S. HRG. 109–505

THE REPORT TO THE CONGRESS ON INTERNATIONAL ECONOMIC AND EXCHANGE RATE POLICIES

HEARING

BEFORE THE

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

ONE HUNDRED NINTH CONGRESS

FIRST SESSION

ON

EXAMINATION OF THE REPORT TO CONGRESS ON INTERNATIONAL ECONOMIC AND EXCHANGE RATE POLICIES, FOCUSING ON IMBALANCES IN THE GLOBAL ECONOMY, AND CHINA'S CURRENCY REGIME

MAY 26, 2005

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

Available at: http://www.access.gpo.gov/congress/senate/senate05sh.html

U.S. GOVERNMENT PRINTING OFFICE

28–972 PDF WASHINGTON : 2006

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2250 Mail: Stop SSOP, Washington, DC 20402–0001

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

RICHARD C. SHELBY, Alabama, *Chairman*

ROBERT F. BENNETT, Utah
WAYNE ALLARD, Colorado
MICHAEL B. ENZI, Wyoming
CHUCK HAGEL, Nebraska
RICK SANTORUM, Pennsylvania
JIM BUNNING, Kentucky
MIKE CRAPO, Idaho
JOHN E. SUNUNU, New Hampshire
ELIZABETH DOLE, North Carolina
MEL MARTINEZ, Florida

PAUL S. SARBANES, Maryland
CHRISTOPHER J. DODD, Connecticut
TIM JOHNSON, South Dakota
JACK REED, Rhode Island
CHARLES E. SCHUMER, New York
EVAN BAYH, Indiana
THOMAS R. CARPER, Delaware
DEBBIE STABENOW, Michigan
ROBERT MENENDEZ, New Jersey

KATHLEEN L. CASEY, *Staff Director and Counsel*
STEVEN B. HARRIS, *Democratic Staff Director and Chief Counsel*
PEGGY R. KUHN, *Senior Financial Economist*
SKIP FISCHER, *Senior Staff Professional*
STEPHEN R. KROLL, *Democratic Special Counsel*
JOSEPH R. KOLINSKI, *Chief Clerk and Computer Systems Administrator*
GEORGE E. WHITTLE, *Editor*

C O N T E N T S

THURSDAY, MAY 26, 2005

WITNESS

THE REPORT TO THE CONGRESS ON INTERNATIONAL ECONOMIC AND EXCHANGE RATE POLICIES

THURSDAY, MAY 26, 2005

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

The Committee met at 10:02 a.m., in room SH–216, Hart Senate Office Building, Senator Richard C. Shelby (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN RICHARD C. SHELBY

Chairman SHELBY. The hearing will come to order. We are very pleased this morning to welcome Secretary of the Treasury John Snow to testify on the Treasury Department's Report to the Congress on International Economic and Exchange Rate Policies.

Secretary Snow, the Treasury report is of great interest to this Committee and will provide us much to debate this morning and in the weeks to come. As you are well aware, many Members of Congress, including myself, find the continued imbalance of trade with China to be a significant concern.

The U.S. current-account deficit hit a record $666 billion last year, or 5.6 percent of GDP. Coinciding with this deficit has been the purchase of large volumes of Treasury securities by the Chinese and Japanese central banks. As of March of this year, Japan's reserve holdings of Treasuries stood at $679.5 billion while the value of China's reserves were at $223.5 billion. While some may argue that these numbers are a natural outgrowth of globalized financial markets, the numbers also raise questions about whether the current world trade situation present a level playing field. The continuing weakness in the manufacturing sector made the trade and exchange rate policies in China and Japan a tangible issue to U.S. businesses and taxpayers.

Treasury's May report indicates that no major trading partner of the United States met the technical requirements for currency manipulation under the Omnibus Trade and Competitiveness Act of 1988 during the second half of 2004. However, Mr. Secretary, the report went on to indicate that "Current Chinese policies are highly distortionary and pose a risk to China's economy, its trading partners, and global economic growth." As you will hear this morning, Members of Congress were disappointed to hear that once again Treasury had failed to make a currency manipulation determination. They think you punted.

Secretary Snow, this Committee would like to engage you in a serious discussion this morning about the specific measures the Administration will take in the next 6 months to move China forward on a flexible rate path. Over the long-term, both the United States and the global economy will benefit most from the continued pursuit of free trade and flexible exchange rate policies. The most desirable way to reduce our current account deficit would be through stronger growth abroad and more open trading markets and policies.

We look forward to a thoughtful discussion this morning so that we might all leave this hearing with a broadened awareness of the situation and the direction ahead. This is a very important issue to the American people, I believe, Mr. Secretary.

Secretary Allard.

I mean Senator Allard. I do not know if I have promoted you or demoted you.

[Laughter.]

STATEMENT OF SENATOR WAYNE ALLARD

Senator ALLARD. Thank you, Mr. Chairman. You gave me more than one job there.

Chairman SHELBY. I will give you two jobs.

Senator ALLARD. That is for sure.

First of all, I would like to thank you, Mr. Chairman, and I would like to thank Secretary Snow in particular for appearing before the Committee today to discuss international economic and exchange rate policy and its impact on the U.S. economy.

The Treasury's report is required under the Omnibus Trade and Competitiveness Act of 1988 and reviews the effects that significant international economic developments have had on the United States and foreign economies.

The report also evaluates certain factors that may bring about these economic developments. I am pleased that this year's report indicates China's desire to move forward to a more open economy with a flexible exchange rate.

However, it is important to remember that there are many factors that contribute to our current trade relationship with China, not just the currency valuation issue. To attribute the source of our trade difficulties with China solely to the matter of currency valuation would be foolhardy and, frankly, much too simple.

While a more aggressive United States foreign policy with China may be necessary, I believe that it is not the job of the Senate to intervene by threatening legislation. Stricter World Trade Organization rules regarding China's membership is one option that needs to be explored further. This can be done through the WTO Dispute Settlement Process or by adjusting what many would consider existing rules that are entirely too lenient.

The United States is committed to promoting and encouraging free and open markets, providing the ability for capital to find its most productive home. This flexibility implies that markets in goods and services will see growth beyond national boundaries.

In order to see that the United States is not at a competitive disadvantage with other countries, policymakers need to see that

Americans stay ahead of the curve with top-notch education, innovation, and research and development.

I feel strongly that the United States must have a comprehensive and consistent policy when dealing with China, and I look forward to hearing from you, Secretary Snow, on the Administration's progress over the last year and their plans for advancing in that momentum.

Secretary Snow, thank you again for appearing before the Committee, and I look forward to your testimony.

Chairman SHELBY. Senator Dole, former Secretary Dole, twice.

STATEMENT OF SENATOR ELIZABETH DOLE

Senator DOLE. Thank you, Mr. Chairman, and thank you, Secretary Snow, for joining us here today. I want to commend you and your colleagues at the Treasury Department for your work on this recently released report. This report is a good outline of the problems inherent to the Chinese currency peg.

Since we first spoke about this issue in 2003, you have recognized my strong interest in the Chinese currency peg, and you have shown a sincere willingness to keep me informed about your progress, including the call from China that you made, which I appreciated very much, when you were there discussing this issue with your counterparts.

In the 1980's, as President Reagan's Transportation Secretary, I had my own experience negotiating with the Chinese, and that was an interesting time. We were negotiating a number of issues. One was maritime, for example, but also I met with the Director General for Aviation while I was there, and we discussed a United States airline opening an office in China.

Now, this had been brought up again and again over a long period of time, and every time this subject came up, we were told, and others before me, that the office "would open soon." Unfortunately, as I say, that existed over quite a period of time—"soon." And when I was not able to pin down the Director General as to what "soon" meant, I suggested that I would just leave behind one of my Assistant Secretaries for Transportation until the office opened. And within 5 days, the office was opened in Beijing.

Now, while I know your negotiations are far more complicated and far-reaching, with great ramifications for the international monetary system, I must say that my experience left me with the impression that the Chinese are sometimes reluctant to follow through unless real pressure is applied. Given this fact, our message to the Chinese must be an insistence on action now.

We are all familiar, of course, with the manufacturing job losses that have hit us on a nationwide basis, and certainly that has been very true in my State of North Carolina, where we have had many job losses over these recent years. Available jobs in the textile and furniture industries have been cut in half since 1998. Earlier this week, I met with John Bassett, who is President of the Vaughn-Bassett Furniture Company, and he informed me that a full bedroom set imported from China sells for $399 in North Carolina, and his company must pay $461 just for the raw materials to make the same bedroom set in North Carolina. Now, that is astounding. The peg on the Chinese currency is a large part, I believe, of what makes that possible.

Textiles and furniture are not the only industries affected by the unfairness of the peg. North Carolina computer software companies are also deeply concerned about this issue, as well as high-tech manufacturers. Just last week, Art Rutledge, President of Fawn Electronics, with about 100 employees in Elm City, North Carolina, was in my office. He explained that because the yuan is so undervalued, the materials for one small printed circuit card, which they manufacture, that uses about five different parts, would cost them $1.98 in North Carolina. Unfortunately, we can buy the finished card from China for $1.57.

These business leaders tell me that they can compete with anyone, given a level playing field. The Chinese currency peg has given Chinese manufacturing an advantage that cannot be explained simply by their lower cost of labor, which we hear about so often. The finished product cannot cost less than the raw materials. That just does not make sense.

Secretary Snow, you have moved the bar with this recently issued Treasury report, and I appreciate that. We have moved the bar here in the Senate. While 2 years ago we were calling for a freely floating yuan, today all we ask is that it simply be revalued. That is why I cosponsored an amendment to the State Department authorization bill to pressure the Chinese to revalue. Sixty-seven Senators voted in favor of this amendment, and only 2 weeks ago, Senators Snowe, Voinovich, and I introduced legislation that would update the technical requirements in the law for designation as a country that manipulates the rate of exchange between their currency and the dollar. I think it is clear that this is not an issue that the Senate is willing to wait on. Given all of the evidence that has been available and referenced in this report, I frankly am astounded that the Administration continues to report that the Chinese peg is not currency manipulation. While I appreciate all the steps that the Administration has taken thus far, I think it is time to redouble these efforts.

In this report states, “It is now widely accepted that China is now ready and should move without delay in a manner and magnitude that is sufficiently reflective of underlying market conditions.” Everyone here agrees with that, Mr. Secretary. Now let us make sure that the Chinese back up their words with actions.

Thank you, Mr. Secretary. I look forward to your testimony because this is a critical issue to the people of North Carolina, and it is a critical issue to the United States as a Nation. Thank you Chairman Shelby.

Chairman SHELBY. Senator Schumer.

STATEMENT OF SENATOR CHARLES E. SCHUMER

Senator SCHUMER. Thank you, Mr. Chairman for holding the hearing. I want to thank our Secretary of the Treasury for being here, and I want to make a few points. Obviously, the Secretary and I have talked both publicly and privately about this issue ever since he became Treasury Secretary.

First, I would say this: It becomes clearer and clearer that China wants the advantages of free trade and not the responsibilities.

They play half the game. When they have an advantage, they are all for free trade. When they have a disadvantage, they come up with all sorts of reasons, excuses, or just abject violations of trade rules to avoid it. And I will argue this: As the global economy expands and free trade becomes more and more important, no matter where you live in this country, if there is not a feeling that it plays fair, we will never get a U.S. consensus or a world consensus for it. And as long as China is allowed to do what it has done, they set back the cause of free trade.

I am utterly amazed. It is not business people, it is not practical people who oppose our legislation. They may say, hey, can you do it in a nice way? But all the nicer ways have failed. It is the academics and editorial writers. But they do not get it. They can afford to sit there in the ivory tower and say everyone should just play by the rules. They do not understand the political reality that you cannot ask one side to play by the rules while the other does not, and all the world shrugs their shoulders and says, well, they do not have to.

China is no longer a Third World country. It is a major player on the world economic scene. And it is a different situation than it was 10 or 15 years ago.

