States would be forced to meet a higher evidentiary threshold than the defending country, likely China. Second, the adjudication and remedy implementation process of WTO appellate panels is painfully slow. Not only is the outcome difficult to predict, it will take years to render and implement any decision—time American producers facing subsidized import competition do not have.

This brief analysis helps explain why chances of any timely solution arising from the existing rules on currency manipulation or misalignment are for all practical purposes zero.

Multilateral Rules Cannot Be Upgraded in the Foreseeable Future

Others have proposed that the solution lies in updating the existing multilateral rules to render them relevant to the realities of this century rather than the last. The most direct approach is that proposed by Arvind Subramanian of the Peterson Institute for International Economics and Aaditya Mattoo of the World Bank. They suggest that WTO rules be amended so as to prohibit currency undervaluation. They choose the WTO over the IMF because undervaluation has clear trade effects and because the IMF has no enforcement powers, especially when it comes to large creditor nations—just the ones who might benefit most from an undervalued currency.

[4] General Agreement on Tariffs and Trade, Article XV, Section 4.

Theoretically, this concept seems direct and sensible. As a practical matter, however, there is little chance whatsoever that the WTO could be amended this way and no chance at all that it could be done expeditiously.

For the foreseeable future, we are stuck with the multilateral rules as they are in dealing with this urgent and still growing problem.

Trade Remedies Are the Only Effective Tool for Addressing Currency Misalignment

Thus, by a process of elimination, we come to national trade laws as the only basis for effective legal action to counter currency misalignment. The FCC has long believed that the most effective, readily available tool is the countervailing duty law, the means authorized by WTO rules for any member to neutralize injurious subsidies.

Under U.S. law and the WTO rules, there are three requirements for a determination of subsidy: (1) a financial contribution by or at the direction of the foreign government that (2) confers a benefit upon the recipient and that (3) is not generally available. In the case of undervalued currencies, the government-established rate—price fixing on a broad scale—forces banks to pay to the seller of an internationally traded good or service extra units of the home currency compared to the fair market value of the currency. The extra units of currency constitute the benefit. That benefit creates an incentive to export. Currency undervaluation thus seems to be a classic example of an export subsidy. Under GATT rules, export subsidies have been prohibited since the 1940s because they are inherently distortive of trade flows. Implementing the multilateral rules through the U.S. countervailing duty law thus seems to be a reasonable reliance on established international law.

In our opinion, the Department of Commerce already has the authority to investigate currency subsidies.[5] Determining it to be an export subsidy would seem to comport well with established Commerce practice and U.S. law. Until now, the Department has not agreed, although its position seems to have shifted at least once. That suggests that the Department would benefit from passage of legislation that clarified the status of currency subsidies under the countervailing duty law by distinguishing actionable from nonactionable forms. The Department would also benefit from clarity regarding the method of calculating the subsidy, the source of data to be used in that calculation, and other procedural matters.

The clear expression of Congressional intent would facilitate the application of existing law to a new area of economic activity, reduce the scope for controversy, strengthen the hand of the government in the litigation that inevitably will follow, and provide helpful guidance to trade practitioners—importers, exporters and foreign governments—about the rules that will govern their trade.

Recently, another significant legislative proposal emerged in the Senate, the Currency Exchange Rate Oversight Act of 2010 (S. 3134). The chairman of this subcommittee and Senator Graham are among the 18 cosponsors. The bill seeks to update the Treasury Department's oversight of foreign government currency practices. An important part of the bill is the attempt to provide Treasury with credible negotiating leverage by authorizing the use of trade law remedies in response to currency undervaluation. The FCC welcomes this legislation. We have concerns about some of the current provisions, especially as they relate to countervailing duty remedies, and are working with the chief cosponsors, Senators Schumer and Stabenow, to strengthen them as much as possible. We do so in the firm belief that countervailing duties are the best available remedy to currency undervaluation.

Responsible Use of Trade Remedies Is Not Protectionism But Supports Free Trade

In closing, let me deal with the standard argument that any use of our trade laws is inherently protectionist. No less a free trader than Ronald Reagan explained his trade policy in a radio address to the Nation in the summer of 1986. Coincidentally, he did so shortly after the Plaza Accord led to a substantial realignment of major currencies.

Reagan made three points: first, trade must be reciprocal—"Free and far trade with free and fair traders" was his motto; second, trade must be based on a respect for the rules; and third, trade policy must produce results.

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[5] This opinion is shared by the 130 members of the House of Representatives who signed a letter to Commerce Secretary Gary Locke and Treasury Secretary Timothy Geithner dated March 15, 2010. Fifteen members of the Senate wrote to Secretary Locke on February 26, 2010, arguing that Commerce had sufficient authority under existing law to initiate a full investigation of alleged currency subsidies. Both document are available at *http://www.faircurrency.org.*

Reciprocity. Respect for rules. Results. Those are three touchstones that should continue to guide U.S. trade and currency policy.

As Martin Wolf wrote recently in the *Financial Times,* "The U.S. was right to give talking a chance. But talk must lead to action." Legislation is the right thing to do. It is the only thing we can do. It is the one thing we must do. It's high time for the Congress to act by passing S. 1027.

Attachment 1

FAIR CURRENCY COALITION: MEMBERS
(As of February 19, 2009)

1. Allegheny Technologies Incorporated
2. American Corn Growers Association (ACGA)
3. American Cotton Shippers Association
4. American Federation of Labor Industrial Union Council
5. American Foundry Society
6. American Iron and Steel Institute
7. American Manufacturing Trade Action Coalition
8. American Mold Builders Association
9. Bakery, Confectionary, Tobacco Workers and Grain Millers International Union (BCTGM)
10. Coalition for a Prosperous America
11. Communication Workers of America (CWA)
12. F & L Metal Finishes, Inc.
13. The Copper & Brass Fabricators Council, Inc.
14. International Association of Machinists and Aerospace Workers (IAM)
15. International Brotherhood of Boilermakers (IBB)
16. International Brotherhood of Electrical Workers (IBEW)
17. International Federation of Professional Employees (IFPTE)
18. Lapham-Hickey Steel Corporation
19. Manufacturers Association of Central New York (MACNY)
20. Metals Service Center Institute
21. National Council of Textile Organizations
22. National Textile Association
23. National Tooling and Machining Association
24. North American Die Casting Association
25. Nucor Corporation
26. Organization for Competitive Markets
27. Penn United Technologies, Inc.
28. Precision Machined Products Association
29. Precision Metalforming Association
30. Sheet Metal Workers International Association (SMWIA)
31. Specialty Steel Industry of North America
32. Spring Manufacturers Institute
33. Steel Dynamics, Inc.
34. Steel Manufacturers Association
35. Tooling & Manufacturing Association
36. Tooling, Manufacturing, and Technologies Association
37. United Automobile Workers (UAW)
38. Universal Electric Corporation
39. United Mineworkers of America (UMWA)
40. United States Business & Industry Council
41. United Steelworkers of America (USW)
42. US Industrial Fabrics Institute
43. Wisconsin Paper Council
44. Wood Machinery Manufacturers of America (WMMA)
45. Vanadium Producers & Reclaimers Association
46. Xcel Mold and Machine, Inc.

Attachment 2

Impact of Inaction on the China Currency Problem:
Key Indicators (Billions of USD)

	U.S. Trade Deficits with China[1]	China Trade Surplus with the World[2]	China Foreign Exchange Reserves[3]	U.S. Manufacturing Employment (Millions)[4]
2000	83.83	24.11	165.57	17.18
2001	83.10	22.55	212.17	15.71
2002	103.06	30.43	286.41	14.91
2003	124.07	25.47	403.25	14.30
2004	162.25	32.09	609.93	14.29
2005	202.28	102.00	818.87	14.19
2006	234.10	177.48	1,066.34	14.00
2007	258.51	262.20	1,528.25	13.73
2008	268.04	295.46	1,946.03	12.82
2009	226.83	196.10	2,399.15	11.53

Sources:
1. U.S. Census Bureau
2. China Customs
3. People's Bank of China
4. U.S. Bureau of Labor Statistics; December Data

PREPARED STATEMENT OF DANIEL J. IKENSON

ASSOCIATE DIRECTOR, CENTER FOR TRADE POLICY STUDIES, CATO INSTITUTE

APRIL 22, 2010

Chairman Brown, Ranking Member DeMint, and Members of the Subcommittee, I am Daniel Ikenson, associate director of the Center for Trade Policy Studies at the Cato Institute. I appreciate the invitation to share my thoughts about the Chinese currency, its relationship to the bilateral trade deficit, the impact on U.S. jobs, and what, if anything, Congress should consider doing. The views I express are my own and should not be construed as representing any official positions of the Cato Institute.

Introduction

Many economists believe that the Renminbi is undervalued, but there is disagreement about the magnitude. Disagreement is to be expected. After all, nobody can know the true value of the RMB unless, and until, it is allowed to float freely and restrictions on China's capital account are removed.[1] Short of that, economists produce estimates of undervaluation—and those estimates vary widely. So that begs a practical question: How will we know when we are there?

That question is important because Congress is once again considering legislation to compel the Chinese government to allow RMB appreciation under the threat of sanction. Regardless of whether sanctions take the form of an across-the-board surcharge or are the product of a countervailing duty investigation or are manifest in exchange rate conversions in antidumping calculations, a precise estimate of the market value of the Renminbi would have to serve as the benchmark. But respected economists from reputable institutions have produced a range of undervaluation of approximately 10 to 40 percent. So what should be the benchmark?

Of course the sanctions approach is fraught with dangers. Not only would it amount to a tax on U.S. producers and consumers—felt particularly acutely by lower- and middle-income families—but it could spark retaliation from China and run afoul of U.S. World Trade Organization obligations at a time when the Obama administration is planning to hold our trade partners more accountable to their own WTO commitments, as part of its National Export Initiative.

Many in Washington blame the undervalued Renminbi for the trade deficit with China, and blame the deficit for U.S. job losses. But those relationships are weak. Before doing something unnecessary or counterproductive, Congress should consider whether, and to what extent, RMB appreciation would even lead to more balanced bilateral trade. Recent evidence casts plenty of doubt.

Laser-like Focus on the Trade Deficit

For many in Washington, it seems the issue is not that the Chinese currency is undervalued *per se,* but that the United States has a large bilateral trade deficit with China, which is popularly attributed to the undervalued RMB.[2] Currency revaluation for many policymakers is just a proxy for reducing the trade deficit to zero—or better still, turning it into a surplus. There should be little doubt that many will take the position that the RMB is undervalued as long as U.S. imports from China exceed U.S. exports to China.

Leaving aside the question of whether bilateral deficit reduction should even be an explicit objective of policymaking in the first place, there is reason to be skeptical that currency revaluation would have the "desired" effect. It is assumed that Americans will reduce their purchases of Chinese products and that the Chinese will increase their purchases of American products if the value of the RMB increases against the dollar. But whether those trends would work to reduce the U.S. deficit with China depends on the extent to which consumers in both countries are responsive to the relative price changes.

What matters for the trade account is how much Americans reduce their purchases of Chinese goods and how much the Chinese increase their purchases of U.S. goods. Import value equals price times quantity, so if the percent increase in price (appreciation of the RMB) exceeds the percent reduction in quantity of imports con-

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[1] To float its currency and let markets determine the value, China would have to remove restrictions on its capital account, so that investment can flow in and out of the country freely. If China did this, it is not entirely clear that the value of the RMB would appreciate. It is possible that there would be more capital flight than inflow, as domestic savings are able to pursue investment options outside of China. This capital flight would have a depreciating effect on the value of the RMB.

[2] Of course, there are many other important determinants of the trade account besides relative currency values.

sumed (in absolute value), then import value will increase. For example, if the RMB appreciates by 25 percent and U.S. consumers reduce consumption of Chinese imports by only 10 percent, then the value of U.S. imports from China will be greater than before (adding to the trade deficit). The same 25 percent increase in RMB value, however, should lead to an unequivocal increase in U.S. exports to China because the dollar price charged (the price used to measure U.S. exports) remains the same, while the quantity sold to China increases because Chinese consumers, by virtue of RMB appreciation, face lower relative prices, and demand more goods. Thus, RMB appreciation should unambiguously increase U.S. export value, reducing the trade deficit. But its effect on U.S. import value is ambiguous.

Whether the aggregate change in U.S. import and export value results in a lower trade deficit depends on the relative responsiveness (price elasticity) of American and Chinese consumers to the price changes they face. If U.S. consumers are responsive (they reduce the quantity of their purchases by a percentage greater than the price increase), then the trade deficit will decline, regardless of the degree of Chinese responsiveness. If U.S. consumers are not responsive (they reduce the quantity of their purchases by a smaller percentage than the price increase), then import value will rise and Chinese consumers would have to increase their purchases of American goods by a large enough percentage to offset the increased U.S. import value, if the U.S. trade deficit is to be reduced.[3]

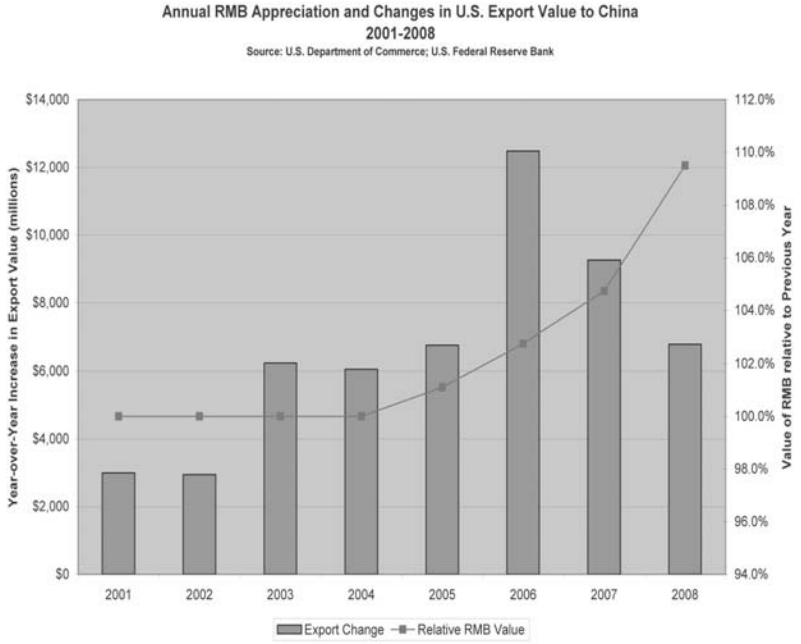
Weak Link Between Currency Values and Trade Flows

Recent evidence suggests that RMB appreciation will not reduce the U.S. trade deficit and undermines the common political argument for compelling China to revalue. Between July 2005 and July 2008, the RMB appreciated by 21 percent against the dollar—from a value of $.1208 to $.1464.[4] During that same period (between the full year 2005 and the full year 2008), the U.S. trade deficit with China increased from $202 to $268 billion.

