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THE TREASURY DEPARTMENT'S REPORT TO CONGRESS ON INTERNATIONAL ECONOMIC AND EXCHANGE RATE POLICY (IEERP) AND THE U.S.-CHINA STRATEGIC ECONOMIC DIALOGUE

HEARING

BEFORE THE

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

ONE HUNDRED TENTH CONGRESS

FIRST SESSION

ON

REVIEWING DEVELOPMENTS IN INTERNATIONAL ECONOMICS AND THE EXCHANGE RATE POLICIES OF OUR KEY TRADING PARTNERS WITH AN EMPHASIS ON THE U.S.-CHINA STRATEGIC ECONOMIC DIALOGUE

WEDNESDAY, JANUARY 31, 2007

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C O N T E N T S

WEDNESDAY, JANUARY 31, 2007

WITNESSES

THE TREASURY DEPARTMENT'S REPORT TO CONGRESS ON INTERNATIONAL ECONOMIC AND EXCHANGE RATE POLICY (IEERP) AND THE U.S.-CHINA STRATEGIC ECONOMIC DIALOGUE

WEDNESDAY, JANUARY 31, 2007

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

The Committee met at 10:05 a.m. in room SD–G50, Dirksen Senate Office Building, Senator Christopher J. Dodd (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN CHRISTOPHER J. DODD

Chairman DODD. Good morning. The Committee will come to order. I want to thank all of you for being here. Let me thank our witnesses for participating this morning in the first hearing with Secretary Paulson, and with the second panel of very distinguished witnesses as well.

Let me inform my colleagues on the Committee that as soon as we get a quorum here, I will interrupt the proceedings and adopt the rules and lay out the structure very quickly for Subcommittee assignments and the like. That could happen as soon as the clerk and others will let me know when we achieve that critical mass here. I will apologize in advance to the Secretary or any of the other witnesses who may be testifying when that occurs, and we will interrupt knowing that that can be a fleeting moment. Members may disappear again, and I may not have a chance to reconvene the Committee. So if that happens here, we will take care of that business. I want to thank Senator Shelby in advance for his cooperation and work on those issues when we come to it.

This morning, the Committee meets to consider the Treasury Department's Report on the International Economic and Exchange Rate Policy and the first meeting of the U.S.-China Strategic Economic Dialogue. We are pleased to have our Nation's 74th Treasury Secretary, Henry Paulson, as our first witness. And, Mr. Secretary, welcome and thank you for being here.

In each of the past 5 years, this Committee, pursuant to statute, has received exchange rate reports and taken testimony from the Treasury Secretary. I want to take a moment to commend Senator Shelby and Senator Sarbanes for hearings and for their excellent oversight on the issue of exchange rates. This is a critical issue for millions of Americans who run businesses, work at jobs that depend on a level playing field in the global marketplace. This is the only report to the Congress that addresses international economics, exchange rate policy, and currency manipulation, and it requires testimony requested from the Treasury Secretary to the Congress.

As America's economic fortunes becomes more entwined with the global marketplace, I think we all agree that this report serves a very important role in allowing this Committee to discharge its oversight responsibilities. More importantly, it allows us to have a very frank, candid, and hopefully constructive conversation about how we can foster freer, fair, and more transparent, and more dynamic markets where America's businesses and workers can compete successfully. That conversation must begin with an assessment of how our National Government is doing in securing opportunity and prosperity for working Americans.

The record, in this Senator's view, over the past 6 years leaves much to be desired. Policies put in place well before Secretary Paulson's confirmation have helped to turn record surpluses into deficits. Those deficits mean that today we are underinvesting in our most important priorities, such things as health care, schools, our Nation's infrastructure, and targeted tax relief. I would point out that just the interest payments alone exceed the entire expenditures in education, the environment, energy policy, unemployment compensation, and job training. I think most Americans, most people would be concerned, given the expenditure of those dollars in interest payments, considering the other things where investments could be made, either in tax relief or support for critical investments in our Nation. And while the economy has produced great results for some, and while we can all be encouraged by some recent positive signs, the fact remains that the median family income has declined by $1,300.

Now, the Secretary and I had a great conversation informally here before the hearing began, with the reports on this morning's GDP growth rate, which are encouraging and need to be cited here. This is welcome news. After 6 months of sub-par growth, the economy is again growing at a healthy rate. A very large component of this economic growth has come from international trade. Without the growth in trade, I think our economic growth would have been under 2 percent, and the Secretary may want to comment on this in his remarks. Much of that improvement in our trade situation I think came from a decline in the price of oil, which reduced our imports, and the fall in the value of the dollar, which helped increase our exports, obviously. It just demonstrates how critically important it is that we not only be allowed to be ready to adjust against all currencies, making the point further along here.

At any rate, we have seen over the last 2 years the decline in the earning power of Americans. More than 3 million manufacturing jobs have been lost since 2001, which is the steepest and most prolonged loss since the Great Depression. About 1 million of those manufacturing jobs have been in critical defense-related industries. I would point out that this Committee has jurisdiction over the Defense Production Act, which is subject to reauthorization, and we will be looking at defense production issues, Mr. Secretary, at the appropriate time in the Committee. And obviously a loss of a million jobs in defense-related areas is an economic issue, but it also raises some very significant national security issues.

This is the first economic recovery, I would add, that we have ever seen in which the manufacturing jobs that were lost have not come back. In a sense, for millions of Americans, the recession has not ended but goes on. In addition to this historic dislocation of America's manufacturing base, we have also outsourced the capacity to produce items of vital importance to our national security.

Just to take one example, every smart bomb is guided by a special kind of magnet, as we know. These magnets used to be produced in two plants in Indiana, which our colleague from Indiana, Senator Bayh, is all too familiar with. Today these magnets are manufactured in China. What would be the consequences if these essential items ceased flowing to our military? The mere question supports what I believe to be an unmistakable and inescapable fact that significant changes are urgently needed to adequately secure America's future, both economically and militarily.

One such change—namely, the exchange rate policy—is the subject of today's hearing. If the global marketplace is going to be truly free and fair, then currencies must be equally subject to the discipline of that marketplace. China's continued resistance to allow its currency to move to where the market would value it has had a distorting effect on global markets and a detrimental effect, I believe, on U.S. companies and workers.

I have already spoken about the loss of manufacturing jobs. China's currency, which credible analysts say is devalued by anywhere from 15 to 40 percent, is not the sole cause of these job losses. But many experts believe it is a significant factor for that result. Likewise, it is a significant contribution to our Nation's record trade deficit. By now, the deficit is projected to be over $750 billion for the year 2006. Nearly one-third of that deficit, $230 billion, consists of U.S. bilateral trade deficit with China. The Treasury's International Economic and Exchange Rate Report requires the administration to examine whether any of our trading partners are manipulating their currency to gain an unfair trade advantage. Previous administrations, including that of former George H.W. Bush, have found several countries to be manipulating their currency under the rules of the report, including China. Many leading economic experts have said for some time that China and other Asian countries are manipulating their currencies to gain an unfair trade advantage.

When he was in China as part of a delegation led by Secretary Paulson, Federal Reserve Chairman Bernanke talked about the distortions that result from, and I am quoting him, "an effective subsidy that an undervalued currency provides for Chinese firms that focus on exporting."

When the administration's Exchange Rate Report was released, Senator Shelby and I issued a joint statement expressing our disappointment that the report failed to recognize what is obvious to most, and that is that China continues to manipulate its currency.

As I said a moment ago, exchange rate policy between the U.S. and China, as well as other countries, is but one of many challenges that our Nation faces in order to secure a prosperous future for our people. But it is a vital challenge. It is critically important that we have a level playing field in the global economy.

One of the issues that the Secretary has made a priority is the importance of ensuring the competitiveness of U.S. capital markets in the global marketplace. I strongly support, by the way, the need to ensure a level playing field for U.S. companies, and I applaud your interest, Mr. Secretary, in that subject matter. But we also need to make sure that we have a level playing field for U.S. companies when they compete against China and other nations in Asia. With a level playing field, I believe the American worker and the American entrepreneurial spirit can compete with anyone in the world.

I want to thank the Secretary for testifying this morning. I believe that this is not only his first appearance before the Congress since returning from China, but it is also his first testimony to the Congress since being confirmed last July. It is especially fitting that Secretary Paulson's first hearing is on the Treasury Department's report on International Economic and Exchange Rate Policy and the first meeting of the U.S.-China Strategic Economic Dialogue. In his previous career at Goldman Sachs, Secretary Paulson worked extensively with Chinese officials. I don't know of anyone in this administration who is as knowledgeable, I might add, about China and the Pacific Rim as the Secretary of the Treasury. In fact, I cannot think of anyone in recent past history at this level that brings as much talent and ability and knowledge about the Pacific Rim and the importance of it as Secretary Paulson does. And I applaud your strong interest in it, your knowledge of it, and we hope this morning as a result of talking about this policy, you can also share with us some additional insights and thoughts as to the importance of this relationship and how we can manipulate or work it better in the coming years. Your skills will be needed if the administration is to achieve better results than it has so far, in my view. Given your impressive experience and ability, Mr. Secretary, I believe you are uniquely qualified to help create a global marketplace where America's work ethic and ingenuity will win the day.

So I am very pleased that you have taken the time to be with us here this morning, and I look forward to hearing your testimony. I am also pleased that we will have a second panel of witnesses to share their knowledge and concerns as well about the conclusions of this report.

Senator Shelby, my colleague, I would ask if you have an opening statement, and then with the permission of my colleagues, in order to move along, I am going to go right to the Secretary's testimony and then use the time available for members to raise their own opening comments, and I will include every comment you have as part of the opening statements for the record. But to move this along so we can get to the question-and-answer period, I am going to limit the opening comments to the Ranking Member.

Senator Shelby.

STATEMENT OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Thank you, Mr. Chairman.

Secretary Paulson, we are pleased, as Senator Dodd has indicated, to have you before the Committee. The Omnibus Trade and

Competitiveness Act of 1988 requires you as the Secretary to provide a semiannual written report on international economic policy, including exchange rate policy, to the Senate Banking Committee and to the House Financial Services Committee. This morning, we will focus on the most recent report which the Committee received on December 19th of this past year. We also look forward to hearing more about our ongoing Strategic Economic Dialogue with China. We are interested in both the results of the first meeting and your plans and expectations for the coming meeting in May.

Secretary Paulson, your first Exchange Rate Report indicates that no major trading partner of the United States met the technical requirements for currency manipulation during the first half of 2006. Your findings, although consistent with your predecessors, are not consistent with my own views. Maybe you have information that we do not have here, and if you do, I hope you will share it.

I believe myself that China is manipulating its currency as part of an export-driven growth strategy. The continued imbalance of trade with China is of significant concern to us, and I know it is to you. The U.S. reported a nearly $23 billion trade deficit with China in November, by far its largest with any country. According to the Commerce Department, Mr. Secretary, the November data shows a year-to-date deficit with China of almost $214 billion, and I am sure it is more. The 2005 full-year deficit was slightly more than $201 billion.

As our trade deficit grows, China continues to accumulate significant foreign exchange reserves. In fact, China recently overtook Japan as the largest reserve holder. The value of China's reserves are now estimated, Mr. Secretary, to exceed US$1 trillion, the majority of which is invested in dollar-denominated assets. The growth in China's foreign exchange reserves has slowed in recent months, but the pace remains quite rapid. This continued growth raises troubling questions as to the sustainability of China's enviable economic growth rate and its ability to control credit and inflation within its domestic economy.

Because the international trade and financial markets are truly global, the pace of China's actions toward greater currency flexibility are critical, I believe, to both China's continued strong domestic economy and to the world economy. The Chinese currency has appreciated roughly 6 or 7 percent since July of 2005 when China first announced plans to move toward flexibility. However, as your report points out, that pace toward greater flexibility has not been fast enough. As a result, we have seen no reduction of the current account surplus of foreign reserve accumulation.

While some may argue, Mr. Secretary, that these numbers are a natural outgrowth of globalized financial markets, the numbers also raise questions about whether world trade has been conducted on a level playing field.

Secretary Paulson, I am interested in hearing about the specific steps today that the administration is taking through our Strategic Economic Dialogue to move China toward a more flexible rate policy. I would also hope to hear more about how international bodies such as the G-97, the International Monetary Fund, and perhaps the Asian Development Bank can also play a role in facilitating increased flexibility.

Over the long term, both the U.S. and the global economy will benefit from the continued pursuit of free trade and flexible exchange rate policies. And I believe the most desirable way to reduce our current account deficit will be through stronger growth abroad and more open trading markets and policies. I look forward to hearing from you this morning.

Thank you, Mr. Chairman.

Chairman DODD. Mr. Secretary, the floor is yours. Why don't you bring that microphone right down close to you.

STATEMENT OF HENRY M. PAULSON, JR., SECRETARY, DEPARTMENT OF THE TREASURY

Secretary PAULSON. I have it. OK. This is my maiden voyage.

Chairman DODD. Yes, and we are one member away from having a quorum, so why don't you get going here. But if someone walks in the door, we will take a break for 2 minutes.

Secretary PAULSON. OK. Mr. Chairman, Senator Shelby, and Members of the Committee, thank you very much for the opportunity to have this dialog with you today on an issue of vital importance to American workers and the American economy. As you know, the Foreign Exchange Report recently issued by the Treasury reviews developments in international economics and the exchange rate policies of a number of our key trading partners.