And it is issue after issue. It is the theft of intellectual property, which they do nothing about. Those are our crown jewels in America—intellectual property. And if you believe, as I do, that people should be recompensed for it, whoever they are, whatever Nationality, to let them just violate these rules and they shrug their shoulders and say they cannot do anything, bunk. They do not want to do anything.

And how about all the companies that are just excluded? I know company after company in my State, and my country, where China does not let the good in. And I have told the Secretary some of these stories. It is big companies, it is little companies. China is not a free trading country. They are mercantilist country. Their goal is to increase their balance of trade and bring jobs and wealth into their country no matter what the consequences. And in the long-run, they do better by playing by the free trade rules, but they do not.

And so the currency manipulation is the area that has become the focal point, not because it is the only one but because it is the one that affects everything across the board. My colleague from North Carolina mentioned textiles and furniture, which are labor-intensive industries, and then some kind of computer—what was it? High-tech, which is obviously an idea-centered industry. But in all of them, my business people say the same thing to me. They said: We will compete against lower labor costs and everything else, but when you put a 27.5- or 30-percent barrier in the way, then we cannot compete.

I would disagree, however, with my friend from North Carolina in one way. I am not willing to settle for just a revaluation of 5 or 10 percent and say never mind. The Chinese have to let their currency float. It is a tenet of free trade. When balances of trade become too great in one direction, when currency floats, there is a wash-back, and the whole situation gets straightened out eventually. It is not something that is optional. If free trade is to work, currencies have to float.

And so while I certainly do not demand—and Senator Graham and myself, who have put our bill forward, which Senator Dole referred to that got 67 votes, we do not demand that they let it float immediately. We need a plan and then we need progress toward the plan. That is why our legislation, even if it were to pass, gives the Chinese a chance to put out a plan before any kind of tariff is imposed.

Finally, I want to salute you, Mr. Secretary. I think for the first time, the Administration has called it like it is. They have said—or almost called it like it is. They have said there are real problems here, and they said if China does not change, we will call it currency manipulation. Well, my view is if it quacks like a duck and walks like a duck and swims like a duck, it is a duck. They are manipulating their currency. We all know it. And I do not mind you moving in that direction, but let us not delay much further.

The Administration has now stepped into the batter's box. We had to push you a little bit, but you are there. Now you have to swing at the pitch. And you will benefit not just American industry but the whole construct of world trade when you do.

So, I want to ask unanimous consent that the rest of my statement be put in the record.

Chairman SHELBY. Without objection, so ordered.

Senator SCHUMER. And thank you for being here.

Chairman SHELBY. Senator Crapo.

STATEMENT OF SENATOR MIKE CRAPO

Senator CRAPO. Thank you very much, Mr. Chairman. Mr. Secretary, I join with other Senators here in welcoming you to the Committee to discuss this issue. And, frankly, I want to associate myself with the comments of the Senator from New York and the Senator from North Carolina and others who have spoken here today about the importance of making certain that we develop the right trade and monetary policy with China.

I was a supporter of the legislation that was voted on in the Senate and for a long time have been a strong proponent of doing everything we can to cause China to stop its currency manipulation and to stop pegging the yuan to the U.S. dollar.

I am concerned, however. I am concerned about what the proper U.S. response should be to the overall issue. The Senator from New York indicated that the focus on the currency manipulation issue is where the focus of the day seems to be, but that is not the only issue. And, frankly, it is not an easy solution. As you are well aware, the Chairman of the Federal Reserve, Alan Greenspan, has indicated that, along with many others, he expects to see China move in this direction, but does not expect that that move will necessarily have a significant positive impact on the U.S. economy because of the rise in domestic prices and potential other dynamics in terms of where the United States will get the imports that we are now getting from China if that reduces Chinese imports.

It seems to me that we have a much larger issue here than simply the currency manipulation issue, and it is an issue of such magnitude that this Congress, this Administration, and this country has to develop a broad, overall policy of how we are going to deal with the current trade and monetary policies that we see emanating from China, one of the most powerful economies in the world and one which will continue to grow.

So, anyway, I just wanted to say to you I appreciate your willingness to come and meet with us today and report to us. I appreciate the report that has just been issued. And I do support the efforts of the Administration to try to work with China to get it to move in the direction of fair and free trade and proper monetary policy. But I really hope, as a result of this hearing and the other efforts that we are all engaged in, that we can get a much broader and more focused action plan put together or game plan, if you will, as to what U.S. policy should be, not just with regard to the currency manipulation issue but with regard to the entire panorama of how we should deal with a nation like China, which is acting in the ways that have been described here, that literally take advantage of proper WTO policies and U.S. trade policies when they benefit them and then ignore them and erect trade barrier and establish monetary policy that is detrimental when it benefits them. And I know that this is a tall order, but as a Nation, we have to develop an overall policy that does much more than just determine what we will do with regard to currency manipulation.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Sarbanes.

STATEMENT OF SENATOR PAUL S. SARBANES

Senator SARBANES. Thank you very much, Mr. Chairman, and, Secretary Snow, we are pleased to have you back before the Committee. This is obviously a very important subject. I notice the Administration is moving a little bit on this issue, but I am not sure it has moved enough yet. And I do not see how you could do anything but move on this issue given the evidence with respect to currency manipulation, which is, after all, the focus of this hearing under the legislation passed by the Congress.

It has been my view for some time that nations, first and foremost China, but other key economies as well in Asia, have been manipulating their currency to gain unfair competitive advantage in international trade within the terms of the 1988 Trade Act.

First, China, Japan, Taiwan, and South Korea are all running material global current account surpluses and significant bilateral trade surpluses with the United States within the terms of the 1988 Trade Act, in my view. I have a chart here that shows the global current account surpluses and bilateral trade surpluses each of these countries is running with the United States. And as you can see, China's trade surpluses in particular with the United States now, in the most recent 12 months, $173 billion, 10.5 percent of GDP. Japan is 78.1; South Korea and Taiwan.

Now, the size of China's bilateral trade surpluses with the United States relative to the size of its economy is particularly striking. Furthermore, each of these countries has been engaging in sharply increasing accumulation of foreign currency reserves, principally dollars. As the following charts will illustrate, the first chart shows the growth in China's stock of foreign reserves, $215 billion over the past 12 months. This is just an incredible run-up in the stock of foreign reserves on the part of China. The second chart shows the growth in Japan's stock of foreign reserves. It has tailed off. It has only been $11 billion over the past 12 months, but that follows very sharp increases of $171 billion in 2004 and $202 billion in 2003. So we have had a tremendous run-up. And the next two charts show the same increase in the stock of foreign reserves held by South Korea, and then by Taiwan.

Now, to get some comparison, because I do not think the same kind of manipulation is taking place in the European Union, the next chart shows that the stock of foreign reserves held by the European Union, it has actually declined over the last 12 months.

So it is a very sharp contrast, what has been happening with respect to the countries in Asia accumulating foreign reserves compared with the European Union.

The final chart I want to show is a consequence of these reserve accumulations for the value of the currency relative to the dollar. The euro has experienced a significant appreciation against the dollar over the past year. That is the blue line at the top that has been rising. The currencies of Japan, South Korea, and Taiwan have experienced a significantly smaller appreciation. Those are these three, which show some appreciation. And the value of the Chinese currency, since it is pegged to the dollar, as represented by the horizontal axis of the chart, has not appreciated at all of course since it is pegged at a fixed figure. So it is an absolute straight line across the bottom. So this economic theory that the currency appreciates, it helps to straighten out the trade imbalances and so forth is just not working.

The trade imbalances are breathtaking. We have the figures here on what has happened to the U.S. trade imbalance. This is the U.S. trade deficit. This is 2001, when your watch began, and this is what has happened to the trade deficit, and the current account of course more or less parallels that obviously. That is what has happened to the current account.

I do not think there is much doubt or ambiguity about what is taking place. Each of these countries is intervening actively in the market to purchase dollars in order to depress the value of its currency. The United States ran trade and current account deficits last year of more than $600 billion, and that was by far the largest we have ever done.

The four countries collectively account for over 40 percent of the U.S. trade deficit. We have now accumulated an external debt in excess of $2.4 trillion, over 20 percent of GDP.

Only yesterday, the Organization for Economic Cooperation and Development released its semiannual economic outlook. The OECD forecasts that the U.S. current account deficit would continue to rise, hitting nearly $900 billion or 6.7 percent of U.S. GDP in 2006. The Chief Economist of the OECD told the *Financial Times,* "We are not saying there will be a doomsday tomorrow morning, but because the adjustments to global imbalances are relatively slow, we are running the risk that an accident will happen. That is where we are. Time is running out. The numbers are getting big, big, big."

It seems to me if we are going to make any progress we have to address this directly, this issue of currency manipulation. Each of these countries is a member of the WTO. All but Taiwan are members of the IMF. Condition of membership in both organizations is not to engage in currency manipulation for competitive trade advantage. Clearly, the intervention has been most egregious in the case of China. There is reason to believe that the other countries in the region, for competitive trade reasons, are hesitant to allow their currencies to appreciate unless China appreciates first. They are standing in the shadow of China, and there is considerable, as I understand it, expert opinion that if China moves they will be able to move as well and get this thing into better balance.

Mr. Secretary, we have differed in the past over how China should try to adjust. You have consistently said, well, we have to move them toward floating rates, and some of us have suggested to you that there is little expectation that they would let their currency float freely because there is considerable concern of the impact on the banking system, and that therefore, the way to approach this is to get a substantial upward revaluation of its currency in terms of the peg, rather than to allow its currency to float.

I notice in *The Wall Street Journal* only yesterday, you say, and I am pleased to see this statement, I want to say to you, "Unfortunately, the debate on China's currency regime is clouded by a number of misconceptions of U.S. policy." I am not sure we misconceive them. I think you may be—I think you are changing U.S. policy. "First, we are not calling for an immediate full float with fully liberalized capital markets. This would be a mistake at this time. China's banking sector is not prepared for such a move today. What we are calling for is an intermediate step that reflects underlying market conditions and allows for a smooth transition when appropriate to a full float."

Actually, I regard that as a significant step in the right direction on the part of the Administration in terms of what we should be seeking and what our policy should be. This notion—the Chinese keep saying, "Well, we want to go to a flexible system," you have been saying. "You should go to a flexible system," then all the experts say, "Well, if they go to a flexible system they are going to have a banking crisis. They cannot go to a flexible system because the banking system cannot withstand it."

So we have this kind of kabuki—wrong country reference—but we have this kabuki going on between us and the Chinese on how to remedy this problem. Now, I gather you are moving away from that position, and it seems to me, obviously, they can reset the peg. How much they do it of course is a critical question, but that would help to address this issue.

Thank you very much, Mr. Chairman.

Chairman SHELBY. Senator Hagel. He is not here.

Senator Bennett.

STATEMENT OF SENATOR ROBERT F. BENNETT

Senator BENNETT. Time is far spent. I will forego, Mr. Chairman, and look forward to listening to the Secretary.

Chairman SHELBY. Senator Bayh.

STATEMENT OF SENATOR EVAN BAYH

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

Mr. Secretary, thank you for being with us, and thank you for your service to our country. You have made some considerable sacrifices to be here, and we appreciate that very much.

You also arrive at an auspicious time when it is nice to be talking about something other than judges, and looking to the long-term economic future of our country. So, I am sure we are delighted to be focused on that here today. I know that I am.

This whole issue of globalization, Mr. Secretary, that this in some ways relates to, is one of the great challenges of our time, the move of our economy from an agricultural based economy to an industrial one, then from an industrial one to a service-based economy, and now looking to the future and thinking about what our comparative advantage going forward is going to be.

I have broken this down into three parts. First and most important, we need to have a positive strategy about what we can do more quickly with higher quality and less expensively than anybody else on earth. What are we going to do to grow our economy and to empower our citizens with research and development, education skills, and all the other things necessary to be globally competitive.