U.S. exports to China increased by $28.4 billion, or 69.3 percent. But how much of that increase had to do with RMB appreciation is very much debatable. The nearby chart shows that U.S. exports to China were already on an upward trajectory, increasing by $3 billion in 2001, $3 billion in 2002, $6.2 billion in 2003, and $6.1 billion in 2004, when the exchange rate was consistently at 8.28 RMB per dollar. Natural sales growth from the confluence of market penetration and cultivation of Chinese demand was already evident.

[3] There is also an "income effect" from the change in currency values. When the dollar declines in value, U.S. consumers experience a decline in real income, which affects their consumption choices. Even though Chinese imports might be relatively more expensive than they were before the currency rise, they may still be less expensive than the alternatives. Accordingly, U.S. consumers with lower real incomes might be inclined to purchase more Chinese imports.

[4] Federal Reserve Board, Federal Reserve Statistical Release G5.A, Foreign Exchange Rates (Annual), release dates January 4, 2010 and January 2, 2009. Since July 2008, the value of the Yuan against the dollar has not changed measurably.



In 2005—the first year in which there was a slight RMB appreciation—the value of exports increased by $6.8 billion. Exports jumped another $12.5 billion in 2006, a year in which the RMB appreciated by 2.8 percent. But in 2007, despite an even stronger 4.7 percent RMB appreciation, the increase in exports was only $9.3 billion. And in 2008, the RMB appreciated by a substantial 9.5 percent, but the increase in exports fell to $6.8 billion. If currency value were a strong determinant, then export growth should have been much more robust than it was in 2007 and, especially, in 2008. Other factors, such as Chinese incomes and Chinese savings propensities, must have mitigated the lower relative price effects.

On the import side, recent experience is even more troubling for those who seek deficit reduction through currency revaluation. The evidence that an appreciating RMB deters the U.S. consumption of Chinese goods is not very compelling. During the period of a strengthening RMB from 2005 to 2008, U.S. imports from China increased by $94.3 billion, or 38.7 percent. Not only did Americans demonstrate strong price inelasticity, but they actually increased their purchases of Chinese imports. One reason for continued U.S. consumption of Chinese goods despite the relative price increase is that there may be a shortage of substitutes in the U.S. market for Chinese-made goods. In some cases, there are no domestically produced alternatives.[5] Accordingly, U.S. consumers are faced with the choice of purchasing higher-priced items from China or foregoing consumption of the item altogether.

It is doubtful that members of Congress, who support action to compel Chinese currency appreciation, would proudly announce to their constituents that they intentionally reduced their real incomes. But that is the effect of relative dollar depreciation.

Globalization Mutes the Effect of Currency Changes

Something else is evident about the relationship from those 2005 to 2008 data. The fact that a 21 percent increase in the value of the RMB was met with a 38.7 percent increase in import value means that the quantity of Chinese imports de-

[5] The dearth of substitutes is probably a function of retailers not wanting to incur the costs of having to reconfigure their supply chains. If the cost of reconfiguring and sourcing products from other countries is similar to the cost of maintaining Chinese suppliers with their exchange-induced higher prices, then retailers may be more likely to stick with the *status quo* and pass on their higher costs to consumers.

manded after the price change increased by nearly 15 percent.[6] Higher prices being met with greater demand would seem to defy the law of demand.

Chinese exporters must have lowered their RMB-denominated prices to keep their export prices steady. That would have been a completely rational response, enabled by the fact that RMB appreciation reduces the cost of production for Chinese exporters—particularly those who rely on imported raw materials and components. According to a growing body of research, somewhere between one-third and one-half of the value of U.S. imports from China is actually Chinese value-added.[7] The other half to two-thirds reflects costs of material, labor, and overhead from other countries. China's value-added operations still tend to be low-value manufacturing and assembly operations, thus most of the final value of Chinese exports was first imported into China.

RMB appreciation not only bolsters the buying power of Chinese consumers, but it makes China-based producers and assemblers even more competitive because the relative prices of their imported inputs fall, reducing their costs of production. That reduction in cost can be passed on to foreign consumers in the form of lower export prices, which could mitigate entirely the effect desired by Congress, which is to reduce U.S. imports from China. That process might very well explain what happened between 2005 and 2008, and is probably a reasonable indication of what to expect going forward.

A 2006 Cato paper on the topic of exchange rates and trade flows found that despite considerable dollar depreciation between 2002 and 2005 against the Canadian dollar, the Euro, the Japanese yen, the Korean won, and the Brazilian real, the U.S. trade deficit expanded during that period with Canada, Europe, Japan, Korea, and Brazil.[8] Factors other than currency movements, such as income and the availability of substitutes, influence trade flows, particularly when exporters are willing to absorb the costs of those currency changes.

In a recently published paper from the U.S. International Trade Commission, economist Cathy L. Jabara observes a weak relationship between exchange rates and U.S. import prices, particularly with respect to imports from Asia. Exchange rate pass-through is quite low because exporters often "price to market" to absorb costs and maintain market share. She notes that the economic literature supports her findings of low exchange rate pass-through, particularly for consumer goods. Ironically, she also notes that economist Paul Krugman, who is among the most outspoken advocates of U.S. intervention on the currency issue, was one of the first to explore and describe the potential for exchange-rate pass-through to mitigate the impacts on trade flows.[9]

Economic Benefits

Although it may be fashionable to think of China as the country to which the U.S. manufacturing sector was offshored in exchange for tainted products and a mountain of mortgage debt, the fact is that the bilateral relationship has produced enormous benefits for people in both countries, including most Americans. China is America's third-largest export market, and has been our fastest-growing market for a decade, providing 20.2 percent annual sales growth for U.S. businesses between 2000 and 2008, when overall annual export growth to all countries stood at just 6.8 percent.[10]

American businesses, portfolio investors, and 401(k) participants also have benefited handsomely from China's high rate of sustained economic growth. Likewise, American consumers have benefited from their access to Chinese goods. Imports from China have helped keep prices in check, raising real incomes and easing the strain on family budgets.

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[6] Assume that the price of imports is $1 and the quantity demanded is one unit. The import value is then $1. If a 15.2 percent increase in price leads to a 38.7 percent increase in value, then quantity must increase by 20.4 percent because: (1.152 x price) x (1.204 x quantity) = 138.7.

[7] Robert Koopman, Zhi Wang, and Shang-Jin Wei, "How Much of Chinese Exports Is Really Made in China? Assessing Foreign and Domestic Value-Added in Gross Exports", U.S. International Trade Commission, Office of Economics, Working Paper no. 2008-03-B, March 2008.

[8] Daniel J. Ikenson, "Currency Controversy: Surplus of Controversy, Deficit of Leadership", Cato Free Trade Bulletin no. 21, May 31, 2006.

[9] Cathy L. Jabara, "How Do Exchange Rates Affect Import Prices? Recent Economic Literature and Data Analysis", U.S. International Trade Commission, Office of Industries Working Paper no. ID-21 (revised), October 2009.

[10] U.S. Department of Commerce, Bureau of the Census, Foreign Trade Statistics, *http://www.census.gov/foreign-trade/balance/c5700.html#2009.* China was the fastest-growing market among America's top 25 largest export markets between 2000 and 2008. In 2009, overall U.S. exports declined 12.9 percent, but exports to China held steady, declining by just 0.23 percent.

What is perhaps less well known—because they are often portrayed as victims—is that large numbers of American producers and workers benefit from the bilateral relationship, as well. This is the case because the U.S. economy and the Chinese economy are highly complementary. U.S. factories and workers are more likely to be collaborating with Chinese factories and workers in production of the same goods than they are to be competing directly. The proliferation of vertical integration (whereby the production process is carved up and each function performed where it is most efficient to perform that function) and transnational supply chains has joined higher-value-added U.S. manufacturing, design, and R&D activities with lower-value manufacturing and assembly operations in China. The old factory floor has broken through its walls and now spans oceans and borders.

Though the focus is typically on American workers who are displaced by competition from China, legions of American workers and their factories, offices, and laboratories would be idled without access to complementary Chinese workers in Chinese factories. Without access to lower-cost labor in places like Shenzhen, countless ideas hatched in U.S. laboratories—which became viable commercial products that support hundreds of thousands of jobs in engineering, design, marketing, logistics, retailing, finance, accounting, and manufacturing—might never have made it beyond conception because the costs of production would have been deemed prohibitive for mass consumption. Just imagine if all of the components in the Apple iPod had to be manufactured and assembled in the United States. Instead of $150 per unit, the cost of production might be multiple times that amount. [11]

Consider how many fewer iPods Apple would have sold; how many fewer jobs iPod production, distribution, and sales would have supported; how much lower Apple's profits (and those of the entities in its supply chains) would have been; how much lower Apple's research and development expenditures would have been; how much smaller the markets for music and video downloads, car accessories, jogging accessories, and docking stations would be; how many fewer jobs those industries would support; and the lower profits those industries would generate. Now multiply that process by the hundreds of other similarly ubiquitous devices and gadgets: computers, Blu-Ray devices, and every other product that is designed in the United States and assembled in China from components made in the United States and elsewhere.

The *Atlantic*'s James Fallows characterizes the complementarity of U.S. and Chinese production sharing as following the shape of a "Smiley Curve" plotted on a chart where the production process from start to finish is measured along the horizontal axis and the value of each stage of production is measured on the vertical axis. U.S. value-added comes at the early stages—in branding, product conception, engineering, and design. Chinese value-added operations occupy the middle stages—some engineering, some manufacturing and assembly, primarily. And more U.S. value-added occurs at the end stages in logistics, retailing, and after-market servicing. [12] Under this typical production arrangement, collaboration, not competition, is what links U.S. and Chinese workers.

Economic Frictions

Despite the enormous benefits of the bilateral relationship, Americans are more likely to be familiar with the sources of friction. Americans have heard that underhanded Chinese policies have had a deleterious impact on U.S. manufacturing. They have been told that China manipulates its currency to secure an unfair trade advantage; "illegally" dumps and sells government-subsidized products in U.S. markets; maintains policies that discriminate against imports and favor domestic industries; steals American intellectual property; treats its workers poorly; degrades the environment; sells us tainted products; and even caused the U.S. financial crisis by lending America too much money. [13]

There is some truth in some of those claims. But there is also a good deal of exaggeration, misinformation, and hypocrisy in them. Some ring hollow because the U.S. government—usually at the behest of the same interests clamoring for action against China—commits the same sins.

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[11] Production of Apple iPod's is the quintessential example of the benefits of transnational production and supply chains. The degree of international collaboration embedded in the value of an iPod has been described in a few other Cato publications, including: Daniel Ikenson, "Made on Earth: How Global Economic Integration Renders Trade Policy Obsolete," Cato Trade Policy Analysis no. 42, December 2, 2009.

[12] James Fallows, "China Makes, the World Takes", *Atlantic,* July/August 2007, *http://www.theatlantic.com/doc/200707/shenzhen.*

[13] It is particularly ironic to hear this last accusation from spendthrift members of Congress who overlook the fact that their own profligacy is what brought China to the U.S. debt markets in the first place.

Manufacturing the Myth of Decline [14]

Nefarious Chinese trade practices are often blamed for the decline of U.S. manufacturing. But the first problem with that presumption of causation is that U.S. manufacturing is simply not in decline. Until the onset of the recent recession (when virtually every sector in the economy contracted), U.S. manufacturing was setting new performance records year after year in all relevant statistical categories: profits, revenues, investment returns, output, value-added, exports, imports, and others. In absolute terms, the value of U.S. manufacturing has been growing continuously, with brief hiccups experienced during recessions over the past several decades. As a percentage of our total economy, the value of manufacturing peaked in 1953 and has been declining since, but that is the product of rapid growth in the services sectors and not—as evidenced by its absolute growth—an indication of manufacturing decline.

The preponderance of Chinese and other imported goods on retail store shelves may give the impression that America does not make anything anymore. But the fact is that American factories make lots of things—in particular, high-value products that are less likely to be found in retail stores—like airplanes, advanced medical devices, sophisticated machinery, chemicals, pharmaceuticals, and biotechnology products. American factories are, in fact, the world's most prolific, accounting for 21.4 percent of global manufacturing value-added in 2008, while China accounted for 13.4 percent. [15] The main reason for continued American industrial preeminence is that the U.S. manufacturing sector has continued its transition away from labor-intensive industries toward higher value-added production.

Regardless of manufacturing's operating performance, the metric that matters most politically is the number of jobs in the sector. That figure reached a zenith of 19.4 million jobs in 1979 and has been trending downward along roughly the same trajectory ever since. China's entry into the WTO and the subsequent increase in bilateral trade did nothing to accelerate the decline. Manufacturing job loss has very little to do with trade and a lot to do with changes in technology that lead to productivity gains and changes in consumer tastes. China has also experienced a decline in manufacturing jobs. In fact, many more jobs have been lost in Chinese manufacturing and for the same reasons—productivity gains. According to a 2004 study published by the Conference Board, China lost 15 million manufacturing jobs between 1995 and 2002, a period during which 2 million U.S. manufacturing jobs were lost. [16]

Policymakers in Washington have been citing a figure from the Economic Policy Institute that attributes 2.4 million manufacturing job losses between 2001 and 2008 to the bilateral trade deficit with China. But that figure approximates job gains from export value and job losses from import value, as though there were a straight line correlation between the figures. And it assumes that imports do not create or support U.S. jobs. But U.S. producers—purchasing raw materials, components and capital equipment—account for more than half of the value of U.S. imports annually, according to the U.S. Bureau of Economic Analysis. Those imports support U.S. jobs in a wide range of industries.

Furthermore, according to the results from a growing field of research, only a fraction of the value of U.S. imports from China represents the cost of Chinese labor, materials and overhead. Most of the value of those imports comes from components and raw materials produced in other countries, including the U.S.

In a 2006 paper, Stanford University economist Lawrence Lau found that Chinese value-added accounted for about 37 percent of the total value of U.S. imports from China. [17] In 2008, using a different methodology, U.S. International Trade Commis-

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[14] For more comprehensive treatments refuting the myth of manufacturing decline in the United States, see, Daniel Ikenson, "Thriving in a Global Economy: The Truth About Manufacturing and Trade", Cato Trade Policy Analysis no. 35, August 28, 2007; Daniel Ikenson and Scott Lincicome, "Audaciously Hopeful: How President Obama Can Help Restore the Pro-Trade Consensus", Cato Trade Policy Analysis no. 39, April 28, 2009, pp. 12–16; and Daniel Griswold, "Trading Up: How Expanding Trade Has Delivered Better Jobs and Higher Living Standards for American Workers", Cato Trade Policy Analysis no. 36, October 25, 2007.