Let me first take a few minutes to talk about the important and multifaceted relationship we have with China. Getting it right is vitally important to the citizens of both our nations and the world and will be so for many years to come.

Since the economic relationship between our two countries is an important part of our overall relationship, I have focused intensely on China from the day I was confirmed. It is my job to press for opportunities for American businesses and American workers. The successful management of our economic relationship with China will benefit the United States and China greatly.

The United States and China share many strategic interests. These range from national security to economic growth and trade to the health of our environment. As a growing leader on the world stage, China must be a full participant in the rules-based world economy. Recognizing this, the President and Chinese President Hu established a Strategic Economic Dialogue to manage the economic relationship between our two nations on a long-term basis.

The SED should help us make progress on fundamental long-term structural economic issues as well as on very pressing short-term issues. It is not a scripted ceremony. It is a serious, focused discussion of the economic issues that matter most.

The SED provides a mechanism through which, for the first time in our relationship, our Government can speak with a single voice on economic issues to the highest levels of the Chinese Government and do so on a regular basis. The dialog is goals based and designed to keep both sides moving forward on goals that we establish. By meeting regularly, we can actively monitor the progress we are making. By making progress on critical immediate issues such as currency reform, we will build the confidence to deal with the important longer-term economic issues, such as the structural challenges China faces.

China's currency policy is a key factor in our economic relationship. China does not yet have the currency policy we want it to have and that it needs. Treasury's Foreign Exchange Report clearly states that China's cautious approach to exchange rate reform exacerbates distortions in its domestic economy and impedes the adjustment of international imbalances. I look forward to discussing the report with you during this hearing.

We are actively pressing the Chinese to introduce greater currency flexibility and to undertake wider market reform. We are seeing some results. China abandoned its pegged exchange rate in July of 2005 and began to introduce some flexibility. Since last July, the pace of appreciation has been more than three times as fast as it had been in the first year after the initial renminbi reform. Foreign currency trading, once conducted entirely by the Chinese Government, is now conducted almost entirely by commercial banks.

China has introduced financial instruments to hedge foreign exchange risk, and the Chinese Government has begun to allow increased fluctuations in the currency. This is welcome progress, but we need to see much more. Although China is moving faster, it is still not moving fast enough. Nor is currency flexibility enough. A major objective of my 2 remaining years as Treasury Secretary will be pressing the Chinese Government to advance toward the goal of renminbi whose value is freely set in a competitive marketplace based upon economic fundamentals.

I will work with the Chinese Government to develop the market infrastructure they need for a freely floating currency. This involves several key steps.

First, the government should progressively widen the band that limits the daily movements of the exchange rate. Widening the band will help businesses and financial institutions learn to operate with a fluctuating currency.

Second, the central bank should progressively reduce its intervention in foreign exchange markets.

Third, China must develop the fundamental components of a capital market, a bond market and a yield curve, to absorb inflows and outflows of foreign exchange and provide ways to hedge against exchange risk.

And, fourth, China's central bank must set clear policy targets to avoid inflation and thereby provide confidence in the value of the Chinese currency.

I want to be clear. Increased flexibility in the short run is absolutely necessary, but it is not sufficient. My goal is to make significant progress toward a fully market-determined floating Chinese currency. The message I delivered to Chinese decisionmakers in the first meeting of our Strategic Economic Dialogue in December is that they are not moving quickly enough to make their currency more flexible. While they agreed they need to increase currency flexibility and move to a floating exchange rate, they are not moving quickly enough for the United States or the rest of the global community, and they are not moving quickly enough for their own good. The Chinese leaders believe there is risk in moving too quickly when, in fact, as I argued to them, the greater risk is in moving too slowly. China may be in some respects a developing country, but it is also a large and powerful country. The international community will run out of patience with China unless the pace of its reform accelerates.

Reform of China's currency policy is a crucial issue for China and the United States, and, Mr. Chairman, the need for reform in the Chinese economy goes beyond currency. Currency movement alone will not eliminate the distortions in the Chinese economy, nor significantly reduce its trade surplus. China needs to restructure its economy so that household consumption—rather than exports and excess investment—powers growth. This is the only way that China can grow without generating huge trade surpluses.

To do this, Chinese policy must address the reasons why Chinese households feel compelled to save so much and spend so little. Only 20 percent of 800 million people who live in rural areas in China have health insurance. The basic government pension covered only 17 percent of Chinese workers in 2005. And only 14 percent of the population is covered by unemployment insurance. China must invest in its people by strengthening its health care system and the social safety net, and Chinese households need financial products that insure against risk and finance major expenditures. The Strategic Economic Dialogue addresses all of these issues.

I believe that the openness of the U.S. economy to competition and our participation in international trade are key to economic growth, higher wages, and increased opportunities for U.S. workers. We saw the importance of trade for U.S. workers, as the Chairman just mentioned, in this morning's strong GDP data. GDP growth in the fourth quarter was 3.5 percent, and inflation was moderate at 1.5 percent. Trade contributed more than 1.6 percentage points to growth, with double-digit exports gains accounting for more than 1 percentage point.

We have reached a crossover point at which American exports are now growing faster than imports and have been doing so for four consecutive quarters. We are pressing China to follow our example of openness, and I am working to ensure that China's growth and expanding market create maximum opportunities for the United States. China must live up to its WTO commitments. It must protect and vigorously enforce intellectual property rights. It must increasingly open its markets to foreign competition for its own good as well as ours. And it must introduce greater transparency in regulation and observe the rule of law. Through the Strategic Economic Dialogue and through the various economic dialogs we have with China, the administration will continue to press very hard in all of these areas.

Mr. Chairman, America's economy and workers benefit significantly from our trade with China. China is our fourth largest export market. Our exports to China have increased more than 350 percent over the last decade, 6 times the growth of our exports to the rest of the world. And nearly half of our exports to China are capital goods, including high-value-added goods such as civilian aircraft, electrical machinery, and medical devices.

I believe strongly that a healthy Chinese economy, growing without large external imbalances, is of vital interest to the people of the United States, to the people of China, and to the global economy as a whole. More constant flexibility in the short term and a fully market-determined floating renminbi in the intermediate term are essential to accomplish this goal. So is restructuring the Chinese economy so that the domestic consumption demand, not exports, fuels Chinese growth. Broad structural changes are necessary to have a major impact on our trade deficit with China.

The next round of the SED will take place here in Washington in May. I understand that all of your constituents are very concerned about the impact of our relationship with China on their jobs and on their livelihoods. China is a big and important part of the world economy. It needs a currency whose value is determined in an open, competitive marketplace and an economy that supports more balanced, stable growth.

I look forward to working with the Members of this distinguished Committee on the many important issues we have before us, and I now welcome your questions. Thank you.

Chairman DODD. Well, thank you very much, Mr. Secretary, and we have a quorum here present. In fact, come on in, Jack. You can add to it here this morning. So I am going to move the Committee into executive session, if I can. We will briefly interrupt here the flow of this.

[Whereupon, at 10:29 a.m., the Committee proceeded to other business and reconvened at 10:32 a.m.]

Chairman DODD. Let me begin, and I am going to ask that the clock run for 7 minutes. We have a good turnout here this morning, and that is not a great deal of time to get into great length. But so that everyone gets a chance to engage in the discussion, I think it is going to be important that we follow the early bird rules that have applied in the past here, which the exception, obviously, of the Ranking Member.

Mr. Secretary, again, thanks for being here, and we appreciate your comments. I was looking at this report also sent to Congress—this was in November of 2006—on the U.S.-China Economic and Security Review Commission, which I presume you may be familiar with. Their report here, which is a rather lengthy report, goes on at some length, and they concluded, on a 12–0 vote, by the way—not actually a divided vote—that China is manipulating its currency and engaging in other unfair trade practices. They are worried about it. As I said, they voted 12–0 that China is engaged in currency manipulation as defined by the statute.

They wanted to point out, by the way, and you made the case about the difficulties China has in serving its large population—unemployment insurance, health insurance, and the like. But I think it is also worthy of note here that China has increased its military budget by double-digit growth over the last 10 years. The U.S.-China Economic and Security Review Commission warned, and I quote them here, "The People's Liberation Army is developing anti-satellite capabilities and space warfare weapons that impede U.S. command and control. Two weeks ago, China launched the first anti-satellite weapon in 20 years."

So while we understand they have got a lot of work to do in providing for the needs of their people, they are not finding any difficulty in providing for what they perceive to be their national security needs, investing some massive amounts into a defense structure at the expense of serving the people of China, who deserve a lot better than they are getting. So here is one Commission that reaches a conclusion on a 12–0 vote that, in fact, China is manipulating its currency.

Now, putting aside, if I may ask you here, the technicalities of the statute here, let me ask you very directly at the outset: What is your personal view about this matter? You have spoken eloquently this morning about what is going on. Is China manipulating its currency in your view?

Secretary PAULSON. Well, Mr. Chairman, let me say I share everybody's——

Chairman DODD. Is your mike on, Mr. Secretary?

Secretary PAULSON. Is it on?

Chairman DODD. You have got to——

Secretary PAULSON. OK, I have got you. I will get the hang of this in a minute or two. I share the views of everyone who is frustrated about the currency because I would like to see China showing much more flexibility, and I am going to be frustrated until they do so.

Now, let me also say that I did not wait for this report to come out. I was not holding my breath for this report to come out to take action. So from the day I was confirmed as Treasury Secretary, I started focusing on China. Shortly thereafter, I was pressing the Chinese on the matter of currency flexibility, and pressing them hard.

They now embrace currency flexibility as a policy. It is a stated policy. It is a goal. And so as you have pointed out, intent is what we look at because the law calls for intent. But what I think is important is action. Even if China had been named as a manipulator in this report, the remedy under the law is to negotiate with them directly on currency and to negotiate through the IMF. That is what we have been doing.

To me, it is not just about currency flexibility in the short term. As I said in my testimony, the Chinese need to make progress over the next couple of years so that they will be in a position in the intermediate term where we will not be having this discussion because they will have a currency where there is no argument about it because the value is determined in a competitive, open marketplace.

Chairman DODD. Let me ask you this: Your predecessor, Secretary Snow, in the 2005 report—and I am quoting from it here—found the following: He says, "If current trends continue"—speaking of China. "If current trends continue without substantial alteration, China's policies will likely meet the technical requirements of the statute for designation as a currency manipulator." He went on to say, "This adjustment has to be material and has to be significant, has to be something that would significantly close the gap between current value and an appropriate, more appropriate value."

I guess the question I would ask you in light of that, Secretary Snow made that statement that China has significantly—or, rather, Secretary Snow made the statement that China has significantly closed the gap, or do you agree with his interpretation of the statute in this sense? I mean, this is your report. It seems to me the language here that at least looking at the predecessor's comments here, it is not materially changing its direction.

Secretary PAULSON. I do not know what was in my predecessor's mind, but as I have said, I have been focused on results and putting a process in place where we can speak with one voice to the top decisionmakers and indeed get movement and get action. As I testified, I have said the way we looked at this I am just like John Snow. I read John Snow's testimony, and he said repeatedly to Members of this Committee that he was in heated agreement with you. And I am in agreement. We need more movement on the currency.

I am not satisfied, I know what my job is, and I know I need to get results. And it is not just flexibility in the short term because, if we do not do something about some of the structural reforms they need and have them move forward on the path of reform, we will still have these trade imbalances because we will need broader structural reform in addition to the short-term movement in the currency.

Chairman DODD. Well, I agree with you about action. I think action is important. And this conversation is important, except if you are the guy out there who has just lost his job in the manufacturing sector because of the disadvantages here, the subsidies that the Chairman of the Federal Reserve talked about on the trip that you all took there. And this is a boiling concern of people across the country to watch this manipulation and to watch the disadvantage and to watch the hardship it imposes on people who work very hard. And losing 3 million jobs in the manufacturing sector, losing 1 million of them in the defense-related areas, while you are watching the country who is sort of dawdling along here having double-digit increases in its defense spending at the expense of its own people's needs raises concerns about whether or not we are going to stand up and insist upon some real concrete action before sort of going along year after year sort of tolerating this behavior at the expense of jobs here and our own economic security in the future.

You point out the action stuff. I am looking—and I know you care about this. In your testimony, you talk about building components of a strong capital market structure, a bond market and a yield curve, which will enable the country to get to the point where it can freely float its currency. And yet only modest concessions have been made as China continues to set barriers intended to prevent foreign financial services—something you were very familiar with obviously in your previous incarnation, the difficulty this critical component of our economy, the financial service sector, has in accessing the markets in China, the barriers they put up to us, and how critical a component that is for getting to the point where they are no longer manipulating their currency. And yet here is action they could be taking that they refuse to take.

How do you square that in a sense?

Secretary PAULSON. Well, let me say, Mr. Chairman, first of all, I really share your concern about people who are losing their jobs in this country. That is what drives me and one of the major reasons I took this assignment on. And I agree with you on the capital markets. I look at the capital markets, and I cannot think of any country in the world that has an economy that works properly and allocates capital efficiently and has a currency where the values are really set in a broad, deep, competitive market that does not also have strong capital markets. And I cannot find any country that has strong capital markets that has not opened itself up to foreign competition and taken off investment caps.

This is one of the things that we are going to be pressing on in the Strategic Economic Dialogue opening up capital markets to the banks and investment banks, and a multitude of other service industries, because a lot of what the Strategic Economic Dialogue is about is the path of reform that China has and the pace of reform post-WTO, opening up their economy to our goods and our services. And so that is very closely related. I am pleased you see that relationship between that and currency.