Second, what do we do about those who are dislocated because of globalization, through no fault of their own, people who need to get back on the ladder toward being upwardly mobile? We have an obligation to them than to say, “Well, it is too bad for you. You are on the scrap heap of history and we are moving on.” We need to put into place ways in which through hard work they can get back on their feet, moving forward again.

And then third, Mr. Secretary, as we have discussed before, when we embrace the difficult decisions to define our comparative advantage, when we embrace open and free competition and make the hard choices, the sacrifices, work hard, think smart, and all the rest, what do we do when there are others who choose a different path and instead engage in an industrial policy, or try and cheat on the rules to give themselves an artificial advantage? We owe it to our workers and businesses that when they work hard, think smart and are productive, that the fruits of that effort not be stolen from them by those who would break the rules by cheating.

So the question is, what do we do in a situation like that? And the answer cannot be nothing, cannot be protectionism but it cannot be nothing. And so in some ways we are gathered here today to answer the question, what do we do when countries seek to gain an unfair advantage for themselves through artificially manipulating their currencies? As you heard today, and I agree, I think we have to take a stand.

I know it is a difficult challenge. In some ways it requires you to not only be the Secretary of Treasury but also an international diplomat as well. Our relationship with China is an essential one, one of the most important going forward in this century, and we need to be sensitive to the fact that they have concerns. Particularly, how do they reallocate approximately 140 million excess workers in agriculture to other lines of work? What do they do about surplus workers in their state-owned enterprises? That will require some real transitions within China. And they understandably have a concern about stability within their country. We need to be sensitive to that.

But our sensitivity to the concerns for stability in China cannot lead us to a place where we unfairly displace hard-working Americans here at home. That simply would not be right. So that is the balance that we need to strike, and it is one that we look forward to having a good dialogue on here today, and how do we pursue our comparative advantage economically? How do we do justice for individual Americans and still retain good relations with countries that we need to to secure our national security interests and others moving forward?

I thank you for your time, and would just say in conclusion, we owe it to individual Americans to ensure that there is justice in the global marketplace. I think that is really what this hearing is all about. Thank you for your time.

Chairman SHELBY. Senator Hagel.

STATEMENT OF SENATOR CHUCK HAGEL

Senator HAGEL. I have no statement at this time. I just want to welcome the Secretary and thank the Chairman for holding this important hearing.

Chairman SHELBY. Senator Stabenow.

STATEMENT OF SENATOR DEBBIE STABENOW

Senator STABENOW. Thank you, Mr. Chairman. This is an incredibly important issue that we are speaking about again today. I want to welcome the Secretary for coming before us again, several times now as I have been a Member of the Banking Committee, and each time this issue has become more critical, more severe. It is really now on par with health care costs as an item that is crippling economic growth in our country and is of great concern to manufacturers as well as farmers and all of the business community in my State of Michigan.

I, frankly, Mr. Secretary, have to share the concerns of many of my colleagues who are deeply disappointed with the Treasury report that was released on Tuesday. I believe that the Treasury Department has failed to do what is right and obvious as the report relates to China and Japan. The report states that no country met the technical requirements of the law governing manipulation, and we all know it is occurring. In Michigan, we would say that is too cute by half. I mean the reality is we know it is occurring, but yet we are told it technically does not meet the requirements as we every day are losing jobs in Michigan and across the country.

Most economists agree that China's currency is undervalued against the dollar so it is difficult to see why once again the Treasury Department is unwilling to state the facts. In fact, given the clarity of the problem I am led to believe that something other than facts are driving this reluctance to find violations. I am wondering if it is the fear of retaliation by the Chinese or the Japanese on our goods and services. Is it because, as many of us have said, that we are becoming more dependent on these two nations to shoulder more and more of our budget deficit? Does this relate to the reluctance to move forward? I think these are serious questions and serious issues.

Many of us have warned the Administration that continued large budget deficits would eventually limit our ability to address trade problems, and here we are. The day has arrived I believe.

I am certain that much of the discussion today will focus on China, but Japanese manipulation is a problem that, Mr. Secretary, I hope we do not lose sight of. In Michigan, where auto manufacturing makes up such a large part of our economy, Japanese manipulation is a major and ongoing concern, and I am doing everything I can to make sure that it is addressed.

The decision by the Treasury Department to again go easy on China and Japan will cost the State of Michigan jobs at a time when unemployment remains staggeringly high. Last month, United States gained 274,000 jobs, but in Michigan we added 7,500 to our unemployment rolls. Specifically, China's currency policies have cost the United States economy over 1½ million jobs in the last 15 years, and in Michigan that is over 51,000 jobs. That is why this is such a critical issue for us. These job losses are damaging diverse sectors, not only auto manufacturing, which is critical, but farming, things like apple juice, as well as auto parts and furniture and boat manufacturers. I can go through a long litany of the types of businesses that are being impacted in Michigan, and the jobs that are being lost as a result of that.

The response that the report gives to these facts is that the Treasury Department is "continuing to engage actively with economies to encourage in both bilateral and multilateral discussions flexible, market-based exchange rate regimes combined with a clear price stability goal and transparent systems for adjusting policy instruments."

I think for all of us today listening to those words, it is murky at best. What it means, of course, is that we are talking to the Chinese, we are talking to Japan, and if talk would make this go away, it would have been solved a long time ago. I do not question the sincerity of the talks, but the reality is that talking has not done it, and it, in my opinion, will not get us the results we need.

The Treasury report dedicates one sentence, one sentence out of 17 pages, to the negative effects of currency manipulation on U.S. workers and U.S. businesses, one sentence, but repeatedly describes why manipulation would be bad for China. I am certainly not opposed to being concerned about China, but as colleagues on both sides of the aisle have expressed we are deeply concerned about American businesses and American workers.

First let us be clear about it, that currency manipulation kills American jobs, and it is illegal under the WTO and IMF obligations. Even foreign exchange markets are sending clear signals that China in particular should revalue its currency. I believe there is a strong case for pursuing action against China in both the WTO and the IMF. China's exchange rate policy frustrates the intent of the WTO and can be viewed legitimately as providing an illegal subsidy to exports and imposing an illegal tariff on imports. Mr. Secretary, we need to crack down both on China and Japan and make sure they are playing by the rules.

Finally, I would just indicate, and would welcome your feedback, I have introduced legislation, along with Senator Lindsay Graham and Senator Bayh, who has additional legislation which I think is very important. We have introduced legislation that would create a chief trade prosecutor within the Office of the U.S. Trade Representative. This is an issue and actually a suggestion that came from the discussions with the United States-China Commission members, and it would set up for the first time someone whose job it is to police our trading partners and to basically speak out and take action on behalf of American manufacturers and workers when there are unfair trade practices like currency manipulation.

I am hopeful that we will be able to move that forward. I think it is incredibly important that we not wait for a report every year, Mr. Chairman, but that we have someone who is watching out on a daily basis for our businesses and workers, and working hard every day to create a level playing field.

So thank you again, Mr. Secretary, for being with us, and Mr. Chairman, for holding the hearings. I cannot stress enough the sense of urgency that the business community and the workers in Michigan have regarding this issue of currency manipulation and the larger issue of having a trade policy that creates a level playing field so we can compete.

Thank you, Mr. Chairman.

Chairman SHELBY. Secretary Snow, we welcome you again to the Committee. Your written testimony will be made part of the hearing record in its entirety. You proceed as you wish.

STATEMENT OF JOHN W. SNOW SECRETARY, U.S. DEPARTMENT OF THE TREASURY

Secretary SNOW. Thank you very much, Mr. Chairman. It is always a pleasure to be here and to continue the dialogue that now goes back well over 2 years with this Committee on a variety of important issues, of which none really is more important than the one that has been so well-addressed by your opening comments this morning, and that is the global imbalances.

It is critically important that we address these global imbalances and that we understand them, and that we address them in the appropriate and right way, and China is part of the adjustment process to deal with the global imbalances.

We have said that it is imperative that China move to greater flexibility of its exchange rate. It is only recently though that we have concluded that they have taken sufficient preparatory steps to be able to introduce exchange rate flexibility, greater exchange rate flexibility without untoward risks to their own banking system and to their own financial system.

One reason they are where they are, I think, is the 2-year engagement that we have had with China, an engagement that has secured from them the commitment to move to flexibility, has secured from them the acknowledgement that flexibility is there a float, in other words, is there a long-term objective, and intermediate steps that are really quite remarkable in preparing the way, in putting in place a strong bank regulator and seeking to recapitalize the banks and opening up some financial market opportunities for non-Chinese firms, widening the amount of capital the Chinese can take out of the country, and that non-Chinese can bring in, opening up opportunities for non-Chinese financial firms to engage in their economy.

All of that is designed to strengthen their financial infrastructure so that they will be able to implement a greater flexibility to their exchange rate. They understand the need, I am convinced, to move to greater flexibility, and they have taken a number of steps to prepare the way.

What is different with this report from our prior reports is that we now say, you are ready and it is time to move. And we have clearly indicated in this report that since you are now ready, you have now taken the positive steps to put yourself in a position to do it, failure to do it will weigh very heavily on us when we do our next report. That is really the principal message of this report as it relates to China, Mr. Chairman.

We have appointed a very talented and able negotiator as the Treasury Secretary's representative, a former Assistant Secretary of the Treasury, Olin Wethington, who is now in Beijing, who will be spending an enormous amount of time, energy, and effort—and this is an extraordinarily capable individual—in working with the Chinese authorities, in helping the Chinese authorities come to the conclusion that now is the time to put in place the appropriate flexibility.

One very encouraging note on this is the fact that the Chinese have indicated their interest in having a forward hedge mechanism put in place, in other words, a derivatives market in their currency, and they have engaged the Chicago Mercantile Exchange, the leading currency derivatives market in the world, to enable them to do that. You do not put in place a forward hedge. You do not put in place a derivatives market. You do not do the effort to prepare for a derivatives market unless there is some interest in moving to flexibility.

But having said all of this, let me say, Mr. Chairman, I am disappointed. I know you are disappointed. The Administration is disappointed that we have not seen action, and we are going to stay on this until we get action. I know from your comments in here today and I know from personal conversations with many of you the intensity with which you address this issue. And it is absolutely essential that China adhere to the rules of fair trade. It is absolutely essential that China play by the rules, and whether it is opening markets, or whether it is enforcing intellectual property rights, stopping the stealing and theft of other people's ideas, or whether it is moving to a currency, we are committed to seeing that they play by the rules.

The larger issue that we are dealing with here is, of course, the consequences of a major player in the international global trading system who does not play by the rules and getting their attention to assure that they do play by the rules because the consequences of not playing by the rules, of course, are to invite protectionist measures that I think are unwelcome, untoward and damaging and destructive. So it is awfully important for the appropriate actions to be taken here to ward off things that Senator Allard said none of us want to see come to be.

While the Chinese currency is an important component of the global imbalances, it is not the only one. Global imbalances start with the recognition, I think, that the United States is growing at a rate that is far higher than our trading partners, particularly our euro zone trading partners and Japan.

With our higher growth rates we are creating more investment opportunities in the United States and we are creating more disposable income. Our higher investment opportunities, giving our relatively low savings rates, mean that we have a current account deficit. That is what a current account deficit is, our level of savings opportunities compared to domestic savings. We need to work on both sides of that. We need to save more in the United States. It is critically important that we increase our savings rates. It is also critically important that the euro zone and Japan and our other trading partners put in place policies to grow faster. The framework we are dealing with encompasses all of those points, faster growth, stronger growth, better growth with our trading partners, higher savings rates in the United States, including reducing dissavings through deficit, and I think we are on a good path there to reduce the deficit. The recent numbers were very encouraging.

And finally, China's part, and China is not just China in this respect, China is of course, as I think the Chairman said, most of Asia that ties itself to China for competitive reasons, adjustments of the yuan to get it into closer alignment with underlying demand and supply realities.

Mr. Chairman, we are going to stay on this one until we see the final result that is reflected in China having a flexible currency, reflecting demand and supply conditions.

Thank you very much.