[15] United Nations Industrial Development Organization, "National Accounts Main Aggregates Database, Value Added by Economic Activity", (2008 data are the most recent available), *http://unstats.un.org/unsd/snaama/resQuery.asp.*

[16] Yuan Jiang, Yaodong Liu, Robert H. McGuckin, III, Matthew Spiegelman, and Jianyi Xu, "China's Experience With Productivity and Jobs", Conference Board Report Number R-1352-04-RR, June 2004, *http://www.conference-board.org/publications/describe.cfm?id=809.*

[17] Lawrence J. Lau, *et al.,* "Estimates of U.S.–China Trade Balances in Terms of Domestic Value-Added", working paper no. 295 (Palo Alto, CA: Stanford University, October 2006; updated November 2006).

sion economist Robert Koopman, along with economists Zhi Wang and Shang-jin Wei, found the figure to be closer to 50 percent.[18] In other words, despite all the hand-wringing about the value of imports from China, one-half to nearly two thirds of that value is not even Chinese. Instead, it reflects the efforts of workers and capital in other countries, including the U.S. In overstating Chinese value by 100–200 percent, the official U.S. import statistics are a poor proxy for job loss.

The fact that China surpassed Germany to become the world's largest exporter last year—a milestone that prompted a string of "end-of-Western-civilization" newspaper commentaries—says less about Chinese economic might than it does about the extent of global economic integration. The global division of labor enabled by intricate transnational production and supply chains still assigns to China primarily lower-value production and assembly operations.[19] That alone speaks to the complementary nature of the U.S. and Chinese economies, underscores the meaninglessness of bilateral trade accounting, and magnifies the absurdity of predicating policy on the goal of reducing a bilateral trade deficit.

Despite occasional fireworks, both governments have mutual interest in harmonious economic relations. Our economies are extremely interdependent. U.S. economic performance will continue to be a determinant of Chinese economic performance—and vice versa—and barring destructive policies, the pie should continue to grow larger. Much more can be done to cultivate our areas of agreement using carrots before seriously considering the use of sticks.

Less Provocative Alternatives

Another reason the Chinese government worries about RMB appreciation is that Chinese investors owns about $800 billion of U.S. debt. A 25 percent appreciation in the RMB would reduce the value of those holdings to approximately $640 billion. That's a high price for China to pay, especially in light of the fact that U.S. inflation is expected to rise in the coming years, which will further deflate the value of those holdings (and ease the burden of repayment on U.S. taxpayers). Likewise, mass dumping of U.S. government debt by Chinese investors—the much ballyhooed "leverage" that China allegedly holds over U.S. policy—would precipitate a decline in the dollar as well, which also would depress the value of Chinese holdings. The assertion that China holds U.S. debt as a favor to America, and would withdraw that favor on a whim, is a bit far-fetched.

China, it seems, is guilty of a failure to heed the first law of investment: it failed to diversity its portfolio adequately. The overwhelming investment focus on U.S. public debt has left China exposed to heavy losses from dollar inflation and RMB appreciation. The fact that the inflation rate is in the hands of U.S. policymakers makes China even more reluctant to allow large-scale or, at least, precipitous, RMB appreciation.

As of the close of 2008, Chinese direct investment in the United States stood at just $1.2 billion—a mere rounding error at about 0.05 percent of the $2.3 trillion in total foreign direct investment in the United States. That figure comes nowhere close to the amount of U.S. direct investment held by foreigners in other big economies. U.S. direct investment in 2008 held in the United Kingdom was $454 billion; $260 billion in Japan; $259 billion in the Netherlands; $221 billion in Canada; $211 billion in Germany; $64 billion in Australia; $16 billion in South Korea; and even $1.7 billion in Russia.[20]

If it is desirable that China recycle some of its estimated $2.4 trillion in accumulated foreign reserves, U.S. policy (and the policy of other governments) should be more welcoming of Chinese investment in the private sector. Indeed, some of China's past efforts to take equity positions or purchase U.S. companies or buy assets or land to build new production facilities have been viewed skeptically by U.S. policymakers—and scuttled—ostensibly over ill-defined security concerns.

A large inflow of investment from China would have a similar impact as a large increase in U.S. exports to China on the value of both countries' currencies, and on the level of China's foreign reserves. In light of China's large reserves and its need and desire to diversify, America's need for investment in the real economy, and the objective of creating jobs and achieving sustained economic growth, U.S. policy

[18] Robert Koopman, Zhi Wang, and Shang-jin Wei, "How Much of Chinese Exports Is Really Made in China? Assessing Foreign and Domestic Value-Added in Gross Exports", U.S. International Trade Commission, Office of Economics, working paper no. 2008-03-B, March 2008.

[19] For a more comprehensive treatment of this topic, see, Daniel Ikenson, "Made on Earth: How Global Economic Integration Renders Trade Policy Obsolete", Cato Trade Policy Analysis no. 42, December 12, 2009.

[20] Bureau of Economic Analysis, "Foreign Direct Investment in the United States: Selected Items by Detailed Industry of U.S. Affiliate", 2004–2008, *http://www.bea.gov/international/xls/LongIndustry.xls.*

should be clarified so that the benchmarks and hurdles facing Chinese investors are better understood. Lowering those hurdles would encourage greater Chinese investment in the U.S. economy and a deepening of our mutual economic interests.

To reduce bilateral tensions and foster greater cooperation from China with respect to market access, intellectual property theft, and other legitimate U.S. concerns, the United States should offer to reform its punitive trade remedies practices toward China. Ending the practice of treating China as a nonmarket economy in antidumping cases would probably do more to improve bilateral economic relations than just about any other possible reform.

China has made no secret of its desire to be designated a market economy. In essence, China's NME status is an asset to U.S. policymakers—but a rapidly depreciating one. In accordance with the terms of its WTO accession, China's economy cannot be treated as an NME after 2016, so U.S. policy will have to change in 6 years anyway. If U.S. policymakers want anything of value from China in exchange for designating it a market economy, that designation has to come soon. The longer this inevitable reform is delayed, the less valuable it becomes.

Short of graduating China to market economy status, U.S. policymakers could reduce bilateral tensions by addressing another systemic, methodological problem that results in Chinese exporters being penalized twice for the same alleged infraction. Since the Commerce Department resumed applying the countervailing duty law to nonmarket economies in 2007 (after a 22-year moratorium), it has failed to account for the problem of "double-counting" in cases where imports are subject to both the antidumping and countervailing duty laws.

Under NME methodology, a Chinese exporter's U.S. prices are compared to a surrogate value based on costs in a third country, such as India. Any difference between the U.S. price and that surrogate accounts for both the dumping and subsidy margin because the surrogate represents a nondumped, nonsubsidized price. However, U.S. practice has been to treat that difference as reflecting only the margin of dumping, while calculating an additional margin to reflect the subsidy only. Both the dumping margin (which already reflects the amount of the subsidy) and the subsidy margin are applied as duties on Chinese imports, resulting in a double counting of the countervailing duty.

Some Hypocrisy in U.S. Allegations

Claims are numerous that China maintains discriminatory policies that impede imports and foreign companies. Indeed, some of those claims have been substantiated and remedied. Others have only been substantiated. And still many more have been merely alleged.

The United States maintains formal and informal channels of communication with the Chinese government through the Strategic and Economic Dialogue, the Joint Commission on Commerce and Trade, and other venues, through which sources of economic and trade friction are discussed and often defused. On eight occasions, the United States decided that bilateral process alone was insufficient, and lodged official complaints with the WTO Dispute Settlement Body about various Chinese practices. Outcomes in two of the cases are still pending, but six of the eight cases produced satisfactory outcomes from the perspective of the U.S. government: either China agreed during consultations to change its rules or practices, or a dispute panel affirmed most of the U.S. complaints and issued opinions requesting that China bring its practices into conformity with the relevant WTO agreements.

It is difficult to find merit in the suggestion that U.S. trade policy toward China should change tack and become more unilateralist or provocative, when the WTO dispute settlement system has worked well as a venue for resolving U.S. complaints. The United States has brought 19 cases against Europe in the WTO, but there is not much talk about adopting a more strident trade policy toward the EU.

The fact is that China has made substantial progress since beginning its reforms to join the WTO. Nevertheless, some trade barriers and subsidy programs still exist or have emerged that, if challenged, likely would be found to violate China's various WTO commitments. And China should be held accountable to its market liberalizing commitments. Still, it is up to the USTR, in conjunction with other stakeholders, to evaluate the evidence and weigh the costs and benefits before deciding whether and when to lodge official WTO complaints.

One of the costs of bringing cases against Chinese market barriers or policies that favor domestic firms would be the exposure of U.S. hypocrisy. The U.S. government subsidizes chosen companies and industries, too. The past 18 months is littered with examples, such as General Motors and Chrysler. Though the U.S. business community is concerned about the emergence of technical market barriers in China favoring local companies, the U.S. government maintains opaque technical barriers in a variety of industries, which hampers and precludes access to the U.S. market for

foreign food products, in particular. Mexican trucks cannot even operate on U.S. highways. There is an element of the pot calling the kettle black in U.S. allegations.

By and large, though, the Office of the U.S. Trade Representative, in its December 2009 report to Congress about the implementation of China's WTO commitments, strikes the right tone and reassures that the economics can and should be shielded from the vicissitudes of politics:

> China has taken many impressive steps over the last 8 years to reform its economy, while implementing a set of sweeping WTO accession commitments that required it to reduce tariff rates, to eliminate nontariff barriers, to provide national treatment and improved market access for goods and services imported from the United States and other WTO members, to protect intellectual property rights, and to improve transparency. Although it still does not appear to be complete in every respect, China's implementation of its WTO commitments has led to increases in U.S. exports to China, while deepening China's integrations into the international trading system and facilitating and strengthening the rule of law and the economic reforms that China began 30 years ago.[21]

Conclusion

The world would be better off if the value of China's currency were truly market-determined, as it would lead to more optimal resource allocations. The impact on the bilateral trade account—meaningless as that statistic is in a globalized economy—would be impossible to predict. But compelling China to revalue under threat of sanction could produce adverse consequences—including reductions in Americans' real incomes and damaged relations with China—leaving us all worse off without even achieving the underlying policy objectives.

For now, it would be better to let the storm pass and allow China to appreciate its currency at its own pace.

PREPARED STATEMENT OF JACK W. SHILLING

RETIRED EXECUTIVE VICE PRESIDENT AND CHIEF TECHNICAL OFFICER, ALLEGHANY TECHNOLOGIES INCORPORATED, AND

CHAIRMAN, SPECIALTY STEEL INDUSTRY OF NORTH AMERICA

APRIL 22, 2010

I am grateful to participate in today's hearing. My conviction, based upon my previous experience—most recently as Executive Vice President, Corporate Development and Chief Technical Officer of Allegheny Technologies Incorporated and as Chairman of the Specialty Steel Industry of North America—is that it is vitally important for job creation, the overall economy and national security that the United States strengthen and expand its manufacturing base. An integral part of this effort must be an international system of exchange rates that reflect market fundamentals and that adjust as those fundamentals fluctuate.

I. To What Extent Is China's Currency Misaligned?

For the past 16 years, China has engaged in the protectionist policy of currency depreciation by effectively pegging the renminbi (RMB) to the U.S. dollar, and other countries have compounded this problem by undervaluing their currencies in an attempt to remain competitive with China.

There is a broad consensus that the RMB is substantially undervalued. The Peterson Institute estimates that the renminbi remains misaligned by about 25 percent on an overall, real-effective-exchange-rate basis and by about 40 percent relative to the U.S. dollar on a bilateral, real-exchange-rate basis. This 40-percent undervaluation *vis-a-vis* the U.S. dollar is as large today as it was 6 years ago before a modest revaluation and nominal appreciation of the RMB by China between July 2005 and July 2008. China's intervention in the exchange markets is now approximately $30–$40 billion per month, and China's foreign reserves are estimated to be at least $2.4 trillion and possibly as much as $3 trillion.[1] These numbers are staggering and contribute to a huge, artificial and competitive advantage for China in various ways.

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[21] United States Trade Representative, 2009 Report to Congress on China's WTO Compliance, December 2009, p. 4.

[1] *See,* Fair Currency Coalition, "Fact of the Week—China's Record Reserves", (Jan. 26, 2010), available at, *www.faircurrency.org.*

II. What Effect Does the RMB's Undervalued Misalignment Have on the Trade Deficit and U.S. Employment?

A. Background

The U.S. manufacturing base has been eroding for a long time, while manufacturing capability in China has been increasing dramatically over the same time period. This shift has been well documented by others. The large and growing trade imbalance with China is one confirmation of this situation.

Loss of our domestic manufacturing base presents serious economic and national security problems as documented recently in the President's Framework for Revitalizing American Manufacturing. These problems include a significant loss of more highly compensated employment opportunities for our citizens. There are many factors affecting the competitiveness of U.S. manufacturers that are far more important than labor rates, which are often cited incorrectly as the reason for this loss of competitiveness.

One of the most important and most easily understood factors undermining U.S. competitiveness is the impact of exchange rates, and particularly the actions of the Chinese government to prevent the RMB from appreciating relative to the U.S. dollar. In order to understand the importance of exchange rates to competitiveness and, therefore, to the U.S. trade imbalance with China and loss of American jobs, it is helpful to understand how products are generally sold and then to apply that knowledge to both imports and exports in various market segments. Some examples are provided below.

B. How Products Are Sold

The following factors come into play when a decision is made by a supplier and a customer to enter into a purchasing agreement: (1) price and its impact on profit margin; (2) availability; (3) supply chain management issues; (4) quality; (5) product capability; (6) short-and long-term customer-supplier relationships; and (7) strategic considerations. All other things being equal, price becomes the dominant issue where exchange rates have a direct and obvious impact. However, in order to understand a specific purchasing decision, it is often necessary to consider some or all of the other factors just mentioned.

C. Imports From China Into the United States

A 40 percent undervalued RMB has a dramatic impact on imports. When a product made in China is sold in the United States, the invoice is paid in dollars and then converted to RMB in China to pay the Chinese producer. If the Chinese product is sold for $100 in the United States, approximately 683 RMB are provided to the supplier in China under the current exchange rate between the RMB and the U.S. dollar. If the costs of manufacturing are 500 RMB in China, the Chinese producer's operating profit is 183 RMB.

If, on the other hand, the RMB were allowed to appreciate to market rates, 40 percent higher in value, only 409 RMB would be generated in China, resulting in an operating loss of 91 RMB. The net result would be an unwillingness by the Chinese producer to export that product to the United States at the original price of $100, and the Chinese producer's export price would rise, making U.S.-origin products more competitive.

Note that the Chinese producer's export price to the United States would not necessarily rise by 40 percent. The specific price increase would depend upon the degree to which costs could be lowered in China and the minimum profit margin that would be acceptable to the Chinese producer. The Chinese producer's price increase would also depend on some of the other factors mentioned above, such as product availability from U.S. domestic suppliers and strategic considerations, including the ability of the Chinese supplier to decrease prices over time through cost reductions, the Chinese producer's ability to supply other products of interest to the U.S. purchaser, and the perceived long-term importance of the business to the Chinese supplier and U.S. customer.