Chairman DODD. Absolutely.

Secretary PAULSON. Because the two go together.

Chairman DODD. Thank you very much.

Senator Shelby.

Senator SHELBY. Thank you.

Mr. Secretary, I just have some technical questions, but I was wondering what would you say to someone who had been working in the steel or foundry business, like in Birmingham, Alabama, my home State, for the third generation and finally at 55 years of age, laid off, had good jobs always, because obviously they see the manufacturing jobs gone. And these are good jobs. They sustain families, they sustain communities a long time. We have to face our constituents like this and explain what is going on with the manipulation of currency, what is going on in the imbalance of trade, and so forth.

What would you say to someone if they would confront you like they confront us, our constituents?

Secretary PAULSON. Let me tell you, when I have met—and I notice you are going to have the NAM here later, and so I have had some very explicit conversations, and let me say that is a very, very tough situation because what I would say to someone is that I am going to do everything I can to represent you and represent our country in opening up markets and ensuring that we have fair trade; but that, unfortunately, we do not always have a level playing field. And although the benefits of trade benefit a whole society and benefit a country by raising the standard of living, the immediate losses we see from time to time are very, very painful.

Senator SHELBY. Do you believe we have a level playing field in our trade relationship with China?

Secretary PAULSON. I clearly do not believe that the American people believe the benefits are shared equally. I know that. And I do believe that our trade with China right now benefits both of our countries, but I want to fight to get it to benefit U.S. workers to a greater extent.

Senator SHELBY. Mr. Secretary, getting into some technical stuff, about a week ago Premier Wen gave a speech, and in that speech he noted, and I will quote, “Management of reserves should be improved and the channels through which they are invested diversified.”

How do you interpret this comment and the general theme of his remarks focusing on expanding the use of the reserves? And how do you believe global financial markets and currency traders are reacting to these comments?

Secretary PAULSON. OK. You almost hate to speculate on what someone else has in mind and what he meant, but let me——

Senator SHELBY. Well, obviously, he meant something, didn't he?

Secretary PAULSON. Yes, he did. He sure did.

Senator SHELBY. OK.

Secretary PAULSON. And so let me speculate a bit about what he might have meant, and let me talk a little bit about China's reserves.

I believe that it would be very healthy for China to diversify their investment policy as it relates to reserves and see more direct investment in certain areas in China and direct investment in other areas of the world.

Now, as I look at their reserves—and let me say to you that I am concerned about a lot of things. I am concerned about the question you raised about people losing their jobs.

Senator SHELBY. Absolutely.

Secretary PAULSON. I am concerned about the income of the average worker. I am concerned about the trade deficit. I am concerned about the Chinese currency. I am concerned about rebalancing the Chinese economy.

The thing that concerns me the least of all of these things is when I look at their reserves and how those reserves are invested. The comment I get most frequently, as I go around and talk with people, is, "Aren't you concerned that they own too much in the way of the U.S. treasuries? Aren't we somewhat"——

Senator SHELBY. Our debt, in other words.

Secretary PAULSON. Yes, hostage, our debt. Our debt, our Treasury debt. And I look at it and say that they currently own somewhat less than $350 billion of U.S. Treasury debt by our estimates. Our public Treasury debt outstanding is over $4 trillion. Our Treasury securities trade $500 billion in a day, so there is more Treasury trading in a day than the Chinese own. They also own other U.S. dollar-denominated securities debt of private parties, non-government debt. And I believe that the Chinese own dollar debt because it gives them the best risk-adjusted rate of return, and the key for us is keeping the confidence up in our economy and have economic policies that do that.

So when I looked at the Premier's comments, and, again, I do not know exactly what he had in mind, but certainly any country has to think carefully about how they manage their reserves. I think it is a healthy sign.

Senator SHELBY. But $1 trillion of hard currency reserve, that is a lot of money—is it not?—by anybody's reckoning.

Secretary PAULSON. It sure is.

Senator SHELBY. What dialog, Mr. Secretary, have you or other officials had with the Chinese officials to determine what direction any change in reserve strategy might take? I know you do not want to be left in the corner on this. Are there any potential negative repercussions to the U.S. from various alternatives that they would pursue?

Secretary PAULSON. When I was in Beijing in December, Chairman Bernanke and I sat down and we had lunch with Zhou

Xiaochuan, who runs the central bank, and the Minister of Finance, and the woman who chairs SAFE, which manages reserves. We had a general conversation, as you would expect us to do, as we would with any other nation in the world that has big reserves—and none of us on our side had any real concern.

As I have said, I take all the things I mentioned to you before very seriously, and we obviously take this seriously. But, again, given the size of our debt outstanding and the way it trades and the diversity and so on, that is not at the top of the list of——

Senator SHELBY. Do they own about 8 percent of our total debt, something like that?

Secretary PAULSON. I would say they own about 8 percent of our treasuries. The Japanese own more than any other Government. The Japanese——

Senator SHELBY. What would that be?

Secretary PAULSON. What?

Senator SHELBY. What percentage would that be, larger than 8 percent, that the Japanese——

Secretary PAULSON. I do not have the exact number, but if the Chinese own about $350 billion of our Treasury securities, the Japanese own something over $600 billion.

Senator SHELBY. OK, twice that. Mr. Secretary, thank you.

Thank you, Mr. Chairman.

Chairman DODD. Thank you, Senator Shelby.

Senator Carper.

STATEMENT OF SENATOR THOMAS R. CARPER

Senator CARPER. Mr. Chairman, thanks. Mr. Secretary, welcome. It is good to be here on your maiden voyage, and I just want you to know I appreciate very much a number of the things you said, but especially when you said, "I am focused on results." And you have been focused on results with respect to another issue that you know I have talked a lot about in the last couple of months, and that is, trying to make sure we have a strong independent regulator for our Government-sponsored enterprises.

Just take, if you will, just maybe 30 seconds and give us an update on what is going on there. I know there are negotiations between you and your staff and some folks, some of our colleagues in the House side.

Secretary PAULSON. The question, Senator—the Senator is very interested in, as I know the Chairman and Senator Shelby and Senator Bennett and a number of other people are, in GSE reform. And I would just simply say that the Administration and I personally feel very strongly that we do need a strong, independent regulator. I was encouraged by some of the progress late last year that we made, and we are going to continue to work toward that goal. So far the conversations have been very constructive, but we have got a lot further to go.

Senator CARPER. Thanks very much.

In your testimony, Mr. Secretary, you go through about four or so key steps that the Chinese need to take, and it is about halfway through your testimony. I will not read them all, but there are one, two, three, four. And let me just ask, I presume that the way we measure progress is to look at what is happening with respect to those four key items. Is that correct?

Secretary PAULSON. That would be one way to measure progress.

Senator CARPER. I always like to say that we measure the things that we do best, and in terms of—what are we measuring here?

Secretary PAULSON. I think that is—well, let me give you a little bit of a longer answer because that is something I have been focused on from literally the first month after confirmation. I thought a lot about how to engage with China to discuss their economic reform. Currency is very important, but more broadly on economic reform, how do we engage? Because this is so important. What hit me was that the U.S. Government and the Chinese Government were agreeing on the principles and the directions. There was broad agreement but big disagreement on the pace of reform, the speed. And we felt very strongly that they needed to move quicker.

And so I took a look at how we were working with China, and I saw that at the top, President Bush and President Hu had a very good dialog. Below that, in the economic arena, we had some effective dialogs in the JCCT and the JEC, all the things you are aware of. But it seemed to me that we were not organized as effectively as we needed to be. We were a bit siloed, and so what we needed to do was to come up with a process where we could speak with one voice to the key decisionmakers and a broad range of decisionmakers at the top. We needed to organize multiple long meetings during the year so we can measure our progress.

Now, what you are getting at is what are the things we want to measure. On the currency, you mentioned four of the things. But, again, as the Chairman and Senator Shelby both said, actions are what matter, and with regard to the currency, I would summarize it to say we definitely need more flexibility. No matter what they do to give it to us, we need more flexibility in the short term. And then we need those actions in the medium term that are going to get us to the point—get them to the point, actually, where they have a currency that trades in the marketplace.

Now, part of that is going to be——

Senator CARPER. I would ask you to wrap it up because I have one more question.

Secretary PAULSON. OK. Then here is how I will wrap it up, because this will be opening up their economy to products and services going beyond WTO, and doing some things to make their capital market stronger, opening to our competition, international competition, and, again, doing some things that are going to help them bring more balance to their economy. But we will be establishing those benchmarks.

Senator CARPER. All right. Thank you.

One question that I would ask you for the record and just submit in writing a response, if you will. Somewhere in your testimony, you talked, I believe, about a sixfold increase in the amount of exports from the U.S. to China. What I am going to ask you to answer for the record is: What is the increase in exports from the Chinese to us during that—don't answer it now.

Secretary PAULSON. I tell you——

Senator CARPER. No, I have another question I want to ask you and I want you to answer right here.

Secretary PAULSON. OK. I would like to just tell you, because the estimate——

Senator BUNNING. Your microphone is off.

Secretary PAULSON. Sorry. This last year, we had a very important crossover point. We had a very important change in the export-import balance with China. According to the latest estimate that I am looking at, it looks like our exports will have gone up about a third to China, 33 percent, to about the $56 billion level, and imports will have increased 19 percent.

Senator CARPER. OK. I appreciate that, but the question I want you to answer for the record is: For the period of time that you cited for our exports to the Chinese were up by, I think, six-fold, what was the increase, the similar increase for them?

Secretary PAULSON. Right.

Senator CARPER. And also, for the same timeframe, what was the growth in their purchase of our debt over the same timeframe?

Secretary PAULSON. All right.

Senator CARPER. A hundred percent, 200 percent, whatever. Here is my question that I want you to quickly answer. You met, along with the President, with the heads of GM, DaimlerChrysler, and Ford a month and a half or so ago at the White House. Among the issues that they raised were investments in battery technology and also the issue of Japanese currency manipulation. You and I have discussed it a little bit. They still feel very strongly that something is going on. Could you just speak to why you think that is not the case?

Secretary PAULSON. OK. I will be as quick as I can, and let me say I have been watching the Japanese currency very, very carefully. I talked with the Finance Minister several weeks ago. I will see him when I am in Germany, in Essen, at the end of next week. The yen is close to—don't hold me exactly to this—a 20-year low on a trade-related basis.

What I said to the auto manufacturers is that there has been no intervention in the yen since March of 2004. I do not believe there has been—although I could be wrong on this, because I cannot read every quote, but I do not think there has been verbal intervention for almost a year. I do not like verbal intervention. I do not think it determines where markets trade.

I think what is going on in the Japanese currency is this: Japan is the second largest economy in the world. All through the 1990's and a couple years, in this century, the Japanese economy was not growing. There was deflation. There was a huge drag on the global economy. They have turned this around now. It is a big reason that the global economy is doing as well as it is. This is an economy where there has been weak growth, where there has been deflation, and so interest rates are very low. I think it is those economic fundamentals that are driving it. And then, of course at any one time, who knows why markets trade the way they do? I am watching it carefully, but the things that concern me are exchange rates—excuse me, currencies where the value is not determined in a competitive marketplace, and the yen has a broad, deep, competitive marketplace.

Senator CARPER. Thank you, and I would just urge you to stay focused on that. Thank you.

Secretary PAULSON. OK.
Chairman DODD. Senator Sununu.

STATEMENT OF SENATOR JOHN E. SUNUNU

Senator SUNUNU. Thank you, Mr. Chairman.

Secretary Paulson, last year, Under Secretary Quarles testified on insurance, and a number of other Treasury officials commented in the hearings we had about the potential benefits and, in fact, the need to modernize the insurance industry, in particular, insurance regulation. I have been working on this issue for a couple of years with Senator Johnson, and we have developed legislation together. And most recently Senator Schumer and Mayor Bloomberg worked with a group of financial service industry representatives about the competitiveness of the U.S. financial services industry.

One of the conclusions of their report was that we need to reform the insurance regulatory system, and they recommended an optional Federal charter approach to that reform. I would like to get your view on the current State-based regulatory system for insurance and whether or not you think that modernization can contribute to some of the competitiveness issues you have been discussing in recent speeches around the country.

Secretary PAULSON. OK. Senator, thank you very much, and thank you for your concern and knowledge and interest in this area. I would also say I was very impressed with the Bloomberg-Schumer report and the issues it raised.

Let me also say that one thing that we are going to be looking at carefully at Treasury is competitiveness in the insurance industry and the impact of regulation on that and, you know, the advantages of an optional charter. As you know, this is not an easy issue given how insurance companies are regulated, and there are strong views on both sides, and it is one that I very much look forward to getting involved in.

I think although we don't have a clear position yet on the optional Federal charter, I personally think it has got a lot of merit, and we are going to be thinking this issue through very carefully.

Senator SUNUNU. Do you feel that in such an approach, if we were to take such an approach, do you feel confident in the ability of a Federal regulator to adequately address safety and soundness issues?

Secretary PAULSON. Well, you are taking it beyond where we are to date, and we are going to be spending a fair amount of time on this. We are going to have a conference at Treasury in March, and as we look at competitiveness, one of the key issues we are going to look at is the regulatory structure in the U.S. So it will take us a while——

Senator SUNUNU. Are you suggesting to me you want to get back to the easy questions about Chinese currency manipulation?