Chairman SHELBY. Mr. Secretary, the Treasury report stops short of labeling China's actions as currency manipulation. You get up to the brink, but you do not cross it. The report also notes that a peg or intervention does not meet the definition of currency manipulation and that the IMF concurs in this assessment.

Mr. Secretary, you are getting close, and I hope that you will finish your work. What condition, Mr. Secretary, or set of conditions would meet the technical definition of manipulation? In other words, what is it going to take?

Secretary SNOW. Well, as I suggested, Mr. Chairman, the fact that China is now ready, has now prepared the way, and——

Chairman SHELBY. To do what?

Secretary SNOW. To move to flexibility, that they now have the technical capability of implementing a flexible exchange rate.

Chairman SHELBY. Do you believe they are going to do that?

Secretary SNOW. Yes, I do.

Chairman SHELBY. And do you believe they are just going to repeg their currency?

There is a lot of difference between floating their currency and repegging it, as you well know, Mr. Secretary.

Secretary SNOW. I do not think it is in our interest or their interest for them to go immediately to a full float. What we like to see them do is take steps in a manner and magnitude that closed the gap between where they are and a float. In other words, I see them on a path to a float.

Chairman SHELBY. Mr. Secretary, what actions, honestly, candidly, will China need to take in the next 6 months to avoid a designation of currency manipulation in your Treasury report to the Congress which is this coming October, 6 months from now? I know you are getting close, but what is it going to take on China's behalf to avoid you designating them?

Secretary SNOW. It is always a fact-based question and it is a complex question and a difficult question, but current trends, if current trends continue, which is large current account surplus with the United States, very large and growing surplus with the world, continuing capital inflows, and build up of large reserves, all of which are the current trends, with inflows of so-called "hot capital" which reflect clearly the sense that the currency is undervalued, those sorts of trend, if continued and no relief for them is put in place in the form of a flexible exchange rate, our certainly the things we would look at in making our next determination.

Chairman SHELBY. Do you believe a timetable has to be satisfactory action by the Chinese with the penalty being such, timetable such as ineligibility to continue IMF assistance, WTO membership, or what? What are you thinking about here?

Secretary SNOW. I am thinking we have their attention and they are going to move. I really believe that.

Chairman SHELBY. It will be interesting to watch. In about six months, you will be back here and we will see what happens.

Senator Stabenow.

Senator STABENOW. Thank you, Mr. Chairman. I first want to thank you for your comments and questions. I think this is really the core. How do we get there? Again, it is nice to have words that are inching along, getting better, but how do we really get to the point where we are going to call it as it is happening?

I know a number of colleagues will speak about China, and so I want to speak for a moment about Japan because both of these are very important, and I support comments that colleagues on both sides of the aisle have spoken to as it relates to China and what is happening, and I think that is why you saw 67 Members on both sides of the aisle vote for the Schumer-Graham proposal on the floor of the Senate, and I expect the same kind of a vote in July at this point.

But Japan, while they have not been fiscally intervening in global currency markets for more than a year, they have been involved in really verbally intervening, Mr. Secretary, and making threats that if the yen continues to strengthen against the dollar, they will resume direct manipulation of their currency, and we have a number of quotes to that effect including just last week from the Bank of Japan, officials saying that they believe that Chinese revaluation would be an unforeseen sudden event that pushes up the yen. Therefore we will have an excuse for carrying out a yen-selling intervention. This was on May 17.

My question is, now that you have chosen to warn China for the first time in this report—and that is a positive thing—why have you not also warned Japan that any resumption of fiscal interventions of remarks from the Ministry of Finance and the Bank of Japan will result in their being named as a currency manipulator as well?

Secretary SNOW. Senator, we are in continuous discussions with the Japanese Finance Ministry and their Central Bank, and our views have been expressed to them any number of times, the view that the world trading system functions best with their reliance on open trade and free trade under rules, with free capital flows and currency arrangements values set in opening competitive currency markets with interventions kept to a minimum.

Now, since I think it is March 2004, March 16, actually of 2004, we have not witnessed any formal interventions, and the Japanese have signed on to that G–7 global framework, which calls for reliance on flexibility, and of course, over the last half of the last 6 months of last year or so, their currency had a fairly significant appreciation.

I think there is a pretty good understanding of what our policies are and what satisfies the requirements of being a good trading partner. We do not want to see interventions occur. We are opposed to interventions. We have made that clear. There have not been interventions for a considerable period of time. Their currency has been appreciating, so while we seem to be on a good course, we are going to continue to carefully monitor that, and we are going to continue to reinforce our views.

Senator STABENOW. Mr. Secretary, with all due respect though, I have in front of me 6 different quotes, one as of last week, and all of them since January, talking about they are going to monitor, they are going to take appropriate action if necessary, will have an excuse for carrying out a yen-selling intervention. They go on and on, we are ready to take proper action against excessive moves and so on. So, I would just suggest again that letting them know our policy obviously is not enough. This is absolutely critical. When I talk to those in the auto industry in Michigan and around the country, they certainly are concerned about China, but they say, what about Japan? This is the area that has been so critically important to us and directly relates to losing jobs, which we cannot afford to lose any more.

I want to ask one other question if I might because I think this relates to both of these things. Because I am very troubled by the fact that there is a reluctance to cite China and Japan as engaging in currency manipulation, and I would like you to address the fact that it is no secret now that Japan and China are funding a large part of our national debt. Together they are funding about half of the foreign debt holdings of our country, and I see adding another $400 billion a year to the national debt when we look at this budget, through a combination of tax cuts and increased spending, while no one is talking about what this does to us in the international arena.

So, I am wondering if you see us continuing down this road, what relationship this will have to our ability to act, when on the one hand we see China and Japan doing things that undercut American businesses and undercut American workers. On the other hand, they are holding more and more of our debt, alarmingly large amounts of our debt. Can you speak to how much this chart relates to our ability to do more than just talk to them about issues of fair play and issues related to our trade situation?

Secretary SNOW. Yes, Senator, of course. China and Japan and the other countries you witnessed there, do have sizable holdings of our national debt. There is no doubt about it. But that debt is widely held, and held on a very diversified basis. And while it is something we monitor, it is not something that is particularly troubling to me. The governments of those countries, including South Korea, Japan, and China recently have issued statements saying that they are not going to pursue diversification of their dollar holdings. Why do they hold dollars and dollar-based assets? Because they are the best assets to hold. It is in their interest to hold U.S. dollar-based assets. We have the deepest, the most liquid, the most efficient capital markets in the world. It is a great source of strength for America that our capital markets are the deepest, most liquid, and efficient in the world, and that investments in those markets provide the best risk-based returns in the world.

So, no. As long as we keep our capital markets working, as long as we keep productivity high, as long as we keep growth high—and I was pleased to see that revised number on the first quarter coming in at 3.5 rather than 3.1—as long as we sustain above-normal growth, high productivity, respect for capital, and maintain these deep, liquid markets, I have great confidence in our capital structure and our ability to fund our obligations.

Senator STABENOW. Mr. Chairman, I know my time is up, and I thank you for your response. I would just say that I have a very different view about whether or not adding to our national debt and having a trade deficit that is even larger than our national debt, which is the largest in the history of the country, and having more and more of it held by countries like Japan and China, whether or not this gives strength for America, and I would suggest that there are many of us that believe it does not strengthen us and in fact puts us in a much more difficult position to act in our own best interest.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Dole.

Senator DOLE. Secretary Snow, I want to follow up on Senator Stabenow's questions. With China's official foreign exchange reserves at $610 billion in the second half of 2004, how much interest does the United States anticipate it will pay China in 2005?

Secretary SNOW. Well, our all-in interest costs, the Treasury's, are roughly about 4 percent, so it is $600 plus billion, $25, $26 billion, something on that order.

Senator DOLE. A May 21 article in the *Economist* states that most economists believe China is concerning three options, the least ambitious of which would be a small widening of the yuan's trading bands against the dollar or a gradual shift from the strict dollar peg to one based on a trade-weighted basket of currencies. Do you believe this option goes far enough to avoid designation under the technical requirements of the law?

Secretary SNOW. Senator, what we have indicated that the Chinese need to do is take steps—and these are of course sovereign decisions; we cannot dictate to sovereign decisions they make, we can indicate what we think is appropriate—but steps of such a magnitude and in such a manner that they clearly get on a path to flexibility, and relieve some of the imbalances and distortions currently associated with the peg. Most observers will tell you that under current circumstances the peg results in undervalued currency. The Chinese are in the best position though, in our view, since it is a sovereign decision, and it depends on local reading of the economy, in which they are far more skilled than we are in understanding their own domestic economy and tradeoffs between job creation and inflation and all those things you have to do for them to make that decision. It has to be a decision to satisfy our report that is a manner and magnitude sufficient to close that gap in a significant way, and get that currency better aligned with underlying demand and supply. In other words, significant enough to improve materially the adjustment process that should be occurring.

Senator DOLE. As you are aware, more than half the loans the banks in China have made are classified as nonperforming, a nice way of saying that they are bad and they are not going to be repaid. In conversations with State Department officials, we were told that we cannot think of Chinese banks as being like our banks, that they are more like government lending programs. Are you concerned that these loans to Chinese manufacturers are nothing more than government grants, further subsidizing their exports?

Secretary SNOW. Senator, the evidence is pretty clear here that the state-run enterprises borrow from the state banks funds that are used primarily to fund payrolls. That is not capital going into the economy to increase long-term output. And in that sense it is a transfer payment, not a loan. So to call it a nonperforming loan in a sense is a mistake. The institutions are not set up as normal banks. The Chinese banking authorities recognize the need to deal with the dual problem here, the problem of state-run enterprises that do not deploy capital very well, and that need to become a smaller part of the national economy over time because they are a source of inefficiency, but at the same time they see a need to fund these enterprises so people are not out on the streets. So it is much more in the nature of a set of transfer payments through nominal banks than it is normal banking activity.

One of our concerns is that some of the reserves of those banks, if China were to go to an open capital arrangement, that people would take the capital out of those institutions, and they would go into primarily dollars which would have the opposite effect from what we are trying to seek here, that is, the yuan come out, they buy dollars, they drive up the value of the dollar. So in our conversations with the Chinese we are very conscious of that risk and we are talking to them about the need to maintain an appropriate measure of capital control so they do not invite these capital outflows.

Senator DOLE. I know my time has expired. I want to just ask one further question very quickly.

Secretary Snow, there are a number of farm families that have contacted my office, people from North Carolina, regarding the tax treatment of the tobacco quota buy-out and the producer payments. The time for signing up expires—I think June 17 is the deadline—and can you tell me when you expect Treasury will promulgate its rule regarding the tax treatment of these payments, because there are families waiting to see that in terms of this sign-up deadline.

Secretary SNOW. Senator, we agree with you. It is being worked on, the guidance is being worked on even as we speak here, and I would expect it to be out very soon. We will meet the deadline.

Senator DOLE. Thank you.

Chairman SHELBY. Senator Bayh.

Senator BAYH. Thank you, Mr. Chairman.

Mr. Secretary, you do not need to respond to what I am about to say, but reading between the lines, it seems to me we concluded that manipulation in fact has been taking place but they have not put into place the steps necessary to make the adjustment in an orderly way until more recently. But that looking out over the next year, understanding that they made those adjustment, we are going to expect something more than lip service moving forward. That is kind of the way I interpreted what you had to say.

I would like to follow on something that Senator Dole said, and you answered this in general. That is, how much is enough. You said we expected something material, to have a material impact on these imbalances. It strikes me that half measures here might be the worst of both worlds, that they could have an impact upon some aspects of our economy without materially impacting our competitive situation. So let me ask you once again, and I do not want to play semantic game or anything, but if their currency is overvalued—or undervalued rather by 25 to 35 percent, how do we define material?

Secretary SNOW. I think, as I said, Senator, if current trends continue and there is not action, we have sent the pretty strong signal—you read us right—what the outcome would be. I do not want to define "material." We do have people in private discussions with the Chinese, and those discussions are probably better left to the discussants. But it has to be enough to matter. It has to be material and significant. I do not want to put quantification on "material and significant," but——

Senator BAYH. Fair enough. I think the two—for others who are listening, just to strengthen your hand—superficial steps alone will not be enough. This issue will not be addressed either substantively in a fair way or otherwise until we have achieved something more than superficial steps.