Importantly, a 40 percent revaluation of the RMB could have a significant favorable impact on a Chinese producer's costs. A central consideration is the benefit the Chinese producer would realize when purchasing raw materials or energy in U.S. dollars with a more valuable RMB. For instance, over 50 percent of the value of stainless steel is in inputs such as nickel, chromium, molybdenum, and natural gas that are priced globally based on U.S. dollars. With reference to the previous illustration, if 50 percent or 250 RMB of the Chinese producer's total costs of 500 RMB were in U.S. dollar commodities, with a 40 percent revaluation of the RMB the Chinese producer's costs would decrease by 100 RMB to 400 RMB, and the loss of 91 RMB after revaluation of the RMB that was postulated above would become a small operating profit of 9 RMB. Nevertheless, such a large revaluation would still have

a substantial, unfavorable effect on profitability even after taking such purchasing benefits into consideration.

To summarize, above all else a long-term, chronic undervaluation of the RMB has led and will always lead to the gradual loss of American manufacturing competitiveness, particularly when the undervaluation is so large. The larger the exchange-rate misalignment, and the longer in time that this misalignment is allowed to persist, the more price will become the determining factor and allow the Chinese producer time to resolve all other issues at least to parity with the U.S. domestic producer. In addition, the longer this misalignment is allowed to persist, the higher the probability is that U.S. competitors will cease to exist when the misalignment is corrected.

D. Exports to China From the United States

The same logic that applies to imports into the United States from China, as discussed above, also applies to exports by the United States to China. In this case, the important issue is how many U.S. dollars a U.S. producer will receive when the U.S. product is sold in China in RMB and the RMB are then converted back into U.S. dollars. If the price in RMB doesn't change and the RMB–U.S.$ exchange rate is allowed to appreciate by 40 percent, a U.S. producer in the abstract should receive an effective price increase of over 60 percent in U.S. dollars.[2]

Such a huge revenue increase would be expected to significantly improve U.S. competitiveness and result in U.S. producers quoting on business in China that otherwise would produce inadequate margins. However, it is unlikely that such success would be completely realized. One reason relates to cost reductions that would occur for Chinese producers associated with dollar-denominated purchases of input materials and energy, as discussed above. In addition, it is critically important to the Chinese government that China be able to maintain a large GDP growth rate. If it is assumed that current prices produce acceptable profit margins to Chinese producers, many of whom have significant ownership by the Chinese government, it seems very likely the Chinese government would intervene in the future in some manner other than an undervalued RMB to prevent a significant disruption to the ability of Chinese producers to supply their own market. In other words, price has not been, nor will it be, the only factor considered in purchasing decisions made in China. We can all speculate on how China would accomplish this, but it seems highly likely that following a significant currency realignment, *e.g.,* by 40 percent, action can and would be taken by the Chinese government to protect China's ability to continue to grow its own GDP and keep its citizens employed.

Because of its impact on jobs and national security, it is my opinion that the impact of Chinese currency manipulation on imports into the United States from China and the resulting inability of U.S. domestic manufacturers to supply their own U.S. market is a much larger problem than a lost opportunity to export products from the United States to China, although both are important.

E. Example 1: Specialty Metals

1. Titanium Condenser Tubing—This is a high-tech product used for seawater cooling in conventional and nuclear power plants. The important issues to understand here are (a) this product is critical to the functioning of these systems and (b) China has not had the capability to supply their own market with acceptable quality product. In situations like this, China has been unable to export product and depends on imports. Pricing relative to Chinese competition has not been a factor, and therefore the exchange rate has not been an issue. Orders are frequently quoted in U.S. dollars, and the currency risk (although there is none if the exchange rate is pegged) is assumed by the purchaser.

However, as China builds this ability over time (as it is attempting to do today), most likely using foreign technology, pricing will become a factor for both imports and exports of this product as discussed above, and exchange rates will become very important. So, as we look to the future, it is very important that we act now to help preserve the technology advantage that currently exists with high-tech products like titanium condenser tubing produced by U.S. manufacturers.

2. Grain-Oriented Electrical Steel (GOES)—This steel also is a high-tech specialty metal product critical to the efficient distribution of electricity in any advanced or emerging economy. Electrical power is generated in power plants. In order to use this electricity, it must be distributed widely to all sectors of the economy. These

[2] If the unit price in China remained at 100 RMB for a U.S. producer's product, for instance, the U.S. producer would receive only U.S.$14.64 at the current exchange rate of 6.83 RMB/U.S.$1, but would receive U.S.$24.45 at the revalued exchange rate of 4.09RMB/U.S.$1, an increase of 67 percent.

distribution systems employ many large transformers, and GOES is critical to their efficient operation.

Ten years ago, the story of GOES in China was much the same as the titanium condenser tubing story. But over the intervening time period, China has added sufficient capacity using foreign technology for the most part so that Chinese producers can now supply their own market. The Chinese government recently implemented antidumping and countervailing duties claiming trade agreement violations by U.S. producers of GOES. The U.S. industry feels these decisions are unjustified and is considering its options.

During the last 5 years or so, imports of this product into the United States from China have not been significant, because China did not have an adequate domestic supply. Exports from U.S. producers to China, however, have occurred because of inadequate supply in China. As China increased capacity over this time period, exchange rate issues became more of a factor. With large import duties now imposed due to China's trade cases against the U.S. producers, exchange rate issues are of significant importance. If and when these duties are removed, exchange rates will remain important to future U.S. exports of GOES to China and will be *critically* important to the ability of U.S. producers of GOES to supply their own domestic market assuming increasing imports into the United States of Chinese product.

3. Commodity Stainless Steel Sheet and Strip—This product is considered a commodity product, because world-wide competition uses very similar technology. Highly productive processes have been developed that make labor costs less important relative to other cost components such as energy and raw materials. In addition, China has built significant capacity over the last 10 years using foreign technology. Major suppliers in China are government-owned, and in that sense, return-on-investment issues are most likely of lesser importance than is true for a normal, free-enterprise company.

Over the last decade, U.S. producers have been unable to sell significant quantities of this commodity product in China, whereas China has become one of the largest exporters of stainless steel sheet and strip to the United States. *See,* Attachment 1. If the Chinese currency were revalued by 40 percent, one would expect imports of this product into the United States to be significantly reduced. However, it is unlikely in my opinion that U.S. exports of commodity products to China would increase as much for the reasons discussed above. China would be expected to intervene in some manner to prevent this from happening.

F. Example 2: Consumer Products

Gas grilles are an instructive example of how the RMB's enforced undervaluation affects trade between China and the United States in consumer products. Most gas grilles sold in big box stores were developed originally in the United States. But now, virtually all of these products are made in China and imported into the U.S. market.

These gas grilles are sold strictly on the basis of price. Were the exchange rate allowed to appreciate by 40 percent, it is highly likely that imports from China would be reduced over time as U.S. manufacturers restored capacity allowing significant production to return to the United States. Not only would such a transition benefit the U.S. producers of gas grilles, but a significant benefit would accrue as well to the U.S. domestic manufacturers of gas grilles' component parts and raw materials, such as commodity stainless steel. At the same time, it is unlikely that U.S. exports to China would increase to nearly the same extent for the reasons discussed above along with the fact that significant Chinese capacity now being used for the U.S. market would need to be diverted to the Chinese market.

G. Economic Segments

The charts and tables in Attachment 2 set forth data with respect to major segments of products traded between China and the United States from 2000 through 2009. During those years China far and away exported more products to the United States in these segments than the United States exported to China. Further, China's exports to the United States have covered a wide diversity of products in terms of technology and sophistication and met a broad spectrum of basic needs for the U.S. economy. In addition, China's exports to the United States during this period generally expanded and grew over time, particularly in the segment of computer and electronic products. U.S. exports to China, in contrast, have been far less. These overall trends are underscored when specific products are analyzed. Considering the discussion above, it seems most likely that significant currency realignment would have the best chance of improving the trade balance between the U.S. and China by reducing imports over time in the following segments: Computer and Electronic

Products; Apparel and Accessories; Electrical Equipment; Appliances and Components; Furniture and Fixtures; and Fabricated Metal Products.

III. What Happened When China Allowed the RMB To Appreciate From 2005–2008? Why Did the U.S. Trade Deficit Not Narrow During This Time?

Between July 2005 and July 2008, the Chinese government allowed the RMB to appreciate *nominally* relative to the U.S. dollar by 17.6 percent, from 8.28 RMB/U.S.$1 to the current rate of 6.82 RMB/U.S.$1. During those 3 years, China's foreign reserves rose from $711 billion to $1.8 trillion, and the U.S. trade deficit and number of jobs lost likewise increased substantially. There are two basic reasons why China gained ground and the United States lost ground despite this appreciation of the RMB during those 3 years.

First, the time between July 2005 and July 2008 was one in which China's economy was growing rapidly, and China's ability to supply the U.S. market was increasing dramatically, both in terms of manufacturing costs and product capability. Moreover, as seen in the examples above, as Chinese producers have become more self-sufficient there has been less reason for China to import from the United States. Each of these influences contributed to a more pronounced trade deficit by the United States with China.

Attachment 3 gives a graphic picture of total trade between China and the United States from 2000 through 2009 and shows the extent of the increasing trade deficit by the United States with China over that time. As depicted in Attachment 3, the U.S. trade deficit worsened considerably during the period of 2005 through 2008, and the largest trade deficit incurred by the United States with China occurred in 2008.

Second, the RMB's appreciation between July 2005 and July 2008 was in nominal terms, but then as now the RMB's undervaluation relative to the U.S. dollar was around 40 percent on a bilateral, real-exchange-rate basis. What was needed then, in other words, was a meaningful revaluation of the RMB in that amount in accordance with inflation-adjusted, trade-weighted exchange rates. The same is true today.[3]

IV. If China Were To Allow for a Currency Revaluation, What Is an Appropriate Appreciation? What Tools Should Congress Consider To Remedy This Imbalance? What Are the Multilateral Policy Options?

What is needed is for China to revalue the RMB relative to the U.S. dollar by 40 percent on a bilateral, real-exchange-rate basis. But what should we do if this does not happen in a timely manner? Unfortunately, while the International Monetary Fund for the last 5 or 6 years especially has been sounding the alarm about China's undervaluation of the renminbi, the IMF's authority is so limited under its Articles of Agreement that China has been able to block publication of the IMF's 2007, 2008, and 2009 reports on China's currency policy. It is apparent that a strengthening of the multilateral rules on protracted currency depreciation is imperative.

In the absence of unilateral action by China to appropriately revalue its currency, a first step that can be taken by Congress and the Executive Branch against this protectionist practice is to authorize the imposition of countervailing or antidumping duties against imports from any country with a fundamentally undervalued currency. This approach would be a reasonable implementation in U.S. domestic law of the World Trade Organization's provisions, would assist materially injured U.S. industries and workers, would act as a deterrent, and would underscore that protracted currency depreciation will not be tolerated.

V. Conclusions

Currency manipulation by the Chinese government has significantly affected the bilateral trade deficit of the United States with China, primarily through its effect on the levels of imports into the United States from China. From 2002 to 2009, the United States ran a cumulative trade deficit of nearly $5.4 trillion for All Merchandise, including a deficit of almost $1.6 trillion with China. China's share of the U.S.

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[3] Morgan Stanley has said that it expects China will permit the renminbi to appreciate to 6.54 RMB/U.S.$1 by the end of 2010 and to 6.17 RMB/U.S.$1 by the end of 2011. Morgan Stanley, "China Economics—Renminbi Exit from USD Peg: Whether, Why, When, How", at 1 (Apr. 5, 2010). Yet that nominal appreciation from the current rate of 6.83 RMB/U.S.$1 would be only 9.7 percent, about the same pace over the next 21 months as the pace China set between July 2005 and July 2008. That pace of nominal appreciation will be no more effectual than the RMB's nominal appreciation was between July 2005 and July 2008.

trade deficit in All Merchandise rose from 22 percent in 2002 to 45.3 percent in 2009.[4]

This deficit has resulted in a significant loss in the United States of important manufacturing capability and its higher-paying jobs that would have been used to supply the U.S. market at realistic prices. Prices of Chinese imports are artificially low due to the effective subsidization associated with the undervalued Chinese currency *vis-a-vis* the U.S. dollar. As the Economic Policy Institute reported in a study last month, the RMB's substantial undervaluation has been a major reason for the United States' imbalanced trade with China, the loss of 1.6 million manufacturing jobs in the United States between 2001 and 2008, and depressed and lower wages for many more millions of U.S. workers.[5]

As devastating to the United States as these trends are, the longer-term prognosis if China persists in its behavior is even more troubling. In addition to further trade deficits and lost jobs, the renminbi's undervalued misalignment is an important factor in making investment in China more attractive and feasible than investment in the United States. It is not necessary or even desirable to stop investment overseas by multinational companies, but it is critical that the protectionist policy of China's enforced undervaluation of the RMB should not be tolerated. If not countered, that policy will increasingly drain the United States of knowledge and expertise, continue to contribute to the demise of its basic manufacturing capability, as well as jobs and revenue, by weakening companies in areas such as the U.S. specialty metals industry, which are constantly developing new technology that has essential applications to the U.S. economy and national defense.

The major benefit associated with China allowing the RMB to appreciate by 40 percent to market levels, or otherwise mitigating this problem, will be to allow U.S. manufacturers to recapture the U.S. market that has been lost or will be lost to Chinese imports. Less benefit to exports of U.S. products into China is anticipated, because the Chinese government's emphasis on large increases in GDP each year will almost certainly be reflected in other measures that favor Chinese domestic production and sales, thereby compensating in part for any meaningful revaluation of the RMB.

Virtually all segments of the U.S. economy should benefit, but major sectors representing high levels of imports into the United States from China would be advantaged the most. As indicated by the charts and tables in Attachment 2, these segments include computer and electronic products, primary metal manufacturing, textile mill products, apparel and accessories, plastics and rubber products, electrical equipment, appliances, and components, furniture and fixtures, and other fabricated metal products.

The importance of this issue, and its potential impact, is directly proportional, or perhaps even geometrically proportional, to the magnitude of the currency misalignment and its remediation. Current estimates of 40 percent misalignment are enormous in this context. Likewise, token efforts to reduce this misalignment will be generally ineffective.

It is critically important that we act now. Pushing the problem ahead will only produce a bigger problem in the future as U.S. GDP weakens and U.S. manufacturing and technology capability is lost. In the absence of unilateral action by China to appropriately revalue its currency, a first step that can be taken by Congress and the Executive Branch is to authorize the imposition of countervailing or antidumping duties against imports from any country with a fundamentally undervalued currency.