[Laughter.]

Secretary PAULSON. There is no important question that is easy. And this is a very important issue, and it is one that we are going to be thinking very carefully about.

Senator SUNUNU. And I appreciate that, and I know this is not an issue that you have to discuss or testify on here, but I certainly want to compliment the work of your staff in approaching this issue in a very constructive way, and the testimony we received last year was extremely helpful.

The regulatory issue in the financial services industry is one that has come up recently. There was an article in the Post about it recently. A few people have visited me on the issue, and that is the 10-percent cap, the statutory limit that we have on banking deposits, limiting total deposits for any bank in the United States to 10 percent of the aggregate. And a very specific concern that has been raised is that that would make it more likely that U.S. banks are acquired by foreign banks because those foreign banks are not necessarily subject to those growth constraints. And so if a U.S. bank gets to a particular level, they really cannot grow through acquisition any longer, and it makes them a little bit less competitive around the world, and they could potentially be acquired.

Do you sort of agree with that view that an arbitrary cap, in this case of 10 percent, could make a foreign acquisition a little bit more likely?

Secretary PAULSON. Senator, this is, a complex issue that touches on competitiveness from two different angles. This is something that I am sure will receive some discussion, but, again, let's remember what the reason for the 10-percent cap was to begin with, which was, concern about competition in our markets.

Senator SUNUNU. I appreciate that viewpoint. Although, as I understand it, I certainly wasn't here. It was a negotiated tradeoff, shall we say, a compromise that was reached between different constituent groups weighing in on both sides of a piece of legislation, and they decided to set the cap at 10 percent. I don't know that it necessarily had a great deal of economic validity to it, but it certainly has served to maintain a much more fragmented market, which could have some strengths, but also could have drawbacks.

All right. I will keep skipping down then. The last question gets back to something raised by Senator Shelby, who I think asked a very good question about the diversification statements of the Chinese leadership, and you gave a very good answer as well. But I am curious about a specific concern or potential concern, which would be, How would you respond if the Chinese Government announced that as part of that diversification strategy they were going to start purchasing U.S. equities, and in particular, let us say for the sake of discussion, they made a tender offer to purchase Ford auto manufacturer? How would the Secretary of the Treasury respond?

Secretary PAULSON. Let me say one thing I have learned is that as Secretary of Treasury, I should not be responding to hypotheticals. So——

Senator SUNUNU. I thought it was only United States Senators that were not supposed to respond to hypotheticals.

Secretary PAULSON. Let me just leave it there. Thank you.

[Laughter.]

Senator SUNUNU. Mr. Chairman, Mr. Ranking Member, I tried. Thank you very much.

Chairman DODD. Mr. Secretary, I told you there is no germaneness rule in these hearings.

[Laughter.]

Chairman DODD. As I told the Senator the other day, when he asked what the subject matters would be, I said the subject matter is the exchange rate policy, but the subject matters my colleagues may raise might digress a bit from that subject matter, and Senator Sununu certainly has every right to raise the questions he did here this morning, and I appreciate it.

Senator Bayh.

STATEMENT OF SENATOR EVAN BAYH

Senator BAYH. Thank you, Mr. Chairman.

Chairman DODD. Senator Bayh, I talked about your State a little bit. I mentioned the companies in Indiana that closed their doors that produced those magnets in the smart bombs.

Senator BAYH. That is exactly right. A subject for another day, perhaps, Mr. Secretary. It is a matter of national security when the manufacturers of important defense systems are acquired or moved to another country. But that is not the subject matter at this hearing.

I want to thank you for your presence today and for your public service, and some of the questions that you are getting, including some of my own relate to, shall we say, legacy policies that you have inherited from your successors and that have been part of the administration's record for some years. And I know you are trying to grapple with this, so I hope you take that into consideration when you field our question.

I listened with some interest to Senator Shelby's comments and the Chairman's comments, and I would like to follow up on that a little bit. And you alluded to it yourself, Mr. Secretary, when you said ultimately it is not what we say but what we do that matters. That applies to other countries as well.

As you know, the Chinese have a history of saying many of the right things, and I am glad that in your private conversations they understand that it is in their best interest to begin to allow their currency to float and to protect intellectual property and to reform their banking system and those kinds of things.

We have been saying for some time that we have been frustrated. You said that this morning as well. And so here is my question. When asked by my colleagues what we intended to do, you mentioned regular meetings and further dialogs and those sorts of things. But it might strike many of us that that is, in fact, what we have had in the past.

Are there any specific steps that we intend to take if they do not show material progress toward moving in a better direction, other than meetings and dialog and consultation?

Secretary PAULSON. Well, Senator, as I said earlier, the process that we have, which I would not characterize as just dialog, because we are now going to be speaking with a single voice to the key decisionmakers. We are going to be doing it very regularly, and we are going to be following it up, and we are going to be holding ourselves and holding them accountable.

But having said that, let me say what you said very nicely, and what I have had a number of other Senators say to me in private. I have talked with Senator Schumer and Lindsey Graham and so on, and they have said when you do this, is that going to get results? And if it does not get results, what are you going to do? And what kind of leverage do you have and so on?

What I have said is that we are dealing with a sovereign state in China, a sovereign nation. It has got its own public to deal with; that I really do believe what we have put in place gives us the best chance to get some progress. I do not mean to sound naive because it very well may be that after we have worked hard, I will be dissatisfied, you will be dissatisfied with the progress, and the American people will be dissatisfied. But I still believe that we will get more progress with the course we have adopted than we will going any other way.

And what I need to do is make a very, very strong case as to why it is in their best interest and how strongly the American public feels about it and how strongly you all feel about it, and be there and be at the table continually pressing and pounding on these issues.

Senator BAYH. Well, I have you are right, Mr. Secretary, and I know you are sincere. As you can appreciate, the issues for many who observe this process, and my staff compiled a list of the statements on behalf of our own Government in consultation and meeting with the Chinese urging them to take these steps, and then the Chinese respond that they intend to pursue the necessary reforms. Ultimately, when a period of years passes, it is a question of credibility on their part. You know, they are saying the right things, but what do they really intend? Are they just sort of placating us but continuing to pursue their own interests? And then ultimately our own credibility, we say the right things, but what do we intend to do to back up our words with actions?

And so many of us are looking for some more material steps, both on their part and on our part.

Secretary PAULSON. Senator, I would also say when it comes to compliance with the WTO, Susan Schwab, our Trade Representative, is quite aggressive. You saw the auto parts case, the other things we have in our arsenal.

So I don't think I would characterize it as being passive about this. This is very important. It is a very, very important relationship to all of us, and managing it properly and making sure we get some progress.

Senator BAYH. Well, that is what the steelworker that Senator Shelby referred to or the autoworker in Indiana, quite frankly, is looking for. You mentioned that the playing field is not always level. What they want to know, to use the colloquialism they would use to me, is: "What the hell do you intend to do about it?"

Secretary PAULSON. Right.

Senator BAYH. And I think that is what we are all looking for, backing up our intentions with actions if there is not material progress, because at the end of the day, this global trading system that we all embrace has to be one of mutual interest, not unfairly weighted on one side or the other. Otherwise, it is not sustainable, and that is not in our interest or China's interest or in anyone's interest.

If I could just shift subject matter for a second, this is a matter of not only financial policy but, frankly, my own concerns about our national security interests, and it relates again to the currency issue and that sort of thing. I was interested in your comments, I think it was with regard to Senator Shelby, about the size of Chinese reserves compared to the daily volume of trading in U.S. securities and that sort of thing. And I gathered from your comments that you did not feel that they could really have a material impact upon the value of the dollar, regardless of the policy of the Chinese Government.

But my thoughts went back to—and I am sure you will remember this well—a couple of years ago when a rumor went through Seoul that the South Koreans were thinking about diversifying their own holdings and set off a free fall in the dollar temporarily until an official of their treasury came out and said that that is not true.

A couple months after that, there was a misstatement, I think by the Japanese Prime Minister, along the same lines. It set off a similar trading pattern in the—so my only—my question to you, Mr. Secretary, is: It seems, at least in those two instances, the marketplace seemed to disagree with your assessment. And so my question to you is—my concern is this: As a great country, we cannot really afford to put ourselves in a position of vulnerability where another nation can affect something materially as profoundly important to us as the value of our money. And so I get back to your question. Did I understand your opinion correctly that they cannot, even if they wanted to, if they chose to diversify to the dollar, affect the value of the dollar? And if so, how do you explain the incidents in Korea and Japan?

Secretary PAULSON. Let me, because what I was addressing was our Treasury and the market for our treasuries and the impact on interest rates and on Treasury securities. Because I made the point that what they own in treasuries, $350 billion, that $500 billion trade in 1 day. And I made the further point that the key thing is the confidence in our economy and in our country, which is why people hold treasuries.

Now, let me say that I think you all know my very, very strong view on how important a strong dollar is to this country. It is clearly in our Nation's interest, and so that is something I feel very strongly about.

But your comment——

Senator BAYH. My time is——

Secretary PAULSON. Let me just simply say, as someone who has been around markets my whole life, I watch people say things. I have watched the Treasury Secretary just say something wrong or misspeak and markets move and I see all kinds of rumors move markets. What I am talking about is long-term fundamental movement, because I am a big believer in markets. And you can get gyrations, and they can be mis-valued at any point in time. But the key to our situation is going to be to have academic policies that drive productivity, keep this economy strong, and that is really where our confidence should come from.

Senator BAYH. Mr. Chairman, my time has expired. If I could just make one comment, Mr. Secretary. Your statement that a strong dollar is in the best interest of the United States is absolutely right. My concern is if another country has the ability to manipulate the value of that dollar in a way that is adverse to us. And given the trade imbalances, I am concerned about that.

Secretary PAULSON. Right, and my point was just to not—I do not mean to trivialize the comment because I will tell you I received—I probably get that question as much as any question since I have been in this job. But again, as I tell you, the confidence in our economy is the big driver, and in our economic policies. If we keep this country strong, we keep our economy strong, and people invest in dollar currencies. They invest in treasuries because they believe they get the best risk-adjusted return, and that is key.

My only point with regard to the Chinese holding of treasuries is that it is not as big as you may think when you look at it in terms of how broad—excuse me—like what our securities are and how diverse the holdings are.

Senator BAYH. Normally it is the microphones you cannot see that get you in trouble, Mr. Chairman. In this place——

[Laughter.]

Thank you, Mr. Secretary. I appreciate it.

Chairman DODD. Before I turn to Senator Bunning, I hope, Senator Bunning, just to make the point, Senator Bayh, I was looking at the quotes and statements from Paul Volcker and Warren Buffett and the IMF. All have raised the same concerns that Senator Bayh has raised here about this issue. You get the IMF saying the other day that a large current account deficit, 6.4 percent of GDP last year, makes the United States vulnerable to a swing in investor sentiment that could put downward pressure on the dollar and see a spike in long-term interest rates. No one less than Warren Buffett has expressed similar language, and Paul Volcker.

I am going to turn to Senator Bunning, but I would just make the point there are a lot of people out there very worried about this issue, Mr. Secretary.

Secretary PAULSON. I would say that is a—what you are doing, to me, they are related. But, you know, I guess there is some relationship in the amount of treasuries that China holds and the imbalances. But with regard to the imbalances, a lot of people have spoken about the imbalances, and it is important enough. I will just take a minute and say a word about this. As long as we have an economy where we are not saving and we are growing and China has an economy where they are saving at 50 percent, and they don't have domestic-driven consumption, and we don't have the kind of growth that we would like with our trading partners in their economy. Japan has begun to grow but it is still growing fairly slow, and we don't have the kind of robust growth—and I am very encouraged by what we are seeing here, but not the kind of robust growth we would like to see—we are going to have those imbalances unless we all work on those together.

We have all got our things that we need to do to deal with the imbalances, and that is what Warren Buffett happened to be talking about. But I think that is a different question than the question that Senator Bayh was asking.

Chairman DODD. Senator Bunning.

STATEMENT OF SENATOR JIM BUNNING

Senator BUNNING. Thank you, Mr. Chairman, and, Mr. Secretary, thank you for being here. I am going to read a quote by Chairman Bernanke, and I want you to respond to it. This was a quote that he gave before the Social Science Academy of China on December 15, 2006. "Greater scope for market forces to determine the value of the yuan would also reduce an important distortion in the Chinese economy, namely, the effective subsidy that an undervalued currency provides for Chinese firms that focus on exporting rather than producing for the domestic market." When this speech was delivered, however, the term "subsidy" was not mentioned.

Why did the Fed Chairman only refer to the undervalued currency in his written remarks? Did Treasury or any other Department ask him to omit the term "subsidy"?

Secretary PAULSON. I was sitting in the audience. I heard the speech the way he gave it. I never even knew that there was the line that you are referring to in the original. So, no, I never had any conversation with the Fed Chairman about this.

Senator BUNNING. Thank you.

Now, all the wonderful things that you have said today that you and the administration and the Trade Representative and all those wonderful conversations you have had with the Chinese and their compliance with WTO regulations or their noncompliance, and you talking back and forth and back and forth—the Chinese do not get it. The people up here make the laws, not you. You can talk about them. You can complain about them. But when you come as an administration to these Senators and ask for support for a policy that we violently disagree with, then who is going to sell it? The Chinese Government whom we are fighting like heck every day on their undervalued currency?