Secretary SNOW. Absolutely. We will not accept that as changing the current course that China is on. It has to be material and significant. It has to change the adjustment process in a real way.

Senator BAYH. I apologize for having to step out. There was a call I had to take during Senator Stabenow's questioning. I gather she asked you about sovereignty and our concern about whether our position in other negotiations was affected by our need to borrow from China these days.

I would like to ask for your reaction to something. I think it was a month or two ago there was a rumor going through Seoul that the South Korean Government might begin diversifying out of dollar-denominated assets, and for a period of time there our currency fell into a free fall until the rumors were put to rest. Several weeks after that the Prime Minister of Japan, in some public comments, either inadvertent or not, said that perhaps Japan should start diversifying at dollar-denominated assets. Again, our currency went into a free fall until someone in the Ministry came out and corrected the record.

What does that say about our position of financial strength when a rumor in another country or an inadvertent slip of the tongue by a foreign leader can lead to a sharp fall in something as important to our national well-being as our currency? Is that not a sign of weakness rather than strength?

Secretary SNOW. Senator, of course, those countries, China, Korea, Japan, have all indicated that they want to continue to hold and will continue to hold dollar assets and do not intend to diversify out of dollars. Currency markets tend to trade on rumors and that is the nature of these markets. They trade both ways on rumors.

Senator BAYH. I appreciate that, but is it not a sign of our dependency rather than our strength and independence?

Secretary SNOW. Senator, no, I would not look at it that way. As I said earlier—I think you were out—that the countries that hold dollar-based assets do so because we have the deepest, most liquid, and most competitive capital markets in the world. We talked earlier of the jewels of America. Our capital markets are absolutely one of the great jewels. There is nothing else like the U.S. Treasury market anywhere in the world. There is no other market nearly as deep and liquid, where sales can occur readily. The Treasury market trades at over half a trillion dollars a day. So that, no, we are not in any way beholden, if that is the question, or is our economic policy or international policy being held hostage in any way. Those countries are holding dollars because it is in their interest to hold dollar-based assets.

Senator BAYH. Is my red light on, Mr. Chairman? Thank you, Mr. Secretary. I would only observe that, in conclusion, I understand that, but sometimes great nations make decisions based upon something other than maximizing their financial well-being. It is possible that some of these countries might take a course of action that we would view as not optimizing their finances for other reasons, and that might not inure to our benefit. But, again, I thank you for your presence and your service.

Mr. Chairman, thank you.

Chairman SHELBY. Senator Allard.

Senator ALLARD. Thank you, Mr. Chairman.

What has happened to the Japanese or the Chinese thinking from the previous report to this report here now that you are bringing forward where all of a sudden they are having a change of heart? It is not entirely clear to me how we got from there to here, and I would like to have you explain that a little bit. And then if they do not—or if they just change the peg, for example, and do not really go to the market, then what are the consequences that you see for them and what do you see the consequences would be for us? I would appreciate if you could respond to this.

Secretary SNOW. Briefly, Senator, what has changed is the fact that we have come to the determination that, after long engagement with the Chinese now, their financial system could accommodate greater flexibility, that it could accommodate it in the sense that it would not create untoward risk, systemic risks to their financial system, particularly if they keep appropriate controls on capital outflows. So that is the principal thing that has changed.

We have had extraordinary involvement with them here with technical teams of Treasury experts in China and their teams over here, just lots and lots of work to make sure the foundation is laid for effectively implementing greater flexibility.

Now, you asked what happens if they just raise the currency or raise the value of the peg by some amount? Going back to the earlier discussion, that will not satisfy the requirements here in and of itself unless it is material enough to get the currency into the alignment with underlying forces that we do not see today. In other words, virtually everybody who looks at it says the currency is undervalued under current circumstances by some amount.

Now, there is a wide variety of opinion on that. The only way to really get the correct answer to that is to use the marketplace. The only way to find out what equilibrates a market is to let the market work. We cannot a priori determine what the price will be for selling hog bellies. You have to let a market work to determine what that is. But you can put in an intermediate price and see how the demand and supply forces adjust to that intermediate price, and maybe with a band around it to give some room to see whether it goes to the higher end or the lower end of that band.

We want China to come up with the right answer to that. They are in a better position than we are to determine just what is the appropriate intermediate mechanism. But we want them clearly, Senator, on a path that takes them to the end result of a float, of a freely fluctuating exchange rate. That is the objective here.

Senator ALLARD. I am going to talk a little bit about the distribution issue and those distribution services in China. Can you explain why the distribution rights are so important to expanding U.S. business in China and how the Treasury is seeing that these rights are expanded?

Secretary SNOW. We are in continuous discussions on financial market openings with the Chinese authorities. The USTR handles the general market openings and trade issues with Commerce. But the financial side of those discussions is really—Treasury has the primary role, and we are continuing to press the Chinese for wider opportunities for our firms, for foreign firms to participate in their financial markets. And here, Senator, we have seen some good progress. They have opened up an auto finance industry, anticipating that as they move into higher income status and more people out of poverty and more middle-class citizens, there are going to be more people buying cars, they need a finance industry. We have seen them open up opportunities for non-Chinese insurance companies. We have seen them open up opportunities for stock brokerage operations. So there has been a lot.

Now, they are doing it because it is part of WTO accession, but they also know that it is what is important for them to modernize their financial structure, to bring in the capital and expertise from abroad. After all, this is an economy that has had relatively little experience with anything but command and control. And there is a good appreciation on the part of the technical people in the government, the Zhu Rongji coterie of people who understand the importance of letting markets work, of letting interest rates play a role, and having financial expertise and bank examiners and bank auditors and all of the infrastructure of a strong banking and financial system in place.

So we are making progress. Is it as fast as we would like? No. But is it real and is it measurable? I would say yes, it is.

Senator ALLARD. It looks like my time has expired, Mr. Chairman. Thank you.

Chairman SHELBY. Senator Sarbanes.

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

Mr. Secretary, your own reports states that concerns of competitiveness with China also constrain neighboring economies in their adoption of more flexible exchange policies. I take it from that it is your view that China's currency manipulation is putting pressure on some of our other Asian trading partners to suppress the value of their own currencies, which would contribute to further deteriorating our global trade balance. Is that correct?

Secretary SNOW. Yes.

Senator SARBANES. Is a general appreciation of Asian currencies plausible without a substantial appreciation of the Chinese currency?

Secretary SNOW. No. I think large parts of Asia are linked competitively to China, and that means to the yuan.

Senator SARBANES. If China moves in a substantial way, will the Treasury raise the issue of currency manipulation with other Asian countries, particularly Japan, Taiwan, and South Korea?

Secretary SNOW. Senator, we are in discussions with countries all through that region about what we think is the appropriate policies for FEx, for currency, and yes, absolutely, if we see countries that are not pursuing the appropriate policies, we will engage with them, absolutely.

Senator SARBANES. I am interested to get some sense of the extent to which the current account deficits matter. Your predecessor was rather dismissive of the current account deficits. To finance our current account deficit, the United States borrowed $666 billion last year from abroad, more than 5.5 percent of our GDP. You only have to go back to the early 1980's when the United States enjoyed a sizable international credit position with the rest of the world worth 12 percent of our GDP. We were a very strong creditor nation. Now we are the world's largest debtor nation.

In his annual letter to shareholders, Warren Buffett recently wrote: "Should we continue to run current account deficits comparable to those now prevailing, the net ownership of the United States by other countries and their citizens a decade from now will amount to roughly $11 trillion. And if foreign investors were to earn only 5 percent on that net holding, we would need to send a net of $0.55 trillion of goods"—over half a trillion—"and services abroad every year merely to service the U.S. investments then held by foreigners. This annual royalty paid the world, which would not disappear unless the United States massively underconsumed and began to run consistent and large trade surpluses, would undoubtedly produce significant political unrest in the United States."

What is your view of this potential situation?

Secretary SNOW. Senator, as I have said, we think that there are important imbalances in the global economy that need to be addressed. We have tried to put in place a constructive framework for doing so. It is a framework that we have put in place with the G–7, for instance, with the IMF. Rodrigo Rato, the Managing Director of the IMF, and I talk about this regularly. We talked about it yesterday morning and yesterday night, actually. That framework, though, it is awfully important to understand this. This framework involves others besides the United States, in addition to the United States. It involves the United States. We absolutely have to bring our deficits down, reduce our net dissavings through governmental policies. We absolutely have to raise household savings rates.

But other parts of the world need to do things, too. They need to pursue policies that will create larger domestic economies that will absorb more of their savings. They need to develop policies that will make their economies more productive and innovative so that our goods will find more of a market. And China and Asia needs to move to flexibility. That combination of things I think will restrain the growth and eventually turn the corner on the current account deficit.

But it is something we follow and monitor very closely, and we have tried to put in place a constructive—we and the other finance ministers and central bank governors from major parts of the world have tried to put in place a framework to deal with it.

Senator SARBANES. There is some concern that the shift in the Treasury's position is in part a move simply to forestall a gathering momentum in the Congress to pass limitations that would affect the United States-China trade, and that the Administration, if they could get some relatively minor adjustment in the peg rate—I mean, I see these preposterous figures being talked about in some articles of 5 percent, and I see the Chief Economist of the China International Capital Corporation says it remains too risky to relax the peg too much, so China may well start from a 5-percent revaluation. The Chief Economist of Galaxy Securities in China says, "The making of decisions in China is mostly consensus-based, so that might lead to a compromise of a 3- to 5-percent rise in the renminbi's value."

It seems to me that thinking in those terms it completely misses the mark. I do not see how you begin to address this problem if that is the framework in which it is being thought about.

I noticed the European Central Bank President has now explicitly stated publicly, calling in unusually frank language—this is an article in the *Journal*—for China to allow its currency to appreciate against the U.S. dollar and, therefore, the euro in a bid to damp the surge in Chinese exports. I think many of us see this as approaching a crisis status, and the magnitude of what is being talked about, at least in some circles, seems totally inadequate to the problem.

What is the Treasury's view about that?

Secretary SNOW. Senator, our view is, as stated in the report, that this adjustment has to be material and has to be significant, has to be something that will significantly close the gap between the current value and a more appropriate value.

As I said earlier, we have a very able representative of the Treasury Department like you and Senator Schumer, a fellow graduate of the Harvard Law School—where I guess you learn a lot about negotiations—in China right now dealing with the Chinese authorities. He is diplomatic, but he is plain-spoken, and he is real smart and he knows how to get ideas across. I am confident that there will be no misunderstanding that when we say material and significant and significant step on the path to flexibility, that he will convey what needs to be conveyed.

Senator SARBANES. Mr. Chairman, could I close with just one final observations?

Chairman SHELBY. Sure, go ahead.

Senator SARBANES. Under the first Bush Administration, the Treasury Department twice found that China was engaged in currency manipulation. In both instances, China was running a trade surplus of about 3 to 3.5 percent of GDP against the United States as compared to the 9.8 percent it ran last year, just under 10 percent. Back then, in the early 1990's, China had a global current account surplus of around $13 billion. Of course, we saw earlier what the figures are now. They are astronomical. And that does raise the question—and I am not seeking an answer. I state it as a rhetorical question. If China was manipulating its currency under those circumstances, how can we possibly find that it is not engaged in manipulation now?

I would pursue with you what these technical items are that you say have forestalled you from finding—our current technical requirements from finding currency manipulation now, but I think it is clear this issue is not going to go away. I think the Congress will continue to press it, and press it very hard. And in some respects, the most direct thing that Congress can do is this legislation that some of my colleagues have put in which would affect the duties on the flow of goods into this country. And obviously there is considerable support in the country for such a measure.

Let me see if I can find it here real quickly. The President of the National Association of Manufacturers said, "If this is not currency manipulation, then what else would ever qualify?"