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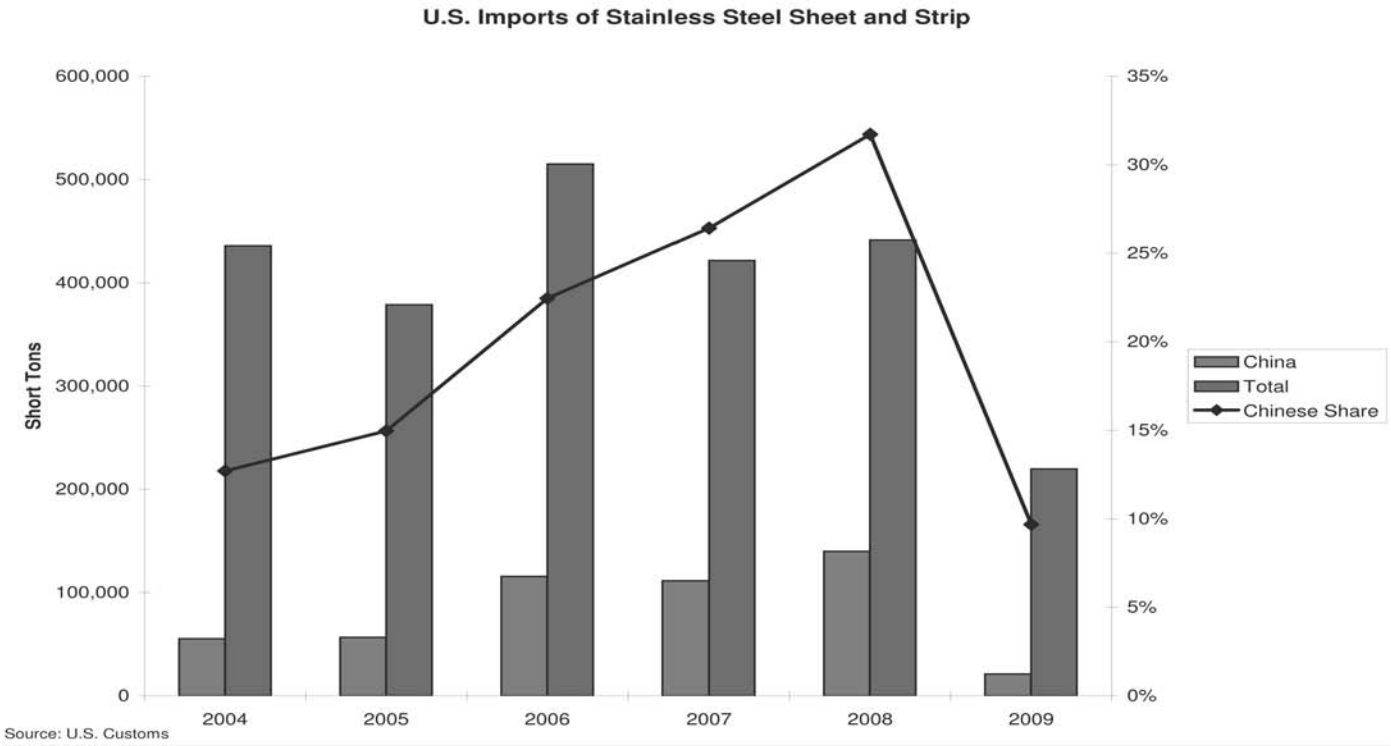
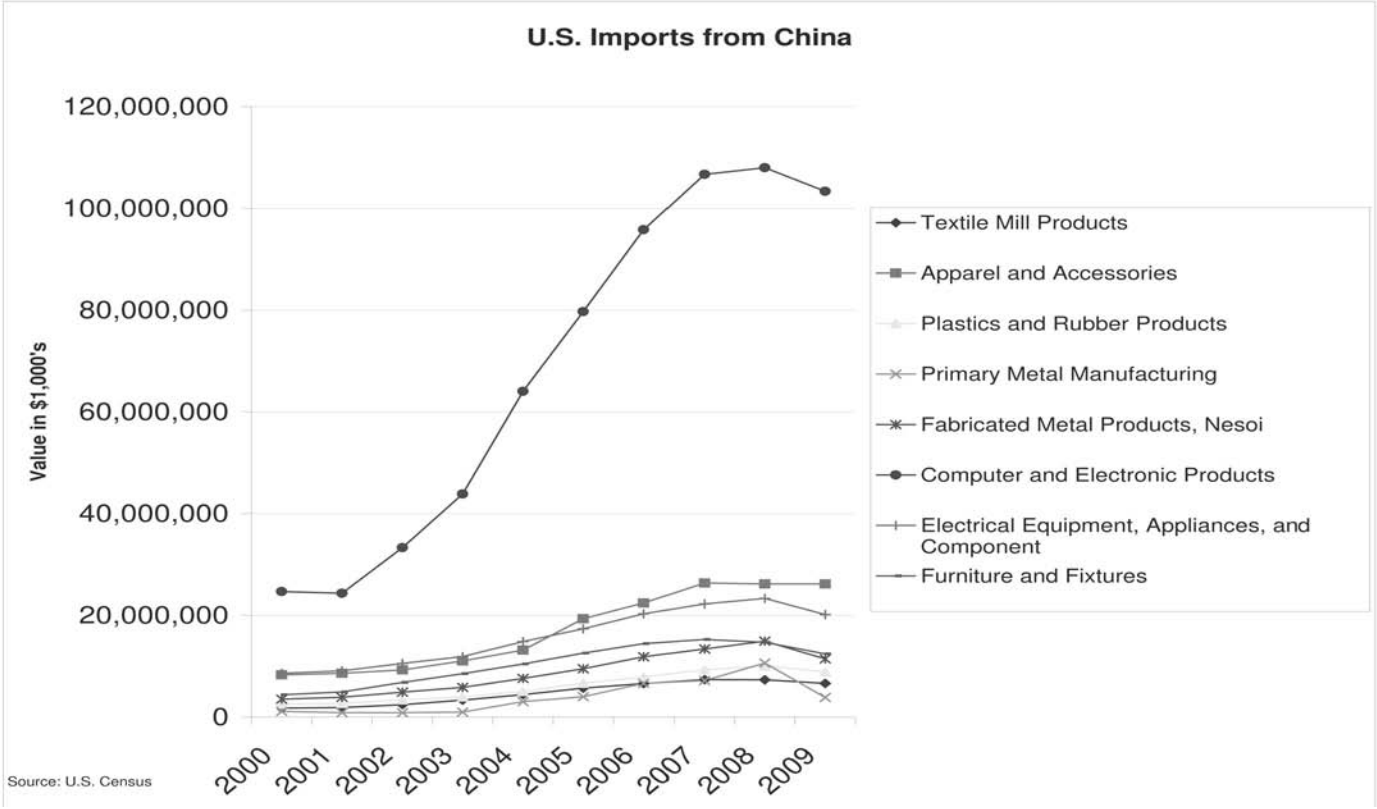
[4] *See,* Fair Currency Coalition, "Fact of the Week—RMB Peg Fuels China Trade Surpluses, Undercuts U.S. Recovery", (Feb. 23, 2010), available at, *www.faircurrency.org.*

[5] Robert E. Scott, "Unfair China Trade Costs Local Jobs", (Economic Policy Institute, Mar. 23, 2010).

Attachment 1



Attachment 2



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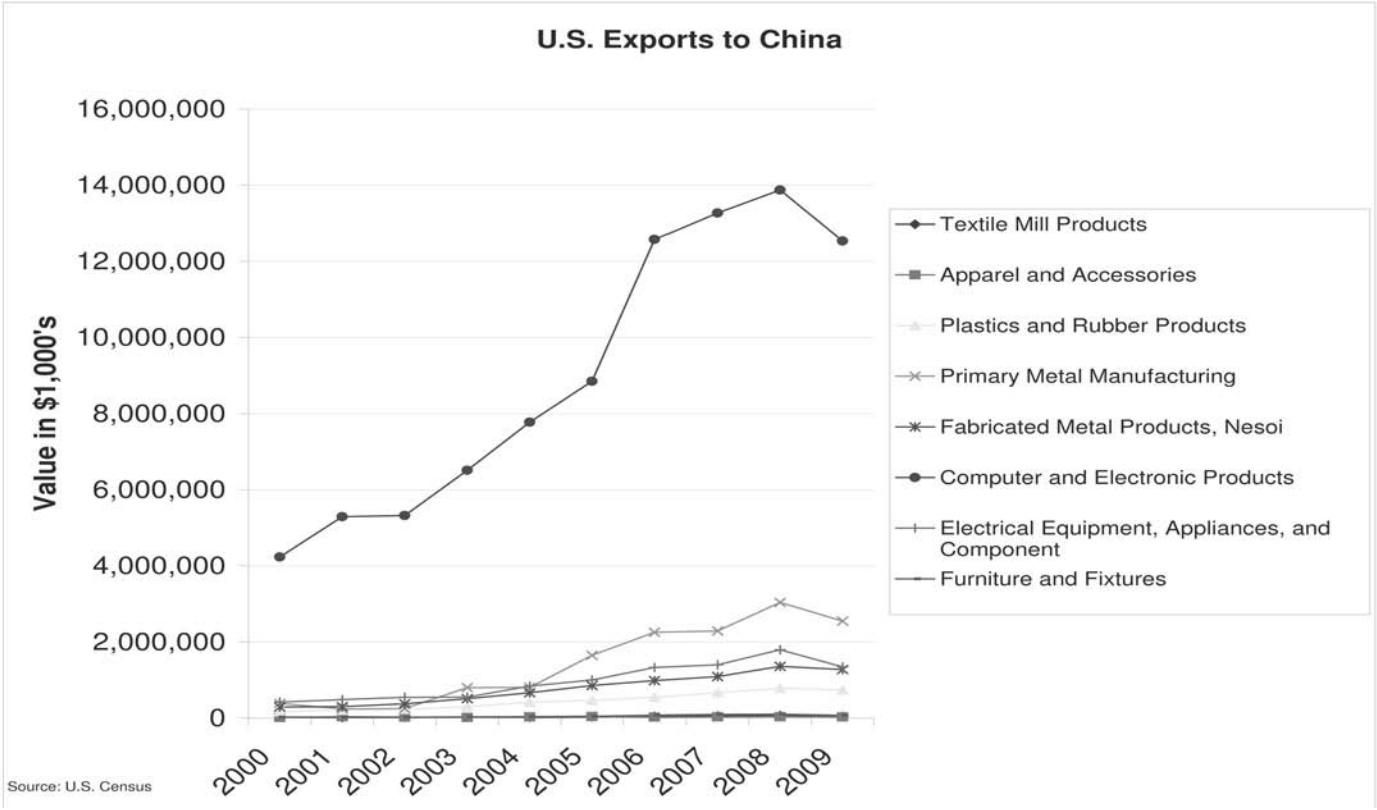
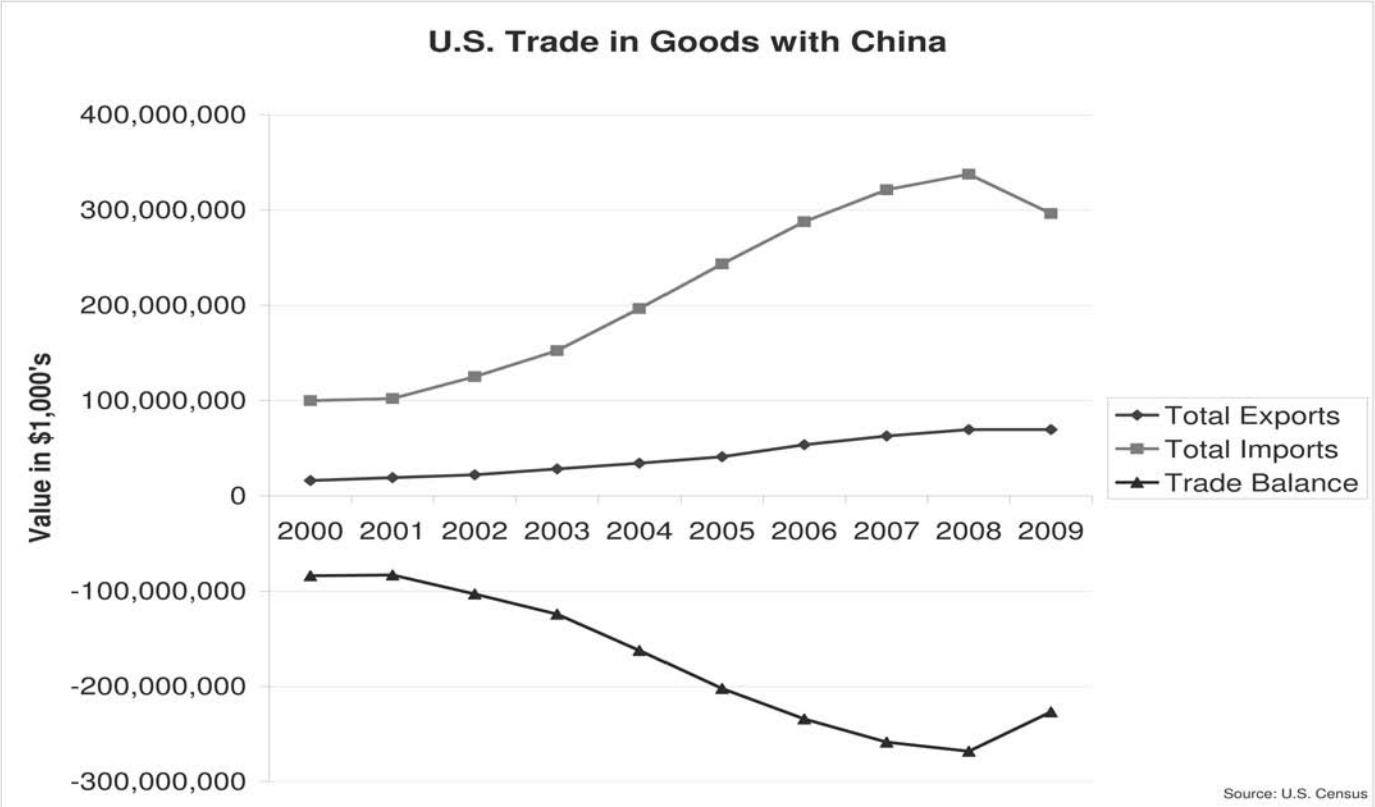


Attachment 3



PREPARED STATEMENT OF MARK A. SUWYN

EXECUTIVE CHAIRMAN OF THE BOARD, NEWPAGE CORPORATION, MIAMISBURG, OHIO

APRIL 22, 2010

Mr. Chairman, Mr. DeMint, and Members of the Subcommittee, I appreciate the opportunity to appear on this panel to discuss China's exchange rate policy and trade imbalances. My name is Mark Suwyn and I am Chairman of NewPage Corporation. NewPage was founded in 2005, when the company purchased certain paper operations of MeadWestvaco. NewPage produces printing and writing papers, including coated and uncoated free sheet and groundwood papers and paperboard, newsprint, supercalendered paper, and specialty paper. NewPage is headquartered in Miamisburg, Ohio, and has production facilities in Kentucky, Maine, Maryland, Michigan, Minnesota, and Wisconsin. NewPage has about 7,500 employees, and is the largest producer of coated printing and writing papers and paperboard in North America. Production of these papers is a multibillion dollar industry in the United States. Today, I would like to speak about how the U.S. paper industry has been impacted by China's exports of coated paper and paperboard, and in particular about the large and distortive subsidy that Chinese paper producers benefit from as a result of China's undervalued currency.