Mr. Secretary, there is an imbalance here. The Chinese will not listen and refused to meet with certain Senators when they went to Beijing to talk trade. I use that as an example because five of our Senators from the Trade Subcommittee of our good Finance Committee went over to talk about it. They will talk to you. They will talk to people who raise the devil, and that is, Senator Schumer and Senator Graham. But the people that make the policy they do not want to deal with. And, therefore, all the jawboning and talking that you are doing with the Chinese is not going to affect one iota that steelworker in Bessemer, Alabama, or that worker in Indiana, who are complaining to us about the unfair practices of the Chinese regulated government in relationship to our open government.

There is a difference, and until you get it, and until you are able to express it forcefully to the Chinese hierarchy that you are dealing with, you are going to have difficulty with the Senators and the Members of the House who pass on whether we want to expand most-favored-nation status for China or regular trade relationship with China.

So I want an answer to the question: When will the Chinese Government listen to the people who make policy, not the people who are supposed to influence policy but the people who actually make it?

Secretary PAULSON. Senator, I thank you very much for that comment. We will have a senior delegation from China here in May for the Strategic Economic Dialogue, and I will encourage them to meet directly with you, and I can use plenty of help in delivering the message. But I appreciate your comment.

Senator BUNNING. But we gave permanent trade relations with China in 1993 or 1994, and we helped them to ascend to WTO, and they have all the rules and laws in place, but they never enforce them. And if you walk the Beijing streets, you can buy anything you want that is illegitimate, that is a knock-off of something that is produced under patent or restrictions here in the United States. And that is never going to be solved just by talk.

Secretary PAULSON. I appreciate how strongly you feel about intellectual property. Some of the companies I worked with in my previous job that sold products that were counterfeited in China felt equally strongly. And this is something that this administration has focused on, and it is something——

Senator BUNNING. That is the problem——

Secretary PAULSON. This is something the USTR, something Sue Schwab and Carlos Gutierrez are very, very engaged in.

Senator BUNNING. They will engage you, talk to you, talk to you until you are blue in the face, but we are not getting any results. We are not getting anything done. The yuan has floated very slightly since we first put it in legislation to market to 27-percent reduction. And I can tell you this: We feel very strongly that that is going to have to be done because all the talking and all the wonderful things that you are doing are not getting it done.

Thank you.

Secretary PAULSON. Well, I would just say this, Senator. I very much appreciate your comments. I have been here a short time——

Senator BUNNING. Well, I am tired of talking.

Secretary PAULSON. We had our first dialog in December. We are going to work very hard to get results. When the Chinese are here in May, I will welcome the opportunity to arrange for you to have a meeting with them.

Senator BUNNING. Thank you.

Chairman DODD. Thank you very much, Senator Bunning.

And do you have a sense here, Mr. Secretary, of the bipartisanship up here on some of these questions.

Secretary PAULSON. Yes.

Chairman DODD. Senator Brown.

STATEMENT OF SENATOR SHERROD BROWN

Senator BROWN. Thank you, Mr. Chairman.

I want to follow up on Senator Bunning's comments about talk and little action for the last decade, decade and a half, from your administration and from the administration before that. I came to the House in 1993. That year—1992 I was elected. That year, we had a bilateral trade deficit with China of barely into the double digits. In 2006, it will perhaps exceed $250 billion. In 1992, when I was elected to Congress, to the House, we had a $38 billion trade deficit with the entire world. Today it will exceed 800-who-know-what for 2006.

I hear your comment—Senator Bunning's comments and your response, and I look back at the opportunities we have had as a Government in the last 5 years to actually respond tangibly. And I would just like to sort of lay out those opportunities and kind of wonder what happened. Back 5 years ago, the national AFL–CIO, with others, filed a Section 301 petition calling on China—calling on our Government to petition WTO—that is the process, you know, with NAFTA it can go directly to the Tribunal. Under other trade law, we have got to get the Government to do it on behalf of our country, whether it is an intellectual property issue or a labor issue or anything in between. But they filed a Section 301 petition saying China had failed to enforce its own labor, minimum wage, health and safety laws, environmental laws, that they had not even enforced their own laws, which amounted to about a 75-percent subsidy, they claimed, a reduction in the cost of production. The administration out of hand just dismissed it, did not even entertain the thought of it.

Then a couple of years later, in 2004, the China Currency Coalition, a group representing several dozen U.S. industrial service, agriculture, and labor organizations, did the same, filed a Section 301 petition alleging that China's currency manipulation was an unfair trade practice, did that in September of 2004. The administration again summarily dismissed it. In fact, the petitioners believed because it was done within a few hours of the filing, the rejection of the petition, not even to read it and hand it on to the WTO and advocate for these industrial, agriculture, and labor organizations in our country representing tens of millions of people.

Apparently, they believe—and I think it is hard to prove otherwise—that they did not take the time—the administration did not even take the time to read the several hundred pages of analysis, documentation, statistics, and tables.

Then 35 Senators and Representatives, we filed a petition in April of the following year, 2005, to have it rejected summarily, just dismissed out of hand again.

So we have these tools that we at least ought to get a hearing in the World Trade Organization, yet our Government is not interested enough to pursue on currency, on labor standards, on the environment, on health and welfare. Why not? Why can't we, Mr. Secretary, at least try something specific? This is not jawboning. This is not just talking. This is following the legal channels of a Section 301 petition, going directly to the WTO on behalf of tens of millions of Americans, many of whom you say are very concerned—I believe you—many of whom have lost their jobs or have tremendous anxiety that they are about to lose their jobs. Why don't we do that, and will we do it in the future?

Secretary PAULSON. Senator, I am a big believer in using the dispute resolution procedures of the WTO. That is one of the real strengths of the WTO. We have rules and we have enforcement measures.

This is something, I can tell you, as I have talked with my colleagues, the U.S. Trade Representative, the Secretary of Commerce, and others who are involved—we all feel the same way. I think the key will be, and I do not know the details of the cases you have cited, but I know one of the things I have looked at is if we cannot get recourse and we cannot get more effective recourse directly, then is it worth going to the WTO? They say, "Is it a case where we can win? What are the merits of the case?"

So I do not—I cannot——

Senator BROWN. With all due respect, Mr. Secretary, they did not look at it, can we win, because they summarily dismissed the petition within a day or a few hours.

Secretary PAULSON. Well, I cannot——

Senator BROWN. I am not saying it was your decision.

Secretary PAULSON. I cannot even debate the merits because I don't know that that is true. But what I can tell you is that I want and this administration wants a level playing field and we want compliance with the WTO rules.

Senator BROWN. OK. I guess I would ask you to commit to this Committee, commit to those of us who are passionate about this, as everybody on this Committee—Senator Shelby's comments, Senator Bunning's, Senator Dodd's, Senator Bayh's—that these petitions will get a fair hearing. I mean, they—it is almost—a cynic would say about this that this administration does not care a whole lot about labor and environmental standards in the United States. Why would they care about labor and environmental standards internationally?

I will put that cynicism aside and just implore you—it is a new team. It is a different USTR today. It is a different Secretary of the Treasury. But I ask you that you will at least give it—at least take a little while, make us think you looked at it, so that we really, in fact, are satisfied that—we have got to do something other than jawboning and other than saying let's play a little with the currency and get a 2-percent adjustment. This is an average that is legal—this is trade law that gives us those opportunities and dispute resolution.

Secretary PAULSON. I am a big believer in trade law and dispute resolution opportunities. I will pass your comments along to our colleagues, and I welcome the opportunity to talk with you more about it.

Senator BROWN. Thank you. One more thing.

Mr. Secretary, as I mentioned, the trade deficit, $38 billion the year I was elected to Congress 14½ years ago, today $800 billion plus. The President is in—I think Wall Street today, yesterday was in Peoria, exhorting the benefits of free trade. All of us think there are terrific benefits from trade if it is conducted on a more level playing field and it really is fair trade.

What is curious about this is the Treasury Department in both parties—it is not a partisan thing, as Senator Bunning knows. The administration has exhorted us to pass these trade agreements saying things are going to get better. Every couple of years, the Treasury Secretary, the Chamber of Commerce, the newspaper publishers all exhort us to pass more free trade agreements with weak or non-existent or unenforceable labor and environmental standards.

Now the President is doing it again. He is saying he wants Trade Promotion Authority. He is going to call for that today. So we have got a $38 billion deficit that went to 200, then 400, then 600, now to $800 billion, and the answer is let's do more of the same.

How do I explain that to a steelworker in Lorain or a textile worker in southeast Ohio?

Secretary PAULSON. Well, Senator, it is going to be very hard to explain anything about trade to someone who has just lost a job. But what I would say to you is that trade is benefiting this economy to a large extent. You heard—I do not know if you were here when I made my comment about the GDP number this year—I mean this quarter, the fourth quarter. It was announced 3.5 percent. A big reason for that was the component that came from trade and the fact that our exports are now growing faster than our imports.

Senator BROWN. We know all that, but you also know, Mr. Secretary, that if you look at economic growth from the post-war years until 1973, our society across the board fared in that economic growth by a decent distribution of wages that—everybody pretty much saw their wages go up. Since 1973, the day we went from trade surplus to trade deficit in this country, a persistent trade deficit, the people on the bottom have not done well. You know the kind of salaries where you came from, the kind of salaries that just kept going up and up and up. And GDP has gone up, but most people in this country are not sharing in that, and part of that is trade policy, that the distribution—you said yourself you know that some are hurt, some are helped. Just I hope you think that through, that part of the reason for this huge chasm in wages has been because of our trade policies, inability to distribute benefits even close to equally.

Secretary PAULSON. Well, I would say to you, Senator, that the widening gap in income distribution is something that I am focused a lot on.

I want to come back to the one thing that you said that I do disagree with, which is equating a trade deficit with workers not doing well. And, frankly, what we would tell you is that growth is important. Some of the times when you look where we have a trade surplus, it will be when the economy is not doing well or there is a recession. I think the important thing for our workers is to keep the economy growing. I really do believe if we keep productivity up, and keep the economy growing, you are going to see the benefits pass through to the average worker. That is what we have seen now in this last year, and the last couple months in particular.

So I think there are some positive signs, but I understand your concerns.

Senator BROWN. Well, 1 year out of six does not convince me, but I am hopeful that you are right. Thank you.

Chairman DODD. Thank you, Senator Brown.

I would just point out that trade has been a drag on growth. In 9 of the last 12 quarters—and the drop in oil prices I think maybe had more to do with these numbers. We welcome the numbers, but I think realistically why they have come down——

Secretary PAULSON. The exports added significantly this quarter, also.

Chairman DODD. Senator Bennett.

STATEMENT OF SENATOR ROBERT F. BENNETT

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

I came here a little late because I was at the hearing of the Joint Economic Committee that was talking about the issue of the disparity in income gap, and I presented some charts there that I probably should have brought here, not realizing we were going to get into this. But if you look solely at wages, the income gap between the top quintile and the bottom quintile is 14 times. And then when you start making adjustments in the real world, it is three times.

By this, I mean the top quintile is paying taxes; the bottom quintile is getting an earned income tax credit. The top quintile has larger families, so if you take the household members and adjust them for the number of individuals, the bottom quintile, which includes a large number of retired people, one or two people in the household, it adjusts.

When you adjust for hours worked, because the top quintile is employed and a large percentage of the bottom quintile is not, it adjusts.

And as you make those adjustments all the way down, you find that the disparity, instead of being 14 times between the top quintile and the bottom quintile, it is three times. And I would be happy to supply those charts for the information of the Committee and that part of my testimony or my comments before the Joint Economic Committee.

I want to focus on several things. First, with respect to the loss of jobs, I have seen it in my State. Everybody has seen it. But I would just take two figures to illustrate one of the things that we tend to ignore. We had a steel mill in the State of Utah that was put there in the 1940s in an effort to keep it away from the Pacific coast so the Japanese could not bomb it. It was really a stupid place to put a steel mill, but, nonetheless, in the World War II mentality, that was what they did. At the time it employed 4,500 people. The steel mill finally closed in 1990. It was under competitive pressure from around the world. And they were producing something like three or four times as much steel as they had produced in the 1940s, and their employment was 1,500.

The loss of 3,000 jobs did not come from the Chinese. It came from a place called "productivity." We must recognize that we have been losing manufacturing jobs for the last 50 years because of increased productivity, and the economy and the level of productivity and the impact of the Information Age today means that our economy has no more resemblance to the 1973 economy than the 1973 economy had to the days when we were an agricultural economy. If this hearing had been held a hundred years ago, we would say over 60 percent of Americans work on the farm. And a hundred years later, in 2006, that number will be two. And what are we going to do about those 67 percent of Americans that are going to lose their jobs?

Well, the 2 percent that work on the farm produce something like five times as much food and fiber as the 67, 68, 69 percent that worked on the farm a hundred years ago. And as we have these discussions, we need to understand that the whole world has changed and the economy has changed in a dramatic fashion.

Now, to get to the Chinese, with that in mind, I would like your response to this. I remember when the bugaboo was Japan. Hollywood was producing movies. There were novels. The Japanese were going to take over everything. And downtown real estate in Tokyo had a higher appraised value than the entire State of California. And then something happened. The economic reality began to intrude on the bubble that occurred in Japan. I owned a business in Japan at the time, and bank balance sheets became readjusted to reality. They were putting appraised values of real estate on their balance sheets as if they were real assets, and all of those kinds of things happened.

I look at China, and I see the following things that tell me that China is not going to be what some commentators are telling us it is.