I will leave that question with you. Thank you, Mr. Chairman.

Chairman SHELBY. Senator Hagel.

Senator HAGEL. Mr. Chairman, thank you.

Secretary Snow, welcome.

Secretary SNOW. Thank you.

Senator HAGEL. I know we are talking this morning about currency exchange rate policy and that is the object of the hearing. But I do not think, as has been evident in our exchange this morning, that we can talk about currency and exchange rate policy in a vacuum. The fact is, as you know so well, we are part of a global marketplace. We are part of a world trading regime. Currency is a big part of that, an important part, but there are many other dynamics that flow into that.

I have been over the last few months concerned that we have focused so totally on currency that we are missing some of the other big pieces here. You had noted not only in your statement by in conversations that we have had privately and other opportunities you have had to talk about this issue, and realizing, as you have said this morning, that you are not the Trade Ambassador nor the Secretary of Commerce, but you are integral to the larger picture of trade.

I would like to take the time I have, Mr. Secretary, to ask you to delve into, for example, internal reforms that you all have been working on with the Chinese, banking reforms, transparency, Senator Allard talked about distribution rights, intellectual property issues, opening up more opportunities for our financial services to compete and participate in China. But it seems to me we may be missing a point here. We are so focused—not everyone—on the currency and the exchange rate that we are letting all the other bigger issues in one sense and far more reaching with far more significant long-term policies and consequences in currencies, that we are not maybe paying enough attention to those, like getting our medium and small businesses into China and doing everything we can to break down those walls, to your point the growth of America's economy. Every conversation we have had this morning is about that, sustaining and strengthening that growth.

Yes, at this point in the marketplace and in our history, we are running deficits. Those are not good, and you noted that. And, by the way, I think you and the Administration deserve some credit for a lot of the things that you are doing under the radar that do not get the attention and the headlines. But you are setting a baseline here that is very important for, I think, the one issue here that we are not paying attention to, and that is America's future competitive position in the world. That is complicated because it enlists many dynamics, and many of those are uncontrollable.

But let us go back to something fundamental. We are in a world marketplace. Trade is not a guarantee. Trade is an opportunity. And we have everything at stake here. And so the blips in the currency and the exchange rates quite frankly do not bother me. What does bother me is that I want to be assured—and I think we all do, and America needs to be—that we are doing what we need to do, is open up those markets for American competitive positions and our products.

With that, would you care to respond to any of that, Mr. Secretary? Thank you.

Secretary SNOW. I would, Senator Hagel. Thank you very much.

I could not agree with you more. This is about a lot more than the currency. Currency is an important component, but it is far from the whole story. I think China will move to a flexible currency because they are going to find it is in their own interest to do so. But if that is all that happens and we do not get market openings to let our firms go in there, and then if when our firms get in there they get knocked off and their products counterfeited so they cannot succeed, we have not accomplished very much.

So while the currency is important and we are going to continue to press it, the activities of your former colleague, Congressman Portman, now Ambassador Portman, are right at the center of this, and Commerce Secretary Carlos Gutierrez, and you may know that the three of us, with the NEC, meet regularly to make sure we have a strong, well-formulated, well-conceived, and clearly understood among us policy, the end product of which is you have to play by the rules. You have to play by the rules. And the rules are you are in our markets, we need to be in your markets. We do not rip off your public sector, we respect intellectual property rights, you have to respect intellectual property rights.

I think you are going to see continued, forceful communication of those basic ideas with the Chinese and with the whole trading world, because it is not just China, but they are the largest single example of a place where the policies need to have major reforms.

So, I agree with you. We are going to continue to press on the currency issue, but others are going to press on the other issues, and I will press on these financial market openings because many of Senator Schumer's constituents, I know, are very interested in being in China. They come and talk to me about it and ask for our help in making sure that the weight of the U.S. Treasury is there to press for market openings, and we are delighted to do that.

Senator HAGEL. Mr. Secretary, I would just add, with the indulgence of the Chairman, I think the Olin Wethington appointment was a very good one, and I congratulate you on putting someone like him who understands the real world in that position so that it gives us not just a monitoring position by an active participant in this process to do the things that you and your colleagues are attempting to do.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Carper.

STATEMENT OF SENATOR THOMAS R. CARPER

Senator CARPER. Secretary, welcome. How are you doing?

Secretary SNOW. Fine, sir. Nice to see you.

Senator CARPER. Very nice to see you.

I apologize. As you can see, now I am here. We have a lot of different hearings we are trying to get to, and this is the third I have stopped by. I have one to go this morning.

I was just going to ask you to just take a minute or two and just show us in a couple of takeaways that you want to be absolutely sure that we walk out of here being aware of. And underline and put an exclamation point at the end of them for me.

Secretary SNOW. Senator, the big takeaway from our report is China is ready to move to a much more flexible exchange rate. They have prepared the way, and now is the time for China to act. If China stays on the course they are on today, without major alteration, then we will have little option but to find them as a manipulator under the technical requirements of the statute. That, I think, is the large message of our report.

Senator CARPER. Even if that were to happen, how significantly would that affect the imbalance that we now have in trade?

Secretary SNOW. The trade imbalance with the global economy, I think, would be affected significantly over time if China moves to a flexible exchange rate that reflects the underlying conditions, allows the market to set it overall, because I think their movement would affect currency valuations with their competitors, who very much watch what China does, and that would lead to adjustments which I think would be favorable for our balance of payments and for our current account.

With China itself, I think there would be a healthy adjustment process. But I think for the foreseeable future we are going to have a trade imbalance with China. I do not think that moving to a flexible exchange rate is going to eliminate our trade imbalance with China, but it would help the overall adjustment process.

Senator CARPER. If our trade imbalance with China were somehow magically eliminated altogether, do you have any idea what our trade imbalance with the rest of the world would be now?

Secretary SNOW. Well, it depends how it gets eliminated. If it gets eliminated because China revalues, moves to a flexible exchange rate and their currency goes up, and then the exchange rates of their competitors go up, then of course the United States is being put in a better position. That would narrow our trade deficit not only with China, but also with large parts of the rest of the world. So it would be a positive development.

Senator CARPER. Do you know, when we try to quantify our trade imbalance from last calendar year, do you recall what it was with the rest of the world?

Secretary SNOW. Yes, we were $500 billion or so.

Senator CARPER. And roughly how much of that was attributable to China?

Secretary SNOW. Last year, it was around $100 billion.

Senator CARPER. So if we eliminated it altogether, we would still have a trade imbalance of over $400 billion?

Secretary SNOW. Well, that is right, Senator, that—China is a part of the trade imbalance. They are roughly $160 billion on $700 billion—or $680 billion. So they are a significant part, but they are not the whole story.

Senator CARPER. When you look at the imbalance with China, has it been growing in recent years? It has, hasn't it?

Secretary SNOW. Yes, it has.

Senator CARPER. When you look at the imbalance with other parts of the world with whom we trade, what is going on in there? Are those imbalances growing as well? Are some stable, others growing, some dropping?

Secretary SNOW. Well, the picture with Asia is general imbalance; it has been rising. The picture with Europe is a slower rate of rise of an imbalance.

Senator CARPER. How about Canada, Mexico, the people to the south of us?

Secretary SNOW. We have a better trade picture with them than we do with Asia, that is for sure.

Senator CARPER. You have probably already talked about this and you may have said this in your testimony. I hear from a growing number of people, not just in Delaware but around the country, who are past unease to a growing sense of concern, even alarm with the magnitude of our trade deficit and the magnitude of our budget deficit. And I am hearing people say to me these are just not sustainable; this level of trade imbalance and budget deficit are not sustainable.

As you look forward down the road and you project ahead, what do we see for this year or next year, maybe the year beyond?

Secretary SNOW. I think we see a pretty good picture on the fiscal deficit. The numbers that just came in for the April tax receipts showed a very sizable pickup in Government receipts, well over 20 percent over the prior year quarter, causing us at Treasury to conclude that we could reduce our borrowings by some $40 billion or $45 billion, causing the private sector forecasters to bring the deficit well down below the initial forecast of $427 billion to about—well, they vary, but in the $350–360 billion range, which would put us at around 3 percent of GDP and, I guess, make us eligible to be a member of the EU, since they have a 3 percent rule there.

With respect to the current account deficit, the numbers we had last month on trade imbalances were encouraging. Imports were down and exports were up. One month does not make a trend, but it is at least positive to have those numbers coming in that way. The revised growth numbers for the first quarter, which went up from 3.1 to 3.5, reflected stronger exports and also reflected higher productivity and more people working.

So, I think the receipts side of the U.S. Government is going to continue to show good results, which means we will be on path to bring the deficit down, as suggested in the budget materials we sent up earlier this year, to a level by 2009 of well below 2 percent of GDP, something on the order of 1.5, 1.6—which of course was quite low by historical standards. We are on the right path there.

Senator CARPER. Thank you very much again for being here. I will just conclude to my colleagues that I believe the numbers that Secretary Snow has shared with us on the declining budget deficit assume, really, no further outlays with respect to Iraq. And I think they presume that we are not going to do all that much to fix the problems we have with the Alternative Minimum Tax and some of the other tax issues that are staring at us down the road.

But thank you so much. It is great to see you.

Chairman SHELBY. Senator Bennett.

Senator BENNETT. Thank you, Mr. Chairman.

A few quick comments on the discussion that has gone before. Many of the goods we currently import from China we used to import from other countries. And China, as it has become more productive, has not been stealing jobs from the United States; they have been stealing jobs from Mexico and Singapore and Malaysia and other places. So we should understand that. This is not just the United States vis-á-vis China, it is China's growing power in the world taking over other jobs—or other goods, I should say, not jobs—other goods that used to come from other countries that are now losing out to China. We are not losing out to China. I think we should make that clear as people talk about, gee, China is now sending us so much more than they used to. It is not a sum zero game with the United States. There are other countries that are affected more than we are.

Let us get back to the whole question of the currency adjustment that you have been talking about this morning, Mr. Secretary. It has always been my impression that if China is going to be a full player in a mature world economy, they are going to have to play by the same rules that the other countries do. So it is in China's long-term interest to let their currency react to the rest of the world economic pressures the same way other countries let their currencies. The problem is that they feel it is in their short-term interest not to do that. And it seems to me, therefore, that the problem that the Chinese decisionmakers are faced with is when do we shift from a short-term strategy to a long-term strategy. And the longer they wait, the greater the disruption that occurs both in their situation and in the rest of the world's.

To use a term that is used in other contexts, we need to find a soft landing for them—or they need to find a soft landing for themselves, to be more accurate about it, because we cannot control what they do. However much we tell our constituents during campaign time that we Senators control all events all over the world and if you just vote for me all of the world will be marvelous, that campaign fiction does not hold up when we come into the world. It is in their interest to find a soft landing when they can make the transition from the short-term advantage that they think they get from manipulating the currency to the long-term advantage that they get when they join the world like the rest of the countries in the world. And I gather from what you are saying today, they are beginning to move toward that soft landing and recognizing that it is in their self-interest to do the kind of thing we have been urging them to do.

Can you give us a sense, without violating any of the sensitive information that might be coming out of the negotiations that are going on in China, as to whether or not they recognize the accuracy of what I have just said and if they have any sense of how quickly they want to get to a regime that is more logical for their long-term goal of being a full trading partner?

Secretary SNOW. Senator Bennett, I think you have well-defined the dialogue that is going on in China now. The technical people, the people at the academies, and the people at the financial institutions, the Ministry of Finance and the Central Bank, in my view from conversations I have had, clearly understand that it is in China's own interest to move. But they do not make that final decision. The final decision is the political decision through the State Council.

Senator BENNETT. That is what is wrong with China: The final decision is made still in a communist atmosphere rather than a free market atmosphere.