China's undervalued currency is a very significant problem for U.S. paper producers, as it is for many other U.S. manufacturers that compete with imports from China. The United States has a significant competitive advantage over China in the production of paper and paperboard used domestically for printing and writing, a fact that has been confirmed regularly in market research studies. Paper producers in this country have access to abundant and renewable fiber sources, and we have a plentiful supply of water required for paper processing. We have a highly skilled workforce with generations of experience producing paper, and state-of-the-art paper equipment. And we have the advantage of being close to our customers in the U.S. market. By contrast, the Chinese producers have to import the vast majority of the virgin fiber they use to produce paper, much of it from Latin America. They also lack an adequate water supply. And although wage rates are lower in China than they are in the United States—paper manufacturing is not very labor intensive, accounting for only about 10 percent of the cost of producing paper—the Chinese do not gain any real advantage from having lower wage rates. The Chinese use comparable state-of-the-art production equipment that U.S. producers use. Finally, Chinese producers are an entire ocean and half a continent away from our customers in the Midwest. Nonetheless, Chinese paper producers have been able to lower prices, increase exports, and gain market share in the United States, all because of large subsidies provided by the Chinese government and their willingness to dump their product in the U.S. market. And the biggest subsidy of all is the 40 percent undervaluation of the Chinese currency.

In September of last year, NewPage, along with other members of the domestic industry and the United Steelworkers Union, filed antidumping and countervailing duty petitions covering certain types of coated paper from China and Indonesia. In the countervailing duty petition covering Chinese subsidies, we listed a host of subsidy programs that benefit Chinese paper producers, including an allegation covering China's undervalued currency.

Our currency allegation provided information demonstrating that all three legal requirements for finding the existence of a countervailable subsidy were met: (1) that the Chinese government had provided a financial contribution, which (2) resulted in a benefit, and (3) which was specific to a particular industry or group of industries in China. With respect to the financial contribution, we explained that by requiring foreign exchange that is earned from export activities to be converted into Chinese yuan at a rate that is set by the Government, a rate which is universally recognized to be about 40 percent below its true value, Chinese exporters reap an enormous windfall. Specifically, Chinese exporters get 40 percent more yuan for every dollar that they exchange than they otherwise would absent Chinese government intervention in the foreign currency markets. This provides an enormous, continuing benefit to those exporters, and allows them to significantly under-price U.S. producers. We also alleged and documented that this subsidy was specific to exporters in China, because it is directly linked with exports and creates a powerful incentive for Chinese producers to export their products to the United States, rather than sell them at home.

The Chinese currency is clearly undervalued. A January 2010 policy brief by Dr. Lardy's colleagues at the Peterson Institute estimates that China's currency is undervalued by 41 percent on a bilateral basis against the dollar. Other estimates are within this range.

Much to our disappointment, the Commerce Department did not initiate an investigation into our allegation when we first made it in September of last year, claiming that we had failed to sufficiently allege that the receipt of the excess yuan is contingent on export or export performance—in other words that we had not shown how the subsidy was specific. But in January of this year, we submitted a revised allegation, this time providing an expert report from an independent economist which demonstrates that based on the Chinese government's own data, 70 percent of China's foreign exchange earnings from Current Account transactions and from long-term Capital and Financial account transactions were derived from the export of goods. The study concluded that no other category of foreign exchange inflows comes close to matching the $1.4 trillion foreign exchange earnings of Chinese exporters. Because Chinese exporters garner the overwhelming share of benefits from the undervaluation of the RMB, the subsidy benefit is *de facto* specific to exporters as a group.

As of the preparation of this written statement, the Department of Commerce has not announced whether it will initiate an investigation into whether China's undervaluation of its currency confers a countervailable subsidy. We believe, as do many Members of Congress, that Commerce has a legal obligation to investigate this practice. We hope an initiation occurs soon, so that Commerce will have sufficient time to fully analyze this allegation.

China's undervalued currency, as well as the other subsidies from which Chinese coated paper producers benefit have had a significant negative impact on NewPage and other members of the U.S. coated paper industry. These consequences are documented in the preliminary unanimous injury determination by the International Trade Commission (ITC), which was issued in November of last year. Among other things the ITC noted:

- The increase in the U.S. market share of imports from China (and Indonesia) which rose from 15.3 percent in 2006 to 25.7 percent in the first half of 2009.
- The large increase in the supply of low-priced subject imports in the first half of 2009 was accompanied by a decline in prices for the domestic product in the first half of 2009.
- The domestic industry faced increasing pressure to lower prices or lose market share, particularly in the first half of 2009 as a result of the pervasive underselling by subject imports.
- Significant underselling by Chinese producers led to price depression during the first half of 2009.
- Imports from China led to decreases in U.S. producer's production, shipments, and employment in 2009.
- NewPage and others in the domestic industry have had to close many mills and converting facilities over the past 4 years, including mills in Kimberly and Niagara, Wisconsin; Muskegon, Michigan; and Columbus, Mississippi, and a converting facility in Chillicothe, Ohio.
- The U.S. industry's financial condition deteriorated in the first half of 2009 as the U.S. industry was forced to reduce prices in order to compete with substantially increasing imports, with operating losses of $17.2 million in the first half of 2009 compared with operating profits of $44.3 million in the first half of 2008.

The impact of Chinese subsidies on the U.S. coated paper industry, including currency undervaluation, is well-document in the ITC determination. It is notable that the deterioration in our industry accelerated in the first half of 2009, which coincides with the time when China halted its gradual appreciation of the yuan in November of 2008. However, the impact goes beyond the borders of the United States. Despite the fact that we have had some success in the past year in increasing our exports to other markets, we have not been able to export paper products to China. The severe undervaluation of China's currency effectively imposes a 40 percent tax on any potential exports from our U.S. mills. This affects not only exports to China, but also exports to other third markets where we compete with the Chinese.

So what is the appropriate response to China's undervalued currency? We believe that the best outcome would be for China to allow its currency to float freely and reflect market forces. This would be the most favorable outcome for all U.S. manufacturers. I would note, however, that past efforts to negotiate with China either bilaterally or multilaterally through the IMF, have thus far produced no result. Whatever may be accomplished through long term negotiation, we believe that the Department of Commerce needs to investigate China's undervalued currency as a countervailable subsidy to Chinese coated paper producers, and to ultimately impose

countervailing duties to offset the level of undervaluation. We believe this is required by the U.S. countervailing duty law, and is critical to prevent material damage to the U.S. paper industry and the jobs and local communities that rely on our industry.

Again, I appreciate the opportunity to appear before you today, and would welcome any questions you might have.

PREPARED STATEMENT OF DEREK SCISSORS

RESEARCH FELLOW, ASIAN STUDIES CENTER, THE HERITAGE FOUNDATION

APRIL 22, 2010

WebMemo

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Deadlines and Delays: Chinese Revaluation Will Still Not Bring American Jobs

Derek Scissors, Ph.D.

The Department of the Treasury has delayed its decision on whether to label China a currency manipulator. Prominent Members of Congress attacked this delay, insisting they will seek trade action against the PRC. At the heart of congressional demands is the idea that a Chinese revaluation would mean millions of additional American jobs. This idea is almost surely wrong.

The *almost* is there only because advocates of revaluation are often vague about how large a change is supposed to manage this feat. Such vagueness should come as little surprise—when one examines American jobs and the value of the RMB, the thread between the two is very, very thin. No currency revaluation of any feasible size will create more than a few thousand American jobs.

The reason for the minimal impact is simple: The exchange rate with China is not genuinely important to the U.S. economy. There are other policies China has adopted, or not adopted, that are more important. There are policies the U.S. has adopted, or not adopted, that are more important. The U.S. should focus on these more important policies, such as Chinese subsidies and the U.S. budget deficit, not an exchange rate shift that will achieve almost nothing.

False Logic. The logic of the exchange rate argument is faulty. The PRC's undervalued exchange rate is supposed to cause the U.S. to run a large bilateral trade deficit, which is supposed to cost many American jobs. The second part of that claim—a bilateral trade deficit costs jobs—is hard to disprove but actually makes very little sense. The first part—an undervalued exchange rate causes the U.S. to run a large bilateral trade deficit—is demonstrably wrong.

From January 1994 to December 1997, the RMB appreciated 5 percent against the dollar. The annual trade deficit still rose from $23 billion before the appreciation to $57 billion afterward. From January 1998 through June 2005, the RMB essentially did not move at all against the dollar. The trade deficit rose to $162 billion for 2004. From July 2005 through July 2008, the RMB rose 20 percent against the dollar. The trade deficit nonetheless rose to $268 billion for 2008. From July 2008 to the present, the RMB did not move against the dollar. This time the trade deficit fell to $227 billion for 2009.[1]

Over the past 15 years, when the RMB has been stable against the dollar, the trade deficit has both fallen and risen. But when the RMB rises against the dollar, the trade deficit rises. This is the evidence of what actually does happen, not merely what some assume is going to happen.

How can this be? The explanation goes back to the fact that the exchange rate is not important in the U.S.–China economic relationship. The bilateral

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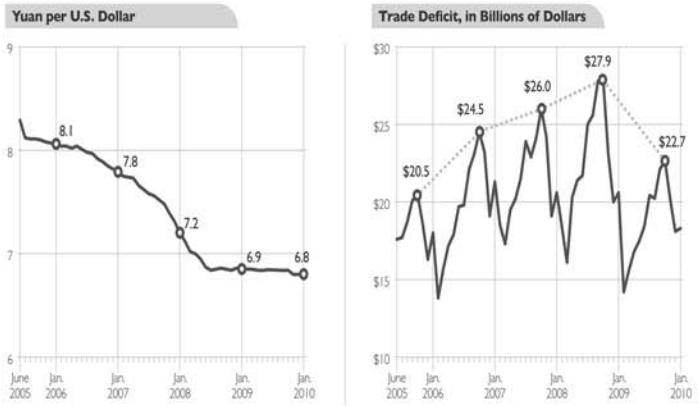
The Yuan and the U.S.–China Trade Deficit



Sources: OANDA, FXHistory: Historical Currency Exchange Rates, at *http://www.oanda.com/convert/fxhistory* (April 1, 2010), and U.S. Census Bureau, Foreign Trade Division, Data Dissemination Branch, "Trade with China: 1995," at *http://www.census.gov/foreign-trade/balance/c5700.html#1995* (April 1, 2010).

Chart 1 • WM 2855 heritage.org

trade deficit chiefly expands when American demand is strong and contracts when, as now, demand is weak. That is sensible because the U.S. has by far the larger, richer economy, so trends in American demand are typically more important than what happens in the PRC.

Chinese Mercantilism. Moreover, within the set of only Chinese policies, the RMB still does not matter much. China has a huge arsenal of market intervention tools at its disposal. Exports are encouraged in various ways—for example, through tax adjustments. These would certainly be used to offset a currency change, as they have been in the past.[2]

More fundamental are the many and powerful ways that the PRC subsidizes its state enterprises. Land has become very expensive in many of the coastal cities through which China trades, but all land is ultimately owned by the state. State firms can be granted land as it suits central or local government, cutting their costs in sometimes dramatic fashion. Capital subsidies are even more potent tools. In response to the financial crisis, state banks lent unprecedented sums to state firms without regard for repayment.[3]

The most pernicious intervention is regulatory protection. Many large state firms are geographic

1. U.S. Census Bureau, "Trade in Goods (Imports, Exports and Trade Balance) with China," March 11, 2010, at *http://www.census.gov/foreign-trade/balance/c5700.html#2009* (April 5, 2010); Oanda, "Historical Exchange Rates," at *http://www.oanda.com/currency/historical-rates* (April 5, 2010).
2. State Administration of Taxation, "70% Machinery and Electronic Products Were Granted Full Export Tax Rebate," at *http://www.chinatax.gov.cn/n6669073/n6669118/9195918.html* (April 1, 2010).
3. Business Week, "Will China's Bank Bailout Do the Trick?," January 26, 2004, at *http://www.businessweek.com/magazine/content/04_04/b3867133_mz035.htm* (April 5, 2010); Gady Epstein, "China: Boom Or Bust?," *Forbes*, February 02, 2010, at *http://www.forbes.com/2010/02/11/china-bubble-mao-ha-renminbi-beijing-dispatch.html* (April 5, 2010).

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monopolies—sole providers of goods or services in a large area. When competition is allowed, it is tightly limited. Sectors that are mandated to be utterly dominated by the state include aviation, coal, gas, oil, petrochemicals, power, shipping, and telecom. State firms must also lead in autos, construction, information technology, machinery, and metals.[4] Not legally reserved but nonetheless entirely dominated by the state are grain distribution, insurance, railways, and, crucially, banking.

Guaranteed revenue and economies of scale make state firms modestly competitive as exporters when they would otherwise be uncompetitive. The real harm, however, is to imports of goods and services from the U.S. The decree of state predominance caps the total share available to all domestic private and foreign companies, leaving American producers in a vicious battle for permanently minor market segments. This is a far more stringent limitation than an undervalued currency.

Not the RMB but the Trade Deficit? Protectionists might ultimately accept these facts and agree that an RMB revaluation will accomplish nothing. However, they could still hold on to the idea that the trade deficit with China costs American jobs. The idea of the bilateral deficit costing some jobs cannot be rejected outright on the basis of the record, but it does not stand up well to scrutiny.

First, there are those inconvenient numbers. The bilateral deficit rises not when the yuan is falling but when U.S. demand is strong. And strong American demand should mean more American jobs, not fewer. Second, the claim that imports cost jobs is narrowly based. Imports also create jobs in transport, retail, and other areas. In addition, the mirror image of a trade deficit is a capital surplus. And incoming capital creates jobs. Even the aggregate U.S. trade deficit over all countries may not cost jobs when gains from imports and capital inflow are counted.[5]

Third, China is just part of the story—action against China will directly involve other countries. Chinese subsidies do not take jobs from the U.S.; they take jobs from others competing for the American market. If Congress imposes tariffs on Chinese clothing, toys, furniture, and basic household appliances, jobs will not move to the U.S. They will go to India, Vietnam, Mexico, Indonesia, Bangladesh, and other low-cost producers.

East Asia, Percentage of Total U.S. Trade Deficit

	1987	2007
Original ASEAN*	4.7%	5.0%
Hong Kong	3.9%	–1.6%**
Japan	37.0%	10.4%
Korea	5.9%	1.6%
Taiwan	13.1%	1.5%
China	1.8%	32.0%
Total	**66.4%**	**48.9%**

* Indonesia, Malaysia, Philippines, Singapore, and Thailand.
** Denotes an American surplus.