No. 1, the United States GDP has grown more in the last 5 years than the entire Chinese GDP is. Our GDP growth in the last 5 years, cumulative, was about $2.7 trillion. Don't hold me to the exact amount, but it is close to that. The total Chinese GDP is about $2.3 trillion. That is not something that causes me to quiver at night by comparison that they are going to take us over.

No. 2, their statistics are not that reliable. Any country that issues their GDP growth statements for the year on the 31st of December, it says, Wait a minute, some of these numbers were cooked in advance.

The banking system is a disaster. An editorial in the Wall Street Journal that appeared on the 29th talks about that and the things they need to do to shore up their banking system.

But, finally, the last time I was in Beijing, I looked at all these fabulous buildings and asked the obvious question: Who is building them? The U.S. Ambassador told me that question was put to the Chinese officials, and the answer was, "Speculators."

So the next question is: "Who lives in them?" And the answer was, "Corrupt government officials." Sooner or later, they are going to run out of corrupt government officials to fill all those buildings.

Would you comment on what China's long-term prospects are with these kinds of structural problems and how that affects all of these things as opposed to just a narrow conversation on currency rates?

Secretary PAULSON. Senator, I think it is a very good question, and I have been very impressed with the capability of the Chinese leadership and no one can argue the success they have had with their reform program. But I also have learned that when something looks too good to be true, it generally is. No one is going to defy economic gravity. There are going to be bumps along the road in every economy.

And so the point that I have made when talking about China is they are now partway between a market-driven economy and an economy with administrative controls. As they become bigger and bigger and more complex and they become increasingly integrated into the world economy, the greater the risk to China and to all of us. Frankly—and I will get to that in a minute—if they don't move quickly enough and they hit some big bumps in the road, because I do believe that many people who worry about China worry about the wrong thing. They are worried that China is going to greatly overtake the United States and it poses some huge threat.

And, frankly, what we should be concerned about is that we—it is in all of our interests to have China keep doing well.

China has been, right along with the U.S., one of the engines for growth in the global economy for a good period of time, and a bump in the road, a serious bump in the road would have repercussions for all of us. And so I really think that is a concern.

I feel also what you feel about the U.S. economy. It is a very interesting thing, because before taking this job, I thought about it this way: I have traveled all around the world, and we can focus on our problems, and we have got meaningful problems to focus on. But our problems are so much less than any other nation's problems, and we have such great competitive strengths, if we just continued to make the changes we need to make to keep our economy competitive.

And so I do agree with you, it is an interesting point and part of the reason why it is so easy for me to push the Chinese very hard on currency and other reforms is that reforms are not only necessary to make sure that we have a level playing field and that our workers share in the benefits, but it is going to help them much more. If they do not open their markets to competition and they do not move more quickly to market-driven forces, there are real problems that they will hit, more than a small bump.

But I would say to date they have managed magnificently well and they have very strong leadership, and I would like to believe they will do the things they need to do to keep their economy moving forward, which would be good for all of us, not just good for them. It is a win-win.

Senator BENNETT. Thank you. I appreciate that, and just a quick comment, Mr. Chairman. One of the reasons they have done well is they have basically ignored the advice of the IMF. Thank you.

Chairman DODD. Thank you, Senator Bennett.

Senator Reed.

STATEMENT OF SENATOR JACK REED

Senator REED. Well, thank you, Mr. Chairman. Thank you, Mr. Secretary. A lot of the discussion today is focusing on our continuing negotiations and discussions with the Chinese, but let me ask a simple question. What is our leverage against the Chinese in these negotiations? If we do not have any, then it is a long discussion without results. So how would you classify or what would you point to as our leverage against them in these negotiations?

Secretary PAULSON. Whenever you are—and I found this in business also. Whenever you are negotiating with a strong counterparty—in this case we are negotiating with a sovereign nation that is accountable to their people, and it has got strong public sentiment—leverage is a difficult thing. But you need leverage. And what I can say to you is we have thought about this. Obviously, we have got the leverage if they do not comply with WTO, all those enforcement mechanisms and dispute resolution procedures. So you have got that. We have got the force of law in our country and the force of law in the WTO.

But in terms of the kinds of things that I am talking to the Chinese about, I think their leverage comes from having very direct and regular meetings—regularly meeting with the key decisionmakers, and I need to advocate very effectively why this is not only important to them, but how strongly all of you feel and how strongly the American public feels. And, again, I know that is not—I know you want to hear more than that, and all I can tell you is I think the plan we have has the best chance of getting progress, and it will get more progress than going other routes. And other things that have been suggested from time to time I think are counterproductive. So that is——

Senator REED. Well, in what way—well, let me go back to Senator Brown's questioning, which I thought was very interesting. You have already suggested you have legal means, that there are at least initial claims that could be made—they might not be favorably decided, but they are certainly at least—I mean, they are credible claims. Why wouldn't you invoke those legal mechanisms as a way, if not to secure final judgment, simply to communicate our seriousness and also to give you more strength in your discussions?

Secretary PAULSON. I would say when we get to what we do, if there is noncompliance with the WTO, that is a topic that Sue Schwab, and a number of people in this administration are focused on, and I am interested in also.

In terms of the kinds of things we are talking about here, which are currency and the path of reform, I believe that the path we have chosen is the way we will get the most results. If we do other things it could be—it is just my judgment this is the best way to go as opposed to getting into a situation where the Chinese get locked into defending their current policies.

Senator REED. How long will you let this process go forward, Mr. Secretary?

Secretary PAULSON. I will tell you something. I have 2 years and you have me for 2 years being a very strong advocate of the policy that I think has the best chance of getting results over that 2-year period of time.

Now, a lot of these issues are going to take much longer than 2 years to resolve when we talk about some of the fundamental reforms. But I will be very disappointed if we do not make some progress over this period.

Senator REED. Well, I think, Mr. Secretary, you bring extraordinary talent to this job, and dedication, but this seems to have been the constant refrain not only of yourself but your predecessors of the last at 6 years about, well, we talk to them, et cetera. And I think Senator Brown made an excellent case about the legal grounds we have to pursue, and if we do not pursue those grounds, I think the Chinese assume, as I would, as you would if you were, I think, in a similar position, that this is important to us but it is not the most important thing.

Secretary PAULSON. Senator, let me just make the one obvious point. What we are doing with the Strategic Economic Dialogue does not determine what legal grounds we are going to pursue with all of the other mechanisms we have in place. What we are doing here, in all due respect, is a different level of dialog, because being able to speak with one voice regularly to all the top decisionmakers—two major meetings a year, frequent smaller meetings, tracking progress—I argue is a different plan.

Senator REED. I appreciate your point, Mr. Secretary. You know, those of us who did support—and I think many here, if not all—admission of China to the WTO did so on the assumption that the rules would be available to the international community to use against China. That was the understanding the Chinese had when they entered the WTO. And yet we are very reluctant to use those rules. I will just make that point.

Another point, a final point that you might comment on if you want, is that one of the problems I think we have is that our relationship with China is not strictly one dimensional in terms of the economy. And let's be realistic. I mean, we are asking the Chinese right now to be immensely helpful to us with respect to the North Koreans. We are asking them to be helpful to us with respect to the Iranians because they have great equities. And I get the sensation—again, you could comment or not—that many times when you take up these economic issues, particularly at the Presidential level, they are third, fourth, fifth, sixth on the list because when you talk about North Korea breaking out, testing nuclear weapons, when you talk about the Iranians doing the same thing or attempting to do the same thing, and China plays a critical role in the Security Council and just as a force in the world, that many times because of the strategic situation we find ourselves in—and I think some of that is the result of decisions that this administration has made—that we are sacrificing some of our economic—what is the right word? Our economic issues with respect to other issues.

Secretary PAULSON. Senator, the economic issues are very important to us. They are very important to China. Very, very important to China. And I do believe that we are going to get more leverage because we are no longer siloed. We are now coordinating what we are doing economically, and we are speaking with one voice. And I think that gives us great leverage.

The other thing I would say to you is that rather than being a hindrance, I think that the stronger the economic relationships are between any two countries, the more shared interests they have, and the greater interest they have in peace, prosperity, the more harmful disruptions are. So, again, I really believe if the economic dialog is handled properly, it will not hurt any of the other dialogs, and, in fact, it will help it and will complement them.

Senator REED. Thank you.

Thank you, Mr. Chairman.

Chairman DODD. Thank you, Senator Reed.

Senator Allard.

STATEMENT OF SENATOR WAYNE ALLARD

Senator ALLARD. Thank you, Mr. Chairman. I want to express my view on free trade since we have gotten into that issue.

This country practiced a lot of trade restrictions first in the 1900's, and it simply did not serve us well. When we look at those times when our economy was most depressed, that is when our trade balance was most favorable. So we had a more favorable trade balance during the Depression, and in the late 1970's when we had the Misery Index, our trade balance was most favorable.

Now, the last four Presidential administrations basically had a free trade policy, both Democrat and Republican, and it served this country well. I hope that we do not get ourselves in a position where we get into trade wars, because they are not going to serve our economy well. That is my view.

Now, I have a State with big portions of its economy in agriculture and high-tech. In fact, we have the highest percentage of high-tech jobs in the country. It is not commonly known. Senator Bennett next door in Utah, also has a very prosperous high-tech industry. We rely on the Far East—China and Japan and others—to trade with because we have a lot of high-tech. I am curious to know your perspective. We have heard from the manufacturing aspect of the economy, and I agree with Senator Bennett. The loss of jobs in that sector has more to do with high-technology where we are more efficient, we get more done with less.

So I would like to hear your comments on the agricultural industry and also the high-tech industry, because those are two very important aspects of the economy that I have in the State of Colorado.

I would also point out that Colorado has benefited as much as any State on our trade agreements. I would just like to hear you talk a little bit about the high-tech and the agricultural aspect of the economy.

Secretary PAULSON. Well, let me say in terms of trade with China, you have hit two of the big areas where we export products: high-tech, medical devices, aircraft, and, of course, agriculture has been an important part of that trade.

I wonder whether I might make, if you would allow me, a comment—you triggered something when you talked about the trade balance. If I could just take a minute and explain one thing that I think is important to understand, and this is not to say that the trade deficit with China is not too large, and it does not say we do not care about it a lot. But it is fascinating what happens. It is happening in Asia, because what happens as you look at production patterns, we have had sort of an integrated production system develop in Asia where China imports components and raw materials from this country also, but largely from other countries in Asia, and then they are the last point of assembly and so China is the exporter of record.

But when you look at what has happened and going back to 1999 to the present, what you see is that China's share of our trade deficit has gone up and the rest of Eastern Asia's has gone down. If you look at China and Asia together, their share of the trade deficit was 46 percent in 1999 and it was—excuse me, it was 53 percent in 1999 and 46 percent today, so it has gone down.

It is really very dramatic in a number of products. For instance, if you look at footwear, big imports. In 1999, 9 percent of our footwear imports came from China. In 2004, 70 percent came from China. But if you looked at the rest of Asia, in 1999, 51 percent came from the rest of East Asia, and in 2004 it was 1 percent.

So you see what is going on, and then your point, Senator, on high-tech, if you look at China's trade deficit with the U.S., there is a Stanford study that showed that for every $1,000 of imports China made to the U.S., they were going out and they were paying $614 to import products or components from other countries. So there was a little bit more than $380 of value added for Chinese employees and manufacturers. But our exports, on the other hand, were high-value-added exports where there was $843. So this is not for me to say this is not important, because it is very important. We need to reduce that deficit. We need to open up the economy. But the reason I give that example is because it is very misleading to look at the trade deficit bilaterally. We need to focus on it with China, but we need to focus on it overall for the U.S. And we need to increase our exports, and we are getting some very positive growth both in our exports to China and globally.

Senator ALLARD. Now, one area, if I could be critical of the administration, is when they put trade restrictions on lumber. Because they put high tariffs on lumber, the cost of lumbers goes up, and it impacts every American family. It impacts the price of our homes. For those people who are building new homes, it raises the cost of that home substantially. This leads me into the subject of the housing market. Senator Bunning and myself last fall had a joint Subcommittee hearing, Subcommittees of this Banking Committee, to examine the state of the housing market and its impact on the U.S. economy.

Your report notes that the U.S. housing market has had international impacts. Now, I know the trade has had an impact on housing, but I am trying to figure out how U.S. housing has an international impact.

Could you elaborate on that?

Secretary PAULSON. Well, I would just say I cannot tell you exactly what those who made that comment had in mind. I can just say to you that this was a significant correction in our housing market, a very, very significant correction. We were growing at an unsustainable level. And I think as the recent numbers have shown, we are making the transition to a more sustainable level of growth, and the economy is so strong and diverse that we are getting through it.

But the U.S. economy is so important to the world and such an important engine for growth that anything that has a material impact on our growth has an international impact. I would say to you that when I would travel around the world and talk at G–7 meetings, meet with the G–7, with leaders at the World Bank meeting, international economists, and international Finance Ministers, one of the first questions they ask me is: What is going on in the housing market? Because they care a lot about our economy, and I think that is probably what they had in mind.

Senator ALLARD. Thank you.

Chairman DODD. Thank you very much, Senator.

Senator Shelby has a point he wanted to raise, and I have a closing comment, and then, Mr. Secretary, we are going to let you depart.

Secretary PAULSON. OK.

Senator SHELBY. Thank you, Chairman Dodd.