Secretary SNOW. And I think that debate is going on right now. In my meetings with the Chinese political leadership, I have emphasized that—what you said: It is in your interest to move; failure to move will build up these imbalances and distortions in your own economy. Because after all, what having a peg means is that they have surrendered control over their own monetary policy and they no longer have a monetary authority that can lean against the winds of inflation or deflation, so these imbalances cannot be dealt with except through command and control, not through market processes, which always introduces the distortions you are talking about.

Olin Wethington is going to continue every day to be making that case, that it is in your interest to move and the longer you wait, the larger the distortions. And I am convinced that the momentum is all on the side of a decision that will put China much more in the mainstream of a flexible currency regime.

Senator BENNETT. If I might just quickly, Mr. Chairman, a final observation. As I look around the world, I see economy after economy, including the European Union, that is being structured for export. These economies are not growing as rapidly as the United States'. As you have noted Mr. Secretary, we are growing at 3.5 percent, maybe even higher, through this year. There is not an economy of substance anywhere in the world that is anywhere close. Which means we are carrying the rest of the world. And they structure their economies for export, and we are the only place where the economy is structured for consumption.

And somehow, somewhere down the line, as you have said here repeatedly and I want to underscore, the other economies in the world had better start consuming because the United States, no matter who is President or who is Secretary of the Treasury, cannot, long-term, carry the rest of the world with us. We have to increase our savings and the other countries in the world have to increase their consumption if we and they are going to prosper. If they depend upon us ultimately to consume their goods in perpetuity, we are not going to be able to do that.

So whatever we can do to get them to understand that—as I say, the Europeans are going down this same road. This is not a Chinese conspiracy against the United States or a Japanese conspiracy against the United States. They have to start consuming themselves and then create a rate of growth, maybe not approaching the United States' rate of growth—China, of course, is higher than we are, but the base is so much lower that it is distortive to look at the two growth rates and make that comparison. The other countries in the world have to recognize that in a period of globalization or an economy without borders, they cannot expect and it is not in their self-interest long-term to try to have the United States being the only consuming economy in the world. And our rate of growth that makes it possible for us to consume must be tempered by a rate of growth elsewhere. This is not a partisan issue or a Republican-Democrat issue; this is something that all of the world economies have to understand and work toward.

Thank you, Mr. Chairman, for your indulgence.

Chairman SHELBY. Senator Schumer.

Senator SCHUMER. Thank you, Mr. Chairman.

I still am a little confused about how we stand. As you know, I have appreciated the movement in the new report. But here is what I would like to know. It is both a prospective and retrospective question.

First, what has China done differently over the last 6 months—you have said there is progress—that has moved it closer, in your view, to the statutory definition of manipulation? What is this progress—or not progress, what is—I mean, in other words you say there is progress, but the report seems to be more harsh on the Chinese than the previous reports.

Secretary SNOW. Senator, there is one——

Senator SCHUMER. And the second, which is prospective. Let us say they do not change anything over the next 6 months. How can, then, they be found to be manipulating if they are not manipulating now? You know, my view is simple: They are manipulating now and you just did not want to say it for some diplomatic/political reason—that may not have bad motivation; I am not denying that. But I am a little confused. What was different 6 months ago that—what they do worse, and what do they have to do to get better? What if they do not change? Because I do not think they have changed at all, except in verbiage, which matters nothing to trade.

Secretary SNOW. Senator, what has changed, of course, is that surpluses have become larger.

Senator SCHUMER. That is an effect, not a cause, of what they are doing.

Secretary SNOW. And the reason that we are now prepared to act as we suggested in the report is that, whereas in prior reports we did not see them fully ready to move to substantial flexibility, we now see them ready to do it. Their financial system can accommodate flexibility.

Senator SCHUMER. So the lack of progress, given their ability to progress, is what makes it worse.

Secretary SNOW. Exactly.

Senator SCHUMER. And so you could say that 6 months from now, if they did nothing, you might be ready to call them manipulators. I did not say you would, but could.

Secretary SNOW. Could. That is right.

Senator SCHUMER. Well, that is important and I appreciate——

Secretary SNOW. You have hit on precisely the distinction.

Senator SCHUMER. So it is somewhat normative. It is not an absolute standard.

Secretary SNOW. No, this is a standard that is somewhat——

Senator SCHUMER. It is based on what the Chinese are able to do.

Secretary SNOW. Right.

Senator SCHUMER. Okay. The next question is, let us say 6 months from now they are officially designated a currency manipulator. And let us hope that does not happen. Let us say they take action on their own. What specific actions would this Administration take to get China to change its practices? You can ask me that question, I will tell you what I would do. But I am now asking you that question.

Secretary SNOW. I think you and I would have different answers to that question.

Senator SCHUMER. I think so.

Secretary SNOW. I do not think it is helpful to speculate on what they are going to do.

Senator SCHUMER. What you are going to do if they do not change.

Secretary SNOW. What we are going to do. Except I will speculate on what they will do. I think we are going to see action by China—and I may have to eat those words in 6 months if you invite me back.

Senator SCHUMER. Oh, well, we are going to have you back. We would be delighted to do that.

[Laughter.]

Secretary SNOW. But I fully anticipate that before I return, before we conclude the next report, that we will have seen the action by the Chinese that we are calling for.

Senator SCHUMER. A second question relates to interest rates and the pegging of the yuan. Some have expressed concern that if China revalues the yuan, interest rates here in the United States. may rise. This is the same—I mean, people make such arguments. First they say, well, you should only make them increase it 5 percent, and then that will not change the trade deficit very much. I mean, you know, it is beggar thy neighbor arguments. Because we do not—5 percent will not be good enough for me and, I think, most of my co-sponsors on the legislation. Again, it does not have to be moving it immediately, but they have to begin to move soon and have a path for movement with a set date.

So they now are saying, oh, interest rates will go up. Now, excluding Social Security, the U.S. budget deficit approaches $600 billion this year, once the new war costs are added; our current account deficit is already over $600 billion, as you have noted. A large and rising trade deficit combined with large budget deficits reduces global confidence in U.S. assets, which could cause asset prices to fall and rates to rise. In other words, doing nothing might also raise interest rates because people are getting more and more upset—who knows when you reach the tipping point—about inaction. So that is why I think your new currency report says the risks of delay outweigh the costs of reform.

So, I would like you to explain this further, particularly as it relates to domestic interest rates.

Secretary SNOW. Senator, I do not think we need fear much at all on the interest rate issue. After all, treasuries trade daily at over half a trillion dollars.

Senator SCHUMER. Right. Exactly.

Secretary SNOW. What we are talking about here is small relative to the volume of trading.

Senator SCHUMER. No, people who just do not like our proposal do these arguments. But I agree with you. They can say, oh, it will not change the trade deficit much, but it will change interest rates much. That is contradictory. The percentage of Chinese action as a whole of our trade deficit is a lot greater than the percentage of Chinese action as a whole of our interest rates measured by treasury trades.

Okay, I have an unrelated question, which I would like to ask you since I am the last questioner even though I wasn't the last to be here.

[Laugher.]

Chairman SHELBY. I think you left.

Senator SCHUMER. No, whoa, whoa, whoa, whoa. Okay, in any case, I am happy to spend more time with you all.

This is about terrorism insurance, which is on our minds, and there is a deadline coming up so I thought I would, while you are here, take advantage.

We are just a little over a month away from the Treasury's deadline to submit the terrorism risk insurance report to this Committee. As you know, many of my colleagues and I would like to see it submitted as soon as possible. We want to get a bill extending TRIA right away. I can tell you not just in New York, which is the epicenter for this, but in other areas, you are having projects now slow down, something none of us want. The ratings agencies have told the reinsurers that they will not give ratings unless we have a bill for future years, so you cannot plan a project that might go into the ground or need its money come January 1. And as you know, these large real estate projects cannot be turned off and turned on.

So we really need to renew our bill. And certainly, whether people agree or disagree with our bill, to make a decision soon makes sense so business people can plot their actions. How close are we to completing the report? Is it possible to get it before June 30, because our schedule, if we got it a little earlier, maybe we could pass a law by July 31, when we recess for a month.

Secretary SNOW. Senator, thanks for raising that important issue. I am reviewing now the final version of the report. It looks good. A lot of work has gone into it. It is my contemplation and certainly hope that we will have it well in advance of the June 30——

Senator SCHUMER. That is great news. Thank you.

I am going to conclude on that happy note, Mr. Chairman. Thank you, Mr. Secretary.

Chairman SHELBY. Secretary Snow, to use a football metaphor, I think you were driving down on, you probably had a first down on China's 20-yard line. And instead of keeping on going and perhaps reaching the obvious conclusion in your report, you elected to punt. I hope you will not continue to do this.

We are inviting you now and we will continue to invite you back in October, because we think this is a very important issue. And it is very complicated, we all know that. But just about everybody in the world recognizes that China is, has been, and will probably continue to manipulate its currency because it gives them certain advantages.

The question is, when are we going to recognize that. And I hope you will. I hope you will if you have to, because if you come up here in 6 months and China has not done anything really material to make their currency flexible, then I think the Administration will lose a lot of credibility in that area.

Secretary SNOW. Mr. Chairman, I thank you for that. And with Senator Schumer leaving and you here, and your analogy to the football field, let me say——

Chairman SHELBY. Senator Schumer might come back. He is a busy man.

Secretary SNOW. No, I want to say one last thing in response to that football analogy, and that is we have a player we would like to put on the field, a quarterback for this initiative, Mr. Tim Adams right here, who has had his hearings to be the Under Secretary for International Affairs. If we had him on the field, I think our chance of throwing touchdowns would be a lot better.

Chairman SHELBY. We have you on the field, though. You are the Secretary.

Senator SCHUMER. Mr. Chairman, he is the general manager and President Bush is the owner.

Chairman SHELBY. Absolutely.

Secretary SNOW. Here is our quarterback.

Chairman SHELBY. We understand.

Secretary SNOW. Thank you, Senator.

Chairman SHELBY. Thank you.

The hearing is adjourned.

[Whereupon, at 12:12 p.m., the hearing was adjourned.]

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

PREPARED STATEMENT OF SENATOR CHARLES E. SCHUMER

I appreciate the opportunity to continue to discuss with the Secretary the issue of China's undervalued currency and its general unwillingness to play fair in the global economy—or its pattern of playing by the rules only when it suits their purposes. The Administration's strategy of "quiet diplomacy" has yielded few tangible results, and it is time for our Government to take more specific action.

Secretary Snow, as you know, I have long been concerned with China's long list of misdeeds—currency manipulation, violation of intellectual property laws, limitation of access to their markets, and subsidizing Chinese companies—misdeeds that also happen to be serious violations of WTO rules.

We have lost a lot of jobs here in the United States because of these actions—but the problem goes beyond job losses. It remains a mystery to me how those who claim to support free trade can stand so idly by while one of the fastest-growing economies in the world so willfully flouts the rules.

Simply put, if you believe in free and fair trade, you should want the Chinese to play by the rules, and you should want their currency to float. The "invisible hand" at work, so to speak. I was glad to see in your testimony that the Administration now supports a gradual shift toward a full float in China. The question is, how do we push them to get there?

I have been working with my colleague from South Carolina, Lindsey Graham, to try and level the playing field with China on the currency issue. We introduced an amendment on China currency during consideration of the State Department Authorization Bill a few weeks back, and to our pleasant surprise, two-thirds of the Senate voted with us—including half of the Senators of your party, Mr. Secretary. This sends a clear signal to the Chinese to shape up. We have been promised an up-or-down vote on our bill before August recess.

It would be preferable, rather than imposing tariffs, for the Chinese to act on their own. That is what we hope will happen. But our bill sends a clear signal to the Chinese that if there is not some movement on their part, the U.S. Congress will act.

Your report was the first time that the Bush Administration has called Chinese currency policies "highly distortionary," but it still falls short of finding them guilty of actual "currency manipulation." It is unclear to me and Senator Graham what else the Chinese would have to do—or not do—to have the Administration finally find them guilty of manipulation. You have stepped up to the plate, now it is time to swing the bat.