Source: U.S. Census Bureau, Foreign Trade Statistics, U.S. Trade in Goods (Imports, Exports and Balance) by Country, at *http://www.census.gov/foreign-trade/balance* (April 1, 2010).

Table 1 • WM 2855 heritage.org

There is precedent for such a migration. The U.S. trade deficit set a record in 1987 and lasted until the mid-1990s. At that time East Asia accounted for two-thirds of the deficit, led by Japan, while China was a minor player. Prior to the global crisis, the trade deficit peaked again and at a much higher level than in 1987. Moreover, China's role in this larger deficit grew tremendously. However, the roles of Japan, Taiwan, Korea, Hong Kong, and Singapore in the deficit all declined sharply. East Asia as a whole now contributes less than half the deficit.

One key change was soaring energy imports; another was that East Asian production for export moved to China in response to early Chinese reform,

4. Zhao Huanxin, "China Names Key Industries for Absolute State Control," *China Daily*, December 19, 2006, at *http://www.chinadaily.com.cn/china/2006-12/19/content_762056.htm* (April 1, 2010).

5. Ambassador Terry Miller, "China Job Loss Claims Miss the Big Picture," Heritage Foundation *WebMemo* No. 2845, March 24, 2010, at *http://www.heritage.org/Research/Reports/2010/03/China-Job-Loss-Claims-Miss-the-Big-Picture*.

the Asian financial crisis, and a stagnant Japan. The U.S. can force that production out of China, but it will simply relocate again elsewhere in Asia and around the world. U.S. job gains will be trivial.

Recommendations. There are steps that may truly bolster American employment for the long term.

The main step is erasing the budget deficit. Government debt is now the biggest threat to sustained U.S. prosperity and leadership, by far. This is not a matter of ideological or partisan debate. In comparative importance, the value of the RMB is a footnote. Also, getting America's own house in order would improve the U.S. position economically and diplomatically prior to making difficult demands on the PRC, especially since the budget deficit is chief among Beijing's expressed concerns.

Regarding the difficult demands of China, the Obama Administration has multiple options, all of them challenging. The direct analog to the American budget deficit is Chinese bank lending, both on-book and off-book.[6] A pledge of verifiable, comprehensive rollbacks of harmful policies by both is an obvious route.

A superior alternative, because it involves market-oriented reform, is for the U.S. to establish a schedule of budget deficit reductions and for the PRC to establish a schedule for the opening of its capital account. This is a stated Chinese goal that was lost in the general abandonment of the market. It would have the effect of slicing into lending, because money could leave the country in response to non-commercial behavior by Chinese financials. It would thus make state firms less unnaturally competitive at home and overseas.

The most valuable, but also most contentious, demand would be explicit limits on the extent of state dominance in most industries. This would not be a call for an end to state control but for transparency concerning the extent of such control followed by partial retrenchment in what Beijing deems the less important sectors. These actions would open the door further for American goods and services, creating a more open bilateral trade relationship.

—Derek Scissors, Ph.D., is Research Fellow in Asia Economic Policy in the Asian Studies Center at The Heritage Foundation.

6. Andrew Peaple, "Tidying Up After China's Lending Binge," *The Wall Street Journal*, December 21, 2009, at *http://online.wsj.com/article/SB10001424052748704238104574603272836308480.html* (April 5, 2010).

RESPONSES TO WRITTEN QUESTIONS OF SENATOR VITTER FROM DANIEL J. IKENSON

Q.1. Article IV, Section 1 of the Articles of Agreement of the International Monetary Fund (IMF) commits member countries to "avoid manipulating exchange rates or the international monetary system in order to prevent effective balance-of-payment adjustment or to gain unfair competitive advantage over other member countries." Moreover, the principles and procedures for implementing the Fund's obligation (in Article IV, Section 3) "to exercise firm surveillance over the exchange rate policies of members" call for discussion with a country that practices "protracted large-scale intervention in one direction in exchange markets." Would it be incorrect to state that China's exchange rate policy violates most relevant international norms and standards?

A.1. China's exchange rate policy is no doubt frustrating to policymakers who believe—or who want their constituents to believe—that the undervalued Yuan is a major cause of the bilateral trade deficit, and that the bilateral trade deficit is a major cause of unemployment in the U.S. manufacturing sector. Although those causal connections are extremely weak, the Chinese currency is more than likely undervalued. That undervaluation has a positive effect on some Chinese and American interests, and a negative effect on other Chinese and American interests. Accordingly, it is crucial that policymakers consider the broader effects of Chinese currency appreciation—its impact on U.S. prices, global commodities prices, the costs of production for U.S. manufacturers that rely on imported raw materials and components, *et cetera*—before pulling the trigger on legislation designed to compel Chinese revaluation.

Despite all of the media and political hype, it would be difficult to convince an objective jury that China's exchange rate policy "violates most relevant international norms and standards." Why? For starters, China is only one of 58 countries in the world that pegs the value of its currency to the value of another currency or to the value of a basket of other currencies. Nearly one-quarter of the world's sovereign nation-states engages in overt currency manipulation. So, in that sense, China's behavior is not extraordinary.

The standard articulated in Article IV, Section I of the Articles of Agreement of the International Monetary Fund (IMF) to "avoid manipulating exchange rates or the international monetary system in order to prevent effective balance-of-payment adjustment or to gain unfair competitive advantage over other member countries" is a difficult one to meet. How does one prove that "prevent[ing] effective balance-of-payments adjustment" or "gain[ing] unfair competitive advantages over other member countries" is the motive for currency manipulation, as opposed to some other more benign motive? It is quite plausible that the Chinese government is worried about the effect of Yuan appreciation *vis-a-vis* the U.S. dollar because its investment portfolio includes nearly $1 trillion of U.S. government debt. A 25 percent depreciation of the dollar amounts to a loss of $200 billion of those debt holdings. Thus, protecting the value of those holdings may be an important motive for keeping the exchange rate stable.

At the end of the day, though, China stands out among the group of 58 countries that peg their currencies to the value of another. China is the largest economy among them and its enormous volume of trade and investment flows require a much higher level of intervention in currency markets, which has resulted in the accumulation of nearly $2.5 trillion in foreign currency reserves. China and the world would be better off if the value of the Yuan were market determined, and if those foreign reserves were reinvested around the world, where capital is most needed and can be deployed most productively and efficiently.

But it would be a reflection of political expedience and economic mismanagement if sanctions were imposed to compel China to revalue or float its currency because such actions would likely generate even greater costs for the U.S. economy and have more serious consequences for the bilateral relationship.

Q.2. Given that China refuses to use nominal appreciation to rebalance the Chinese and global economies, assuming currency manipulation and protectionism are not the root cause, what is the economic rationale for China's insistence on a stable RMB?

A.2. The desire for stability, as opposed to uncertainty, explains the Chinese government's commitment to a currency peg. Investors like certainty; planners like predictability. Within that framework, I believe the Chinese government knows it is in China's best interest, eventually, to allow supply and demand to determine the value of its currency. The government recognizes that the Chinese economy will have to become less reliant on exports and more reliant on domestic consumption to fuel its economy, which is a transition that is fostered by an appreciating currency. But at the same time, the government is worried about disrupting the double-digit annual economic growth it has experienced nearly without interruption for three decades. China's reluctance on the currency issue is a reflection of the government's aversion to tinkering with a model that has been hugely successful.

Does China's insistence on currency intervention harm U.S. interests? It carries adverse consequences for some interests and benefits for other, just as appreciation of the Yuan will carry benefits for some and costs for others. The undervalued currency probably suppresses, somewhat, the sales of U.S. exporters, which, incidentally, have been rising by 20 percent each year since China joined the World Trade Organization in 2001. But the effect of an undervalued Yuan on import-competing U.S. producers is less clear. The cheaper Yuan artificially inflates the costs of production in China, where one-half to two-thirds of the value of Chinese exports is first imported into China as raw materials and components. Yuan appreciation will reduce the cost of production by making those inputs cheaper, enabling Chinese producers to lower their prices for export to the United States.

Finally, currency stability acts as a buffer that supports the value of China's nearly $1 trillion holding of U.S. government debt. Yuan appreciation against the dollar will reduce the value of those holdings, which is already exposed to devaluation that would result from inflationary U.S. monetary policy. Since the rate of U.S. infla-

tion is purely in the hands of U.S. monetary authorities, China is reluctant to relinquish its control of the exchange rate.

If the U.S . Congress were more responsible with the taxpayers' money, and did not insist on spending beyond its means, there would be no need to borrow from the Chinese or any other government. And the corresponding interest of those debt holders in a strong dollar would be mitigated.

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

LETTER FROM DAMON A. SILVERS, POLICY DIRECTOR AND SPECIAL COUNSEL, AFL–CIO

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February 18, 2010

The Honorable Gary Locke
Secretary of Commerce
U.S. Department of Commerce
1401 Constitution Avenue, NW
Washington, DC 20230

Re: Certain Coated Paper Suitable for High Quality Print Graphics Using Sheet Fed Presses from the People's Republic of China

Dear Secretary Locke:

On behalf of the over 11.5 million members of the American Federation of Labor and Congress of Industrial Organizations (AFL-CIO), I write to you concerning the October 19, 2009 decision of the Department of Commerce ("Commerce") to exclude allegations of currency undervaluation from the scope of the countervailing duty investigation in the *Certain Coated Paper from China* case. This decision is has significant broad policy implications because it is the first occasion, to our knowledge, on which the Obama Administration has taken a position on whether currency undervaluation is a subsidy under U.S. countervailing duty laws. The Commerce Department's decision appears contrary both to the language of the countervailing duty provision of the U.S. code and to the Obama Administration's policy of vigorous promotion of exchange rate realignment. The AFL-CIO strongly urges the Commerce Department to reverse its decision and include the currency claim within the scope of the investigation.

On September 23, 2009, three U.S. paper producers and the United Steelworkers (USW) union jointly filed countervailing duty petitions with Commerce regarding certain coated paper from China. The petitions estimated a 40 percent increase in total imports of coated paper -- from 131,687 tons in the first six months of 2008 to 185,422 tons in the first six months of 2009. Imports from China and Indonesia together now account for nearly 30 percent of the domestic market.

The petitioners alleged that this injury was the result of various subsidies that China provided to paper producers, including low interest loans, tax exemptions and reductions, VAT and tariff exemptions on imported equipment, and numerous grants. Commerce decided to undertake an investigation on each of these subsidies. However, the petitions also alleged that

China's intentional currency undervaluation also provided a countervailable subsidy to Chinese exporters of coated paper. Commerce declined to initiate an investigation on the currency claim, stating, without further explanation, that the petitioners failed to allege that the subsidy was "specific" – i.e., that the receipt of the excess RMB was contingent on export or export performance.

On January 13, the paper manufacturers filed revised petitions with regard to the currency allegation based on subsequent discussions with Commerce. The revised petitions provided further support to demonstrate that currency undervaluation is a benefit specific to exporters, including a detailed economic study finding that 70 percent of all currency exchanges in China are made by exporters. In addition, petitioners showed that 55% of all exports from China are made by Foreign Invested Enterprises, which receive a disproportionately large amount of the currency undervaluation subsidy benefit. In light of this additional information, petitioners aver that the subsidy is plainly export contingent and meets the definition of "specificity" under U. S. and international law. We believe that Commerce erred in initially rejecting the currency claim; however, with the supplemental information, Commerce has no basis on which to refuse to initiate an investigation on the currency claim.

The issue of currency undervaluation is critical to addressing the U.S. trade deficit and enhancing exports. While the U.S. trade deficit fell sharply with the rest of the world last year, nearly 40 percent, our bilateral trade deficit with China barely budged – falling from $268 billion in 2008 to $226.8 billion in 2009. China now accounts for roughly 80% of our goods trade deficit. This is largely the result of China's decision to substantially undervalue its currency, pegging it roughly to the now-falling value of the U.S. dollar. As a result, China's exports are artificially cheap and imports are more expensive. As President Obama recently stated, currency undervaluation "puts us at a huge competitive disadvantage." As Chinese exports gain more market share here, U.S. manufacturers are forced to close plants and lay off workers.

U.S. exports to China and to other markets have also been affected by Chinese currency undervaluation. U.S. goods cannot compete in the Chinese market or in third country markets against Chinese products in part due to the subsidy provided by currency undervaluation. Addressing China's unlawful currency advantage is essential to any effort to increase U.S. exports. We applaud President Obama's recent promise to pursue "very serious negotiations" with the Chinese government on currency, setting a one-year goal of persuading China that it is in its own best interested to allow its currency to rise. It is critical to that effort that the U.S. at a minimum enforces our own laws in relation to unlawful currency-related subsidies.

For all of these reasons, we strongly urge Commerce to immediately include the currency claim within the scope of the investigation. If you have any questions regarding our views on this matter please contact Jeffrey Vogt at 202-637-3904.

Sincerely,

Damon Silvers
Director of Policy and Special Counsel

cc: Michael Froman, Deputy Assistant to the President & Deputy National Security Advisor for International Economic Affairs

Jason Furman, Deputy Director, National Economic Council

LETTER FROM ERIK O. AUTOR, VICE PRESIDENT, INTERNATIONAL TRADE COUNSEL

April 22, 2010

The Honorable Sherrod Brown
Chairman
Economic Policy Subcommittee
U.S. Senate Committee on Banking, Housing & Urban Affairs
543 Dirksen Bldg.
Washington, DC 20510

RE: Hearing: China's Exchange Rate Policy

Dear Chairman Brown:

On behalf of its members in the U.S. retail industry, the National Retail Federation (NRF) welcomes the opportunity to submit these comments to the Economic Policy Subcommittee regarding China's exchange rate policy.

The **National Retail Federation** is the world's largest retail trade association, with membership that comprises all retail formats and channels of distribution including department, specialty, discount, catalog, Internet, independent stores, chain restaurants, drug stores and grocery stores as well as the industry's key trading partners of retail goods and services. NRF represents an industry with nearly 1.6 million U.S. retail establishments, 24 million employees - about one in five American workers - and 2009 sales of more than $4.1 trillion. As the industry umbrella group, NRF also represents over 100 state, national and international retail associations.

Retail Industry Profile

Retailing represents one of the largest industries in the United States in terms of the number of companies, employment, and contribution to gross domestic product. According to the most recent annual (2009) statistics:

- The U.S. retail industry comprises more than 1.1 million retail companies;
- Among American retail companies, the vast majority (98.5 percent) are small businesses located in every Congressional district in the country;
- The U.S. retail industry had annual sales more than $4.1 trillion;

- Of the more than two-thirds of U.S. GDP generated from consumer spending, over 41 percent of that spending (*i.e.*, nearly 30 percent of U.S. GDP) occurs in retail establishments;
- With 24 million employees – nearly one in five American workers – the retail industry provides more jobs than any other U.S. industry;
- Retail employees averaged $16.77 per hour in total compensation (wages, salaries, and benefits).[1]

Like any other business, retailers face the daily challenge of creating value for their customers and shareholders, in an industry marked by cutthroat competition and an average profit margin of 2-3 percent. Currently, retailers are slowly climbing their way out of the worst economic environment for our industry in over 40 years. During the past 18 months, retailers suffered a huge number of bankruptcies, store closures, and over one fifth of all the job losses in the United States.

Retailing is also an extremely trade reliant industry that is directly impacted by the direction and operation of U.S. trade policy. Like other U.S. industries, including manufacturing and agriculture, every retailer, from the largest national chains to the smallest neighborhood shop, depends on a global supply chain to procure the products that its customers – the American consumer - need and want.

The commercial activity generated by global sourcing of consumer goods by American retailers supports good-paying, skilled blue and white collar jobs, many of them union jobs. These millions of American workers are employed not only in the retail industry, but also in many ancillary industries that support retail operations and supply chains – *e.g.*, manufacturing, farming, ports, rail, trucking, warehousing, air delivery, and logistics.[2]

As an industry engaged in importing, we would point out that, contrary to popular opinion, evidence shows that imports as a whole support millions of U.S. jobs, and help, not only retailers, but all U.S. companies involved in international commerce to enhance their productivity, competitiveness, and ability to expand

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[1] Source, *Retail Industry Indicators*, Prepared for the NRF Foundation by The Trade Partnership.

[2] *See, Imports and America: The Rest of the Story*, prepared by The Trade Partnership for the National Retail Institute and the Council of the Americas, August 1998, and *Impact of Imports from China on U.S. Employment*, prepared by Trade Partnership Worldwide, LLC for the National Retail Federation, November 2005.

employment. Research demonstrates that imports support more than 10 million American jobs, and that imports from China alone support nearly 1 million net jobs in the United States.[3]

U.S.-China Trade Relations

Much of the national economic anxiety over trade and globalization is focused on issues in the U.S.-China trade relationship as China has become an increasingly significant player in the global economy. In the unfolding debate on the U.S.-China trade relationship, few U.S. industries have more at stake than retailers. Consumer goods comprise nearly 80 percent of all U.S. imports from China, and China is a key supplier, and sometimes the dominant supplier, in every consumer goods category. Moreover, retailers have been adversely impacted by a recent increase in trade remedies investigations (antidumping, countervailing duty and safeguards) against imported consumer products mainly targeting China. Indeed, many of the proposed changes to the trade remedies laws currently under consideration in Congress are intended primarily to target imports from China.

The retail industry acknowledges that there are serious and legitimate issues with China that need to be effectively addressed, including inadequate protection of intellectual property rights, proliferating market access barriers, the need for a monetary system that allows for more flexible exchange rates and a fully-convertible currency, ensuring that China abides by its obligations under international trade rules, and dealing with the difficulties inherent in China's transformation from an isolated, centrally-planned, non-market economy to a market-economy country. In considering how best to address these issues, the retail industry urges prudence and thoughtfulness on the part of policy makers. Policy makers should support appropriate action through diplomatic efforts and the use of multilateral mechanisms to address issues in the U.S.-China relationship that can yield effective progress and are consistent with World Trade Organization (WTO) rules.

However, we continue to see descriptions of issues in the U.S.-China trade relationship presented in the most reckless, sweeping, facile, and grossly exaggerated terms – China "cheats"; China has "stolen" "millions" of American jobs; China exports goods made by "slave labor" working for "pennies a day"; the "devastating" impact of China's "enormous" subsidies and "massive" currency

[3] *See, e.g., Imports and America, Ibid.*

undervaluation; a "flood" of "unsafe and poisonous" Chinese products; etc.[4] Indeed, from the tone of many of these and other statements, one might be led to think that China is responsible for the loss of every manufacturing job in the United States, is largely to blame for the current state of the U.S. economy, and that China's exchange rate policy is the main reason behind the U.S. bilateral trade deficit with China. These are absurd propositions on their face.

Too frequently, the intention behind this hyperbole is not to propose serious solutions to any of the issues the United States has with China. Rather the goal is to justify a protectionist agenda – blocking imports from China and punishing U.S. companies that do business in China all purportedly in the emotionally-charged, but largely meaningless name of "fairness." The U.S.-China trade relationship is simply too complex and important to be driven by such emotional rhetoric.

In looking at serious policy options to address issues in the U.S.-China trade relationship, NRF and the retail industry have consistently supported the Strategic and Economic Dialogue (SED) and recent actions by the U.S. Trade Representative's Office against China under the WTO dispute settlement mechanism over practices that violate WTO rules, and coordination at the multilateral level. We applaud statements by the Obama Administration and Chairman Levin emphasizing the use of all available diplomatic avenues and constructive dialogue with China to address issues such as currency policy and practices. By the same token, we believe it is appropriate for the United States to protect its rights by challenging China at the WTO where there are clear violations of international trade rules. Diplomatic avenues, such as the SED, the G-20, and dispute settlement through the WTO may be slower processes than some may prefer, but are most likely to yield positive results while avoiding unintended consequences that could hurt the U.S. economy and jobs.

On the other hand, the Administration and Congress should reject unilateral, counterproductive, and WTO illegal restrictions on imports of Chinese goods as a policy tool to compel action by China. There is no evidence that these actions would be effective in addressing any of the issues in the U.S.-China trade relationship. Meanwhile, they would impose huge costs on the U.S. economy, seriously harm U.S. retailers, manufacturers, services providers and

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[4] *See e.g.*, AFL-CIO website, www.aflcio.org; American Trade Action Coalition (AMTAC) website, www.amtacdc.org; National Council of Textile Organizations (NCTO) website, www.ncto.org; Public Citizen website, www.citizen.org; Stand Up For Steel website, www.standupforsteel.org; UNITE-HERE! website, www.unitehere.org.

farmers that depend on trade with China and global supply chains, and adversely affect millions of American consumers.

Chinese Currency and Exchange Rate Policy

The subject of this hearing – Chinese currency policy and the value of the yuan – are central issues in the debate over U.S.-China trade relations. Some claim that the yuan is greatly undervalued vis-à-vis the dollar, and blame it as the driving factor behind the sizable bilateral trade deficit with China and the loss of U.S. manufacturing jobs.[5] Among their proposed remedies is to impose trade barriers to imports from China through various means, including changes to the U.S. antidumping and countervailing duty laws. They would also essentially force the U.S. Trade Representative to initiate dispute settlement proceedings at the World Trade Organization (WTO) against Chinese currency policy and the Secretary of the Treasury to determine that China is a currency manipulator. Not surprisingly, these proposals are strongly endorsed by certain domestic industries, such as steel and textiles, that for decades have relied on, and continue to seek new means to impose trade barriers against imports, particularly from China.

There is no real disagreement that China must move toward a more flexible currency regime. The only disagreements are the means to effect that change and how quickly it can reasonably be accomplished without creating further turmoil in the financial sector, and adversely impacting the U.S. economy. As a guiding principle, we oppose unilateral, counterproductive, and WTO illegal restrictions on imports of Chinese goods as a policy tool to compel action by

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[5] Evidence does not support the claim that China's exchange rate is a significant factor in the size of the U.S. trade deficit or in the loss of "millions" of U.S. manufacturing jobs. As the US-China Business Council correctly observed in its paper, *China and the US Economy: Advancing a Winning Trade Agenda* (Jan. 2009), much of what is imported from China had been imported from other Asian countries. Moreover, while transportation and labor costs, as well as inflation had a significant impact on the price of imports from China in the first half of 2008, there is little evidence of such an impact from the 20 percent appreciation in the Yuan from 2005 - 2008, which had the offsetting effect of lowering the cost of imports into China. This fact bolsters the conclusions of an economic analysis by the Atlanta Fed, Eduardo J.J. Ganapolsky and Diego Vilán, *Buy Foreign While You Can: The Cheap Dollar And Exchange Rate Pass-Through*, Federal Reserve of Atlanta Economic Review (2005), that there is a low rate of exchange rate pass through on many consumer goods that China makes. That means that yuan appreciation will not directly correlate to import prices. Accordingly, it is simply not credible that forcing China to appreciate its currency further will reverse the U.S. trade deficit. The economic crisis itself resulted in a huge drop in Chinese exports – 17.5 percent in January 2009 – which adversely impacted both the U.S. and Chinese economies.

China. By the same token, we are convinced that the best course of action is dialogue and negotiation through mechanisms such as the SED and the Joint Commission on Commerce and Trade (JCCT). A deft diplomatic and multilateral strategy by the United States will ultimately be a much more effective tool in identifying mutually-beneficial goals, and moving the Chinese Government in a more constructive direction, while strengthening, rather than undermining the important U.S.-China economic relationship.

By the same token, we will continue to oppose the use of trade remedies as a means to address China's currency policy for two reasons. First, many of the proposed changes to the trade remedies laws would violate WTO rules. Second, there may be widespread consensus among economists that the Chinese currency is undervalued, but there clearly is no agreement over the extent to which the yuan is undervalued. Thus, any attempt to quantify the degree to which the yuan may be undervalued, with the degree of specificity required in an antidumping or CVD case, will result in an entirely arbitrary and inaccurate calculation.

One proposal to address the currency issue through the use of the trade remedies laws that raises particularly troubling concerns is legislation that would redefine countervailable subsidies to include the undervaluation of a foreign currency through exchange rate manipulation or misalignment. NRF has argued in the past that this unilateral attempt by Congress to redefine what constitutes a countervailable subsidy would conflict with WTO rules and invite trade retaliation or reciprocal action to the detriment of U.S. companies and workers.

The WTO Subsidies Code[6] identifies three types of subsidies – prohibited; actionable (*i.e.*, subject to countervailing duties); and non-actionable (*i.e.*, permitted). Articles 1 and 2 of the Subsidies Code specify that to be countervailable, a subsidy must be: (1) a <u>financial contribution</u> from a government (2) that provides a <u>benefit</u> (3) to a <u>specific</u> industry or industries or enterprise or group of enterprises.

Because the "benefit" from currency valuation is generally available to all economic players in a country, the proposed legislative change would conflict with the specificity requirement under WTO rules. Because currency policy does not involve the transfer of anything of tangible value from the government, the proposed legislation would also conflict with the financial contribution

[6] WTO Agreement on Subsidies and Countervailing Measures of the General Agreement on Tariffs and Trade 1994.

requirement under WTO rules. Currency policy also cannot meet the WTO definition of a prohibited subsidy because its benefit is not contingent on exportation and does not require the use of domestic goods.

Moreover, some proposals would direct that currency misalignment be determined on the basis of a country's trade balance, amount of foreign direct investment, and foreign currency reserves. What these proposals fail to recognize is that these matters are influenced by many factors that may have nothing to do with a country's currency policy.

In the end, defining a countervailable subsidy in a way that violates WTO rules would undermine efforts to ensure that other countries abide by international trade rules, expose exports of U.S. goods and services to possible trade sanctions, and does nothing to address the underlying issue in an effective manner.

Another troubling proposal with respect to the currency issue would require adjustments to antidumping margins in investigations and reviews to offset the amount by which a country's currency may be undervalued or "misaligned." There is, however, no widely accepted benchmark for determining the extent to which a particular currency may be undervalued. In the case of China, it was claimed the Yuan was undervalued by 15 to 40 percent. That is a huge range that demonstrates the imprecision of the calculation. Thus, any calculation by the Commerce Department, that has no expertise on such matters, will be an entirely arbitrary exercise, and therefore subject to political influence.

However, the bigger threat from this proposal is the precedent it would set to allow any country to game the antidumping process by unilaterally setting an arbitrary value on another country's currency. The result will be to make the trade remedies system even more unpredictable for U.S. importers and exporters.

Another problem with this proposal is that it would violate Article 2.4.1 of the WTO Agreement on Antidumping (AD Agreement), which establishes the rule for currency conversion and adjustments by reference to the value set by currency markets:

> "When the comparison [between export price and normal value] requires a conversion of currencies, such conversion should be made <u>using the rate of exchange on the date of sale</u>, provided that when a <u>sale of foreign</u>

currency on forward markets is directly linked to the export sale involved, the rate of exchange in the forward sale shall be used." (emphasis added)

No other provision of the AD Agreement would permit this type of adjustment. Notably, Article VI.2 of the General Agreement on Tariffs and Trade applies only to multiple currency practices, not "fundamentally misaligned currencies."

In addition, the surrogate country methodology used in AD investigations against imports from China and other non-market economy (NME) countries already addresses the effect of any currency undervaluation. In calculating an AD margin in NME cases, the Commerce Department uses market-based values from a surrogate country to determine the normal value of the subject imports, which it then compares to the U.S. export price. As a result, the AD calculation effectively offsets the effect of the currency undervaluation on price. Requiring an additional adjustment would violate WTO rules by capturing the effect of the undervaluation twice.

Thus, we are left with the question of what would be an effective approach to the currency issue. We agree with several points on this issue raised in an article in the opinion section of the Wall Street Journal on March 18, 2010.[7] In particular, moving China to a fully-convertible currency and loosening capital controls are more important reforms than a futile attempt to force China to revalue or float the yuan. As pointed out in the article, lack of full convertibility and excessive capital controls are two factors spurring the Chinese government to buy huge amounts of U.S. Treasury notes and hindering efforts at further liberalization of the Chinese financial sector.

In any event, as also noted in the article, there is no assurance that a revaluation or full float of the Chinese currency will have any appreciable impact on the U.S. bilateral trade deficit with China, especially if the Chinese economy is adversely affected through deflation and imports into China decline as a result as happened under similar circumstances with Japan in the late 1980s and early 1990s. Indeed, appreciation or float of the yuan will certainly have no impact on the overall merchandise trade deficit as any Chinese production adversely

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[7] *The Wall Street Journal*, Opinion: The Yuan Scapegoat, The U.S. establishment flirts with a currency and trade war with China (Mar. 18, 2010).

impacted by a higher valuation of the yuan will likely simply move to another foreign country.

In conclusion, before acting on any legislation targeting Chinese currency policy, Congress and the Administration need to ask three questions: (1) Does the legislation conform to WTO rules?; (2) Will the legislation be effective in achieving the stated goal?; (3) Will any benefits of the legislation outweigh the harm it may inflict on U.S. companies, workers, and the economy? If the answers to any one of these questions is no, then the entire exercise will be seen as merely protectionist political posturing.

NRF appreciates the opportunity to comment on China's exchange rate policy. Should you have any questions please contact me at (202) 626-8104 or by e-mail at autore@nrf.com.

Sincerely,

Erik O. Autor

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

cc: The Honorable Jim DeMint (R-SC), Ranking Member
The Honorable Jon Tester (D-MT)
The Honorable Jeff Merkley (D-OR)
The Honorable Christopher J. Dodd (D-CT), Chairman, Senate Banking Committee
The Honorable Richard C. Shelby (R-AL), Ranking Member, Senate Banking Committee