Mr. Secretary, we all know that economies constantly change, and they do not remain static. They always have. But there is a lot of concern by all of us in America about the erosion of our manufacturing base, of jobs, good jobs. I alluded to it earlier dealing with the steel and foundry business, but this is just part of it. It not only affects a lot of the people in the Birmingham, Alabama, area but Pittsburgh, Cleveland, you name it. And I think that goes on.

I think we have to concede the basics that trade is good. Trade should be fair. We are taught trade should be free. Free trade. Economics. That is a principle of economics. But I am not sure that it is, and that concerns me in a big way. And I see the erosion of the working middle class in America, as you do.

Sure, we benefit from high-tech. We have a high-tech area in Huntsville, Alabama, big time. And we appreciate all that. But everybody—there are 300 million people—will not be involved in high-tech. We have benefited over the years in America with the manufacturing base, and I think we are losing that, and there has got to be a reason.

I think we are competitive. This is a great economy. It is a great Nation. But, you know, if the roof is leaking, we better fix it. I think the roof is leaking as far as the imbalance of trade. It is just too much.

We have talked about this before, and you have got 2 years left as the Treasury Secretary. You did not come down here to just be here. You came down here to make a difference. I know you and I believe that is why you are here.

Do you believe—I know there is always hope. And I hope but I do not believe that there will be much change in our imbalance of trade with China 2 years from now. I think it will keep growing, the deficit will keep growing, to our detriment overall. And that is a real concern.

I do not want to build walls around this country. That is the worst thing we could ever do. But we have got to do something. I don't know. Somebody asked about leverage. We know they are a sovereign nation. They are an important trading partner and an important nation in the world, and they have many facets—in fact, there are many facets of our relationship: trade, international diplomacy, and you name it.

But do you really believe that 2 years from now when you will be gone as Secretary of the Treasury that there will be a balance of trade with China? Or will we be working toward a significant goal, I mean, progress, benchmark toward making that imbalance close to even, Mr. Secretary?

Secretary PAULSON. Senator, you ask the right questions, and I would say to you that I can think of very few big important issues that can be solved in 2 years' time. As I said in my testimony, currency flexibility is essential. We need it. China needs it. We need a currency whose value is determined in the competitive marketplace. But the primary driver of the trade imbalance with China has to do with structural issues that we have talked about today. And do I believe that those structural issues can be resolved in 2 years? No way.

Senator SHELBY. Well, at least——

Secretary PAULSON. But do I believe we can make progress and benchmarks to doing some things we can look at as progress along the way? Yes, I do. And if I did not think we could make progress, I would not be working as hard at it as I am.

Senator SHELBY. Thank you.

Chairman DODD. Mr. Secretary, thank you very much as well, and I am going to pick up on that point because I think you have—I was sitting here, and I was trying to imagine if I were listening to this or watching the hearing this morning, what I would come away with if I were a steelworker in Birmingham or that autoworker in Indiana or a small manufacturer in Connecticut. What do I get out of this?

I am concerned that—and I appreciate your last statement. It is a strong statement, the very last response you made here. But if you look back over it, we have been through this so many times on this over the last number of years, and it is hard to find any consistency in this. Again, I am not talking about this was on your watch per se, but what has come before. I was looking back at what happened under George Bush 41's watch when these numbers were substantially less than the numbers we are talking about today, but that I presume make up the determination of intent. So you look at a bunch of these factors. It isn't you listen to someone give a speech about intent but, rather, what is the hard evidence that exists in this relationship that draws us to the conclusion that the intent is what you have suggested here today as opposed to being a different set of judgments.

Obviously, in previous administrations they drew different conclusions, and it is hard today to wonder why we are not sort of following a similar set of conclusions given the multiples of the numbers that they relied upon to decide that not only China but Taiwan and I think it was—China, Korea, as well as Taiwan were all currency manipulators, going back to Bush 41's Presidency, the Treasury Department drawing its conclusions in 1992. And I will not go into the numbers and so forth, but we have talked a lot about this already, the reserves and so forth.

And so I am worried in a sense that we are not—if you are sitting here watching this, you would say it sounds like more of the same in a sense. What are we really going to be doing here? And you made a point earlier that I think we did not bring up enough here today that the lack of currency flexibility has not only been disadvantageous to China and certainly to us and the people who paid a price for it in this country, but China's neighbors in the Pacific Rim. It disadvantages them tremendously as they try to compete for markets and for services and goods.

So the implications of China's actions I suggest certainly are bad for them in the long term, and not only bad for us in many ways because of what is occurring here, but also from a global perspective, this is having a huge negative impact.

So I would like you to give some consideration, if you could, on this watch of yours. And I agree with you the likelihood we are going to dramatically change all of this in 2 years is pretty small.

But it seems to me on your watch we could maybe change—maybe we ought to look at this law again. Are the criteria for intent—but we can get far more consistency out of this. We can set some real benchmarks. I think it is important that China understand what we care about and that we watch this carefully. We are a very attractive market to them. We are in a buyer's market in a sense. They want to be here. They want this relationship. That is our leverage point to a large extent.

So how do we leverage that point to set up a good set of criteria that have a degree of predictability to it so that we can get the kind of responses that we would all like to have in a far more expeditious way than certainly has been the pattern over the last number of years? And I would invite your knowledge and expertise. What I said at the outset was not just a gratuitous comment. There are very few people I have ever met in Government in my 26 years who bring as much knowledge about this relationship as you do. And so you are a valuable asset in this moment of time we have here to figure out how to do a better job of this, because that person out there watching this hearing today is going to wonder if we are just going to be back here again next year or the year after with the same kind of conclusions, no one really wants to take this on, their jobs disappear, the problems get worse, the balances grow higher, and they wonder if there is going to ever be light at the end of the tunnel. And then the day arrives where we find ourselves behind the eight ball, and we wonder, What were we thinking of that we did not take stronger action, more clarity in our relationship with this country, with China, than we should have at the outset of the 21st century?

So I raise that for you for a quick comment, if you would, about whether or not we might think about restructuring something here that gives us a higher degree of predictability.

Secretary PAULSON. Well, first of all, Mr. Chairman, I thank you very much for the opportunity to be here today. I thank you for your comment.

To your specific question, I think one thing is clear. We all have the same goal. Clearly, we have got to——

Chairman DODD. We all agree with the same result, despite the language here.

Secretary PAULSON. Now the question is we say——

Chairman DODD. We also agree with the same conclusion today despite—they are still manipulating this currency.

Secretary PAULSON. Well——

Chairman DODD. I understand you have got a position and I——

Secretary PAULSON. Well, I would say we have got the same goal. We are talking about tactics as to how to get there. I think what you are saying is, what specific target do you put out there and, again, I am very open to talking to you about it, any option.

I would just say to you that having thought about it very carefully, I don't think a specific target, a specific public target will help us make more progress, or I would have suggested that. I really do believe—and I know it is frustrating for some people, but I do believe we have come up with a plan in place that gives us the best chance of making progress. That could actually be true, and we could still be frustrated because we would like to see more progress.

But I think we are going to get progress, but, again, I welcome continuing this conversation.

Chairman DODD. I thank you for that. And I would just add, having been in this body and on this Committee for 26 years, I have the same warning. Events are going to overtake, and all this other goes back, and my colleagues here—you listen to Senator Bunning. He is not alone in his comments here, and this is not about Republicans and Democrats. This is about people who go home every weekend in these times off, and we meet our constituents, and they are livid. They are livid, Mr. Secretary. And the Congress is not going to wait necessarily for us to get some sort of vague definition of how this is kind of progressing when they watch 3 million manufacturing jobs leave this country, when they watch a country that is investing heavily in armaments and not investing in its own people, and then complaining they cannot do this quickly enough because of their problems with unemployment insurance, and yet the tenfold increase in defense spending, people are going, "What are you people thinking of up there?" And you are going to get blown by with this problem if we do not get a better handle on this. And that is why this is important to recognize the moment is now to start to think this thing through so we don't have the inconsistencies in it.

I thank you very much, and I apologize to our second panel. We will get to you right away. But this has been tremendously valuable. I hope you have enjoyed your first appearance here. [Laughter.]

Secretary PAULSON. Thank you. Thank you very much.

Chairman DODD. We hope you come back more often, and thank you very much for being here.

We will move right to the second panel, if we can. Thank you, Mr. Secretary, very, very much.

Let me introduce the second panel and thank my colleagues as well, on this very important hearing.

As the Secretary and his team are leaving, I will do the introductions and people can make their way to the table here.

The committee is very pleased with our second panel of witnesses: Richard Trumka, a good friend of mine. I must say we have known each other many, many years. Mr. Trumka is the Secretary-Treasurer of the AFL–CIO, a position he has held for 10 years. Previously, he was the President of the United Mine Workers.

In fact, I recall that you testified before this committee about 5 years ago on the very same subject. So we welcome you back. You know a lot about it.

I am also delighted that we have Mr. Michael Campbell who is testifying today as both Vice Chairman of the National Association of Manufacturers, the NAM, and as President and CEO of Arch Chemicals. Politics is always local. It is nice to have a constituent here. Mr. Campbell thank you, and congratulations on your assumption of the presidency of the NAM, an organization we deal with quite frequently here, as well.

I know that Mr. Campbell will be able to discuss these issues in great depth. We should note that he is going to be taking over from Chuck Bunch, who has served his 29-year term as the Chairman.

Albert Keidel is a Senior Associate at the Carnegie Endowment for International Peace. Before joining the Carnegie in September 2004, Dr. Keidel served as the Deputy Director in the Office of East Asian Nations at the Treasury Department. That experience has provided him a very useful perspective on the subjects we have before us today. Doctor, we thank you for being with us.

And Dr. Fred Bergsten, who is no stranger at all to this committee. We thank you for coming back. He is the Director of the

Peterson Institute for International Economics. He has been a Director of the Peterson Institute for International Economics since its creation in 1981. He served as the Assistant Secretary of International Affairs at Treasury during the Carter Administration, and also testified before this committee and many other committees on this and related issues.

We will ask you to submit your testimony in full, and I would like you, if you could, to try to keep your comments to five or 6 minutes. I am not going to hold you to that too tightly, but if you keep the idea in mind we can get through here. And I promise, all of your documents and supporting material that you think would be valuable to the record will be included in the record.

Richard, we will begin with you.

STATEMENT OF RICHARD TRUMKA, SECRETARY-TREASURER, AFL–CIO

Mr. TRUMKA. Thank you, Mr. Chairman, members of the committee.

I am delighted to have the opportunity to testify today on behalf of the 10 million working men and women of the AFL–CIO.

I am also the co-chair of the China Currency Coalition.

As you know, the issues you are discussing today go right to the heart of the economic challenges facing America's working families and our middle class.

We, in the labor movement, feel a certain amount of urgency to develop and implement concrete solutions sooner rather than later. Unfortunately, it often appears that this Administration does not share our sense of urgency. We hope that Congress will step into the void left by the Administration's failure to act, and we welcome this hearing as a crucial first step in that direction.

In December, the Treasury Department issued its 2006 Report to Congress on International Economic and Exchange Rate Policy. The report finds no currency manipulation on the part of any of our trading partners.

Yet the same report also finds that China's current account surplus rose to around 8 percent of GDP in the first half of 2006. That is a 500 percent increase since 2001. China's foreign exchange reserve reached $1 trillion in October. That is $200 billion more in 1 year. The U.S. trade deficit with China will reach about $230 billion in 2006. That is a 15 percent increase in 1 year. And the Economic Policy Institute estimates that the growing bilateral deficit with China has displaced more than 1.5 million jobs.

Now either there is something wrong with the criteria Treasury is using to determine currency manipulation, or there is something wrong with the Treasury Department's math.

Josh Bivens and Rob Scott of the Economic Policy Institute laid out three very clear criteria for determining whether or not a country is manipulating its currency. First, does it have a high and rising bilateral trade surplus with the United States? Second, is the global current account surplus high and rising? Third, does it possess a high and rising accumulation of international reserves?

Table 1 in my testimony compares China's current position to nine past instances when Treasury Department found that nations were manipulating the value of their currency vis-a-vis the dollar for competitive gain. On each front, the current position of China well exceeds the previous threshold that led to a finding of manipulation.

Many respected academic experts have also weighed in on this issue. As you noted, the bipartisan U.S.-China Commission found that China's currency manipulation harms American competitiveness and is also a factor encouraging the relocation of U.S. manufacturing overseas while discouraging investments in U.S. exporting industries.

Ben Bernanke, Chairman of the Federal Reserve wrote recently that China's undervalued currency provides an effective subsidy for Chinese firms that focus on exporting rather than producing for the domestic market.

Mr. Chairman, Japan has also intervened aggressively and repeatedly in their currency markets to gain an unfair trade advantage, spending nearly $450 billion to keep the yen undervalued since the year 2000. That is according to the Automotive Trade Policy Council.

And not only did the Treasury Department fail to cite Japan as a currency manipulator during that time but, according to John Taylor's recent book, Treasury officials implicitly sanctioned the Japanese interventions. We find that extremely troubling.

I know the Treasury Secretary is no longer here, but we would like to ask Secretary Paulson and his staff exactly what it would take for Treasury to find that a country had, in fact, manipulated its currency. Perhaps more important, what it would take to move beyond yet another round of endless diplomacy and strategic dialog to concrete action and results.

This is not an academic exercise for the union members that I represent. The difference between currency manipulation and market equilibrium exchange rate is the difference between having the job and watching your factory shut its gates. It is the difference between having health insurance for your kids or not having it. And for our country, it may be the difference between having a healthy middle class or sitting back and watching as economic divisions tear us apart.

Giving the soaring U.S. trade deficit with China and the burgeoning Chinese foreign exchange reserves, we are bitterly disappointed that Treasury found no manipulation again this year, and we were underwhelmed by the announcement of the Strategic Economic Dialogue as a response to the global imbalances that the report did concede. On paper, the SED promises a forum for addressing critical economic issues and planning for long-term cooperation. The SED offers too little, too late.

The proposed forum, dialog and cooperation are grossly inadequate given the magnitude of the economic problems that we face with respect to China. And the SED does not even begin to address a separate and equally serious economic concern, and that is the egregious and widespread repression of workers' rights in China.

Violation of workers' rights is just as much an economic issue as currency manipulation, violation of intellectual property rights, or illegal subsidies. We estimate that hundreds of thousands of U.S. jobs are lost because the Chinese government brutally suppresses the rights of Chinese workers to form independent unions and bargain collectively for their fair share of the wealth that they create.

I do not mean to sound cynical, but I am starting to feel like Bill Murray in the movie Groundhog Day. Every year, I come up and testify on the importance of these economic issues, the effect that they have on workers throughout this country. Every year the trade deficit worsens, more jobs are lost, and the economic pressure on workers and the middle class continues to grow. And every year, someone from the administration comes up here, agrees completely with everything that we say, responds with pledges of increased dialog, engagement and cooperation.

Now my written testimony lists quote after quote from administrative officials over the last several years offering more meetings, more reports, more dialog. The time for talking is past. The Administration needs to move beyond consultation and dialog. The Congress cannot wait for this administration to act.

We urge Congress to give immediate consideration to the Fair Currency Act, which we expect to be introduced shortly. I would like to thank Senator Bunning for his leadership in addressing this important issue. The Fair Currency Act is a crucial first step in addressing the urgent economic problems that we face today.

The thing I would like to end with is I listened to the Secretary's testimony. And I listened to him say that he would do everything that he could to help that steel worker in Alabama that got laid off, the same people that I see every day. Or a coal miner somewhere, or an auto worker, or a teacher or anything else.

And I would like to ask him if he is willing to take any action and use all of the tools? If taking every action he can to help them includes using all the tools at his disposal? That is what needs to be done, Mr. Chairman.

Thank you.

Chairman DODD. Thank you very much, Richard. I appreciate very much your testimony and your caring of the issue, too. It has been very impressive over the years. And I could not agree more with you about running out of patience here, with these conversations about dialog and conversations.

Mr. Campbell, welcome.

STATEMENT OF MICHAEL CAMPBELL, VICE CHAIRMAN, NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. CAMPBELL. Thank you, Mr. Chairman

The National Association of Manufacturers seeks a positive and mutually productive trading relationship with China. China's emergence as a leading world economy has meant significant new opportunities for many of our members, including increased exports and investment opportunities.

However, as we all know, China is also posing great challenges for other of our NAM members. Some of our members see prices of Chinese products so low, sometimes even lower than the cost of raw materials, that it becomes virtually impossible for them to see how they can compete. And others are seeing their customers move to China and cannot find new ones to replace them.

NAM's concerns with China cover a range of issues, including protecting intellectual property rights, maintaining a currency value that reflects the strength of the Chinese economy, and ending prohibited trade subsidies.

We are also concerned by a growing Chinese industrial policy that favors domestic producers, making it more difficult for foreign firms from the United States to participate in China's economy.

On the issue of China's currency, manufacturers large and small are united. We may come from different points of view, but we have all agreed that the Chinese government needs to allow much greater flexibility in the valuation of their currency. Our goal is to see the currency moving closer to what a market value would likely be, with the eventual goal of a free-floating currency set by market forces.

The need for the yuan to appreciate has been recognized by the International Monetary Fund, the World Bank, many finance ministers, most economists and, even recently, Chinese leaders. It is no longer a matter of if but when and how rapidly.

But this matter of timing is very important as frustration is growing, evidenced by the last speaker, as it has negative effects on support for free trade if it does not contribute to a sense of fairness in global free trade. If we point out that the Chinese currency is undervalued, say they must do something about it. But if they do not, we cannot or will not respond. We must respond.

I do note that there has been a 6.5 percent appreciation since July 2005, but that is not enough progress. More needs to be achieved. Without more progress, we risk seeing action that could do serious damage, not just to our bilateral relationship but also to our own economy, and the world's as well.

Would a considerably stronger Chinese yuan have beneficial effects? Unmistakably yes. Yes for U.S. manufacturing, yes for adjusting global imbalances, and yes for the Chinese economy itself. Not infrequently, companies have told NAM staff that even a 15 percent shift could change their competitive situation dramatically.

Much reference has been made to the Treasury's Report to Congress, and that report can play an important role in the process. NAM has consistently called on the Treasury Department to cite China for currency manipulation, as discussions have seemed to have borne very little fruit.

NAM understands that citing a country for currency manipulation would not, in and of itself, compel change. But it would provide a strong and highly visible signal that the U.S. Government believes it important for the currency to move.

Citation under the Report is also an important signal to the International Monetary Fund, as IMF officials have already noted that it would be incongruent for them to cite China for currency manipulation if the U.S. Treasury is not willing to do so.

I will say that we did not criticize the Administration when the last Treasury report came out in December and was silent on China. Secretary Paulson asked for time to let the efforts made at the new Strategic Economic Dialogue work, and we agreed to support him in that effort. We will certainly be following progress on this issue and we will revisit it at mid-year.

The Strategic Economic Dialogue is, we believe, an excellent idea. We hope that the SED will help shift the balance from those within the Chinese government who feel that China must move more slowly on its currency to those who understand a more rapid appreciation is necessary to achieve both internal domestic goals as well as international goals.

In September of last year Secretary Paulson addressed our board of directors and indicated that the Chinese currency issue was a top priority in the SED. At that meeting, the NAM board considered whether or not to support legislation that would make currency manipulation subject to U.S. countervailing duty laws. The majority of board members, after discussion, decided not to support the legislation.

The board instead called for the creation of a board level U.S.-China Task Force to work with the Administration on SED issues, especially currency. I chair this task force with executives from large and small companies that span the whole spectrum of views on China's currency.

We met with Secretaries Paulson and Gutierrez and U.S. Trade Representative Ambassador Schwab prior to their trip to Beijing for the first SED meeting. In our extensive meeting with Secretary Paulson, we made it very clear that manufacturers want to see significant progress in the appreciation of the yuan or we risked actions that could do serious damage with our bilateral relationship. We have seen some progress but we are looking for much, much more.

In conclusion, I would like to point out that we, as American manufacturers, must take advantage of opportunities offered by the large and emerging market in China, as well as constantly improve our own competitiveness. However, it is important that there be confidence that our Government will insist on our trading partners living up to their commitments, including commitments regarding currency.

I applaud the committee's interest in China's currency issue and in seeing that all major currencies are market determined.

The NAM thanks you, Mr. Chairman, for holding this important hearing and we look forward to working closely with you and other members of the committee and your excellent staff.

Thank you.

Chairman DODD. Thank you very much, Mr. Campbell. We appreciate your testimony very much and again, congratulations.

Dr. Keidel, thank you.

STATEMENT OF ALBERT KEIDEL, SENIOR ASSOCIATE, CARNEGIE ENDOWMENT FOR INTERNATIONAL PEACE

Mr. KEIDEL. Thank you, Mr. Chairman, and thanks for the opportunity to testify.

In my comments today on the Treasury Department's currency report, I want to pull out and amplify some of its findings, especially the muted criticism of Germany and Japan. At the same time, I want to question and criticize other of the report's findings, especially its characterization of China.

I also want to emphasize how important the Treasury Department's new dialog with China could be for American competitiveness. But if the dialog is going to play this important role, we have to use it wisely and avoid squandering its potential.

Let me start with the Treasury report's coverage of global imbalances. The key statistic here is trade in goods and services, not the current account balance which the report uses. As a share of the U.S. trade deficit, global trade surpluses by Germany, Japan, and the rest of non-China Asia have been large for many years, continue to be large. In contrast, until 2 years ago, China's trade surplus was quite small. I will come back to China in a minute.

In this score, let me give you what I call a user's warning alert. When the U.S. Commerce Department reports each month how big the U.S. trade deficit is and says which countries make up what share of that deficit, you should ignore the latter part of that information. It is meaningless. A country could have a surplus with the United States and a deficit with the rest of the world.

The bilateral two-way balance for the U.S. says nothing by itself about how much a country contributes to our deficit. This is especially true of China, which processes and repackages exports from other countries for final shipment to the U.S.

America has a large deficit with a global supply chain. Other countries have surpluses with the global supply chain. If we look at which rich countries are running large, long-term surpluses with the global supply chain, the list includes Germany, Japan, and other non-China Asian countries.

Let me point out a second lesson on the U.S. trade deficit. We may think it is a problem. But the U.S. trade deficit is essential for the global economy. Poor countries need markets so that they can develop and become eventually markets for the U.S. exports. America wants to promote healthy growth, but not with foreign aid and not with subsidized loans, but with trade. Somebody has to buy their products. America plays that role in the world.

Other major industrialized countries are not helping, especially Germany and Japan. Germany and Japan, to put it not too politely, are slackers. Instead of running modest deficits and sharing the burden with America, Germany and Japan are feeding off our deficit themselves. They should not need to do that. They have per capita GDP 20 times China.

We need to pressure them to get with the program. They should spur their own domestic demand, especially consumption. This is an important message, and it is one stressed in the Treasury report. But the report's position is kind of muffled. It is polite. I do not think it should be so muffled or polite.

People say but Germany and Japan have foreign exchange markets. Their currencies must be at the right levels. This misses the point. Exchange rates will not fix this problem. Germany and Japan run surpluses because they have structured their economies and their finances to save rather than consume. Exchange rates will not fix this. Germany and Japan need to change this structures and America needs to strongly encourage them to do so.

Yes, I know, Germany and Japan host our troops and military bases on their soil. But that should not be a Treasury report concern. From the prospective of global economic leadership, Germany and Japan are, as I say, slackers and have been for a long time.

Now let us turn to China. Until 2 years ago, China's global surplus was 8 percent of America's deficit. Only 8 percent. The Netherlands had the same surplus size. The European currency areas, the euro area surplus that year was 27 percent of the U.S. deficit. And non-China Asia had an even larger surplus.

China's surplus was only 8 percent then. In 2005–2006, yes, its surplus jumped. What happened? It is not an exchange rate shift. China, over the last 5 years, has joined the WTO, a wrenching change to its trade relations with the world that has nothing to do with its exchange rate.

And then the multi-fiber agreement ended. In the short term, the repercussions of these changes are certain to be unstable, and they have been. These are huge adjustments compared to any exchange rate effect.

China's global surplus really took off with the domestic credit tightening that slowed imports in 2004–2005 to let them grow less quickly. In 2005, China's surplus was slightly less than Germany's 17 percent instead of Germany's 20 percent.

In the first half of last year, 2006, China's surplus was slightly more than Germany's, 20 percent instead of 19 percent. This change over two short years did not reflect a sudden shift in China's exchange rate. At this preliminary state in China's WTO adjustments, so many parameters are changing so fast that I think it would be foolish to insist that they are caused by exchange rates.

Let me repeat that point. China's global trade surplus has grown suddenly larger, putting it on a par with Germany's, but not because of exchange rate shifting.

Will China's WTO accession process eventually shake out to a more balanced trade pattern? We have to wait and see. WTO requirements that China open more to imports, for example by enabling foreign retail branches, have not really matured. They came online with a delay, with a lag. If we want to pressure China, this is the place to do it, on our exports' access to the Chinese market, not the exchange rate.

I have a second quick warning. Do not look at China's foreign exchange reserves for evidence of exchange rate manipulation. There is a speculation game going on out there and the U.S. Congress may be an unwitting participant. When a speculator hears the U.S. Government criticism of China's reserve levels, they are encouraged to think America will force China to revalue, so they speculate more. And China's reserves go up as a result. And then there is more criticism and then more speculative floats. And then higher reserves, and so on.

This all could have a bad ending for the speculators, but it is not a sign of exchange rate manipulation.

My most important point for this hearing is that China is a legitimate commercial competitor. Its success does not rely on currency manipulation. And China will continue to be a legitimate commercial competitor. America's strategy has to be focused here at home. Strengthen our own fundamental competitiveness, education, labor force mobility, pension mobility, health care, and safe cities as attractive places to work so we can compete in the global market for technical and managerial talent. Visa reform would help.

Instead, if we pretend that our problems are because China's exchange rate or China's banking system or China's low wages, that is like sticking our heads in the sand.

Treasury's China dialog is a chance to move away from this misperception of our challenge. It is a terrific opportunity, and I was in Treasury when we worked on this. We tried long and hard to elevate our access to Chinese leaders, and we mistargeted. Now we have succeeded. Let's use it well. It has taken many years. Let's not waste it on what I consider to be dead end, feel good distractions like exchange rates.

Thank you, sir.

Chairman DODD. Thank you very much, Doctor.

Mr. Bergsten.

STATEMENT OF FRED BERGSTEN, DIRECTOR, PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS

Mr. BERGSTEN. Mr. Chairman, my written statement tries to provide a