To help you along, Senator Graham and I have also reintroduced our bill that would define currency manipulation for you, thereby making it easier for Treasury to take decisive action.

Mr. Secretary, I look forward to the opportunity to ask you some direct questions about China and the currency report. Thank you, Mr. Chairman.

PREPARED STATEMENT OF SENATOR DEBBIE STABENOW

Chairman Shelby, thank you for calling this hearing. I want to welcome Secretary Snow and say that I cannot think of a more pressing issue facing our manufacturers and farmers. It is now on par with healthcare costs as an item that is crippling economic growth in this country. So, I appreciate that you have made yourself available to us, Mr. Secretary.

I will tell you up front that I am deeply disappointed with the Treasury report released last Tuesday. I believe that the Treasury Department has failed to do what is right and obvious as the report relates to China and Japan. The report states that no country met the technical requirements of the law governing manipulation. Most economists agree that China's currency is undervalued against the dollar so it is difficult to see why the Treasury Department is unwilling to state the facts. In fact, given the clarity of the problem I am led to believe that something other than facts are driving this reluctance to find violations.

Is it that we fear retaliation by the Chinese and Japanese on our goods and services? Is it that our Government is reluctant because of our dependency on those two nations to shoulder our budget deficit?

Many of us have warned the Administration that continued large budget deficits would eventually limit our ability to address trade problems—and here we are . . . the day has arrived.

I am certain that much of the discussion today will focus on China, but Japanese manipulation is a problem that we cannot lose sight of. In Michigan where auto manufacturing makes up such a large portion of our economy, Japanese manipulation is a major concern and I will be doing everything I can to make sure that it is addressed.

The decision by the Treasury Department to again go easy on China and Japan will cost the State of Michigan jobs at a time when unemployment remains staggeringly high. Last month the United States gained 274,000 jobs. Despite this fact, Michigan added another 7,500 to our unemployment rolls. Specifically, China's currency policies have cost the U.S. economy 1.5 million jobs over the past 15 years—and 51,000 of those jobs were lost in Michigan. And, these job losses are damaging diverse sectors of our economy, from auto manufacturing, apple juice, and auto parts, to furniture and boat manufacturers.

The response that the report gives to these facts is that the Treasury Department is "continuing to engage actively with economies to encourage, in both bilateral and multilateral discussions, flexible, market-based exchange rate regimes combined with a clear price stability goal and transparent system for adjusting policy instruments." For those of you here that find that statement murky, you are not alone. What it means, of course, is that Treasury is talking to the Chinese and Japanese. If talk would make this problem go away, it would have been solved years ago.

The Treasury Report dedicates one sentence out of 17 pages to the negative effects of currency manipulation on U.S. workers. But, repeatedly describes why manipulation would be bad for China. First, let us be clear about it—currency manipulation kills American jobs and it is illegal under WTO and IMF obligations. Even, foreign exchange markets are sending clear signals that China, in particular, should revalue its currency.

I believe that there is a strong case for pursuing action against China in both the WTO and the IMF. China's exchange rate policy frustrates the intent of the WTO and can be viewed legitimately as providing an illegal subsidy to exports and imposing an illegal tariff on imports. Also, its persistent one-sided intervention in foreign exchange markets flies-in-the-face of the rules governing membership in the IMF. Mr. Secretary, we need to crack down on countries like China and Japan and make sure they are playing by the rules.

I, along with Senators Graham and Bayh, have recently introduced legislation that would create a Chief Trade Prosecutor within the Office of the U.S. Trade Representative to police our trading partners and protect our manufacturers from unfair trade practices like currency manipulation. In fact, the type of case this office should bring immediately is a WTO case against countries that manipulate their currency. It does American workers no good to have trade agreements that are not enforced.

One outcome that would effectively address my concerns with this currency problem would be for China to revalue its currency substantially upward. And, for Japan to immediately stop intervening (verbally or otherwise) on behalf of the yen. Absent this, a legislated tariff on imports is a potential course of action.

The bottom line is that we cannot continue to set on the sidelines while our trading partners continue to artificially control prices, look the other way when it comes to enforcing intellectual property rights, and fail to live up to all of their obligations under WTO and IMF rules.

Mr. Secretary, I hope that you will take this opportunity today to provide a constructive path for the United States on this issue. Last week's report fell short in my opinion. And, unless some concrete steps are immediately taken to stem this problem, I am confident you will see the Schumer-Graham currency bill pass the Senate in July.

I would like to avoid that outcome in lieu of some other remedy, but unless you offer a third way, what we are left with here is the lesser of two evils. We either allow China and Japan to continue to manipulate their currency and destroy our domestic job base or we take matters into our own hands and level the playing field through tariffs.

Mr. Chairman, thank you. I am looking forward to our discussion on this issue.

PREPARED STATEMENT OF JOHN W. SNOW

SECRETARY, U.S. DEPARTMENT OF THE TREASURY

MAY 26, 2005

Chairman Shelby, Ranking Member Sarbanes, Members of the Committee, it is a great pleasure to appear before you to testify on the Treasury Department's latest report on "International Economic and Exchange Rate Policies."

The May 2005 Report encompasses a period of strong global economic performance, which reflects both great opportunity and challenge. The global expansion remains robust, more so than in many decades.

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

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

The United States is doing its part to address imbalances by aggressively tackling our fiscal deficit and our long-term liabilities. Because of strong growth and appropriate fiscal policy, the U.S. budget deficit in 2004 was well-below projections, and with recent data, I expect improvement in our fiscal deficit position this year as well. Some private forecasters predict that our fiscal deficit will be below 3 percent of GDP this year if we continue to hold the line on spending. We are also working to put in place innovative policies to increase the savings rate. But our actions alone will not be sufficient.

I expect strong economic growth in the United States to continue. This is in the U.S. interest, and the world's. It is an essential component of our deficit reduction strategy as strong growth results in rising government receipts, as we have been seeing. But it is important to recognize that there is also no one-to-one correspondence between reductions in our fiscal and current account deficits. We do not, and will not, have a current account target. The best contribution the United States can make to our own people and the global economy is to keep our economic house in order and ensure continued strong growth.

Our actions alone will not be sufficient to unwind global imbalances. Simply put, large imbalances will continue if growth in our major trading partners continues to lag. European and Japanese GDP together exceeds that in the United States. Some European countries, such as Ireland and Spain, continue to perform well. But on the continent, notable weaknesses persist, and Japanese growth, while turning upward, remains modest. These economies must continue to adopt and implement vigorous and necessary structural reforms to establish robust rates of growth—both for the good of their own citizens and to contribute to reduction in the imbalances in the global economy.

The Treasury Department's Report to Congress on International Economic and Exchange Rate Policies outlines the currency practices of America's major trading partners. The report addresses the third—and most immediately pressing—element of the effort to address global imbalances: The imperative of exchange rate flexibility, especially in emerging Asian economies.

The report finds that no major trading partner of the United States met the technical requirements of the statute for designation during the period covered, which is the second half of 2004. However, it would be a mistake to interpret this conclusion as acquiescence with the foreign exchange policies of many of America's trading partners. In fact, Treasury is actively engaged with several economies to promote the adoption of flexible, market-based exchange policies and to help facilitate broader adjustment. Most notable among these is China.

While the currency report that you have before you discusses several countries I would like to focus my remarks here on China. China's rigid currency regime has become highly distortionary. It poses risks to the health of the Chinese economy, such as sowing the seeds for excess liquidity creation, asset price inflation, large speculative capital flows, and over-investment. It also poses risks to its neighbors, since their ability to follow more independent and anti-inflationary monetary policies is constrained by competitiveness considerations relative to China. Sustained, noninflationary growth in China is important for maintaining strong global growth and a more flexible and market-based renminbi exchange rate would help the Chinese achieve this goal.

A more flexible system will also support economic stability, which we understand is of paramount concern to Chinese leadership. China's 10-year-long pegged currency regime may have contributed to stability in the past, although it no longer does so, as China has grown to be a more significant participant in global trade and financial flows. Currently, China relies largely on administrative controls to manage its economy—controls that are cumbersome and increasingly ineffective. An independent monetary policy will allow China to more easily and effectively pursue price stability, stabilize growth, and respond to economic shocks. China has a history of significant swings in credit-fueled investment and inflationary pressures and these have often ended in "hard landings." Such swings are disruptive to the Chinese economy and may prove more disruptive in the future—not only to China but also to the global economy.

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

And a more flexible system would also quell speculative capital inflows that are costly to China's Government and increasingly likely to prove disruptive. China's ability to sterilize capital inflows is increasingly limited and harmful to its banking sector.

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

Chinese officials have publicly acknowledged the need to move to a more flexible system, have repeatedly vowed to do so, and have undertaken the necessary and appropriate steps to prepare for such a move.

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

- It has introduced a foreign currency trading system permitting onshore spot trades in 8 foreign currency pairs and allowing banks to act as market makers.
- It has adopted measures to increase the volume of foreign exchange trading, for example: Eliminating the foreign exchange surrender requirement for many commercial firms; allowing domestic Chinese insurance firms and the national Social Security fund to invest in overseas capital markets; and increasing the amount of foreign currency business travelers can take out of the country.
- It has taken steps to develop foreign exchange market instruments and increase financial institutions' experience in dealing with fluctuating currencies. Foreign exchange forward contracts can now be offered in China; foreign exchange futures are being developed; and domestic Chinese banks can now trade dollars against other foreign currencies, not just remnimbi.
- It has also acted to strengthen its financial sector and regulation, so that this sector is more resilient to any fluctuations in exchange rates.

As a result of our approach, of constant intense engagement, China is now ready to introduce flexibility and should do so now.

Unfortunately, the debate on China's currency regime is clouded by a number of misconceptions of U.S. policy. Allow me to address a couple of these. First, we are not calling for an immediate full float with fully liberalized capital markets. This would be a mistake at this time—China's banking sector is not prepared. What we are calling for is an intermediate step that reflects underlying market conditions and allows for a smooth transition—when appropriate—to a full float.

Second, we recognize that a more flexible system in China, in and of itself, will not solve global imbalances—as I have said, this is a shared responsibility. However, greater flexibility in China and other Asian economies is a necessary component.

Third, some argue that a more flexible system will prove deflationary and increase Chinese unemployment. In fact, a flexible system will provide China with a more sophisticated array of policy tools—namely an independent monetary policy—that will prove much more effective in achieving price stability and the ability to adjust to shocks.

Our engagement with China over the past 2 years, including fruitful accomplishments associated with Treasury's joint Technical Cooperation Program, leaves me with little doubt that China is now prepared to begin reform of its currency regime.

In fact, I believe that the risks associated with delay far outweigh any concerns with immediate reform. The current system poses a risk to China's economy, its trading partners, and global economic growth. Concerns of competitiveness with China also constrain neighboring economies in their adoption of more flexible exchange policies.

As the report that was sent to Congress last week states, if current trends continue without substantial alteration, China's policies will likely meet the technical requirements of the statute for designation. China is now ready and should move without delay in a manner and magnitude that is sufficiently reflective of underlying market conditions.

As the need for adjustment is global, multilateral organizations are addressing the need for flexibility. The Group of Seven finance ministers and central bank governors have adopted a policy, stated in its communiqués, that "more flexibility in exchange rates is desirable for major countries or economic areas that lack such flexibility to promote smooth and widespread adjustments in the international financial system, based on market mechanisms." The Asian Development Bank and the Asia-Pacific Economic Cooperation (APEC) have also publicly stressed the importance of flexible currency regimes.

The chief officers of the International Monetary Fund and the Asian Development Bank have also stressed the need for currency flexibility. I have called on the International Monetary Fund (IMF), as part of its strengthening of multilateral and regional surveillance, to report on the potential contribution of emerging Asia to unwinding global imbalances, including an analysis of the regional impact of the Chinese foreign exchange system. As policymakers, we have a responsibility to fully understand these important forces that are shaping the global economy. As the central international institution for global monetary cooperation, with a wealth of technical expertise, the IMF is best placed to undertake this work, and indeed has the responsibility for doing so.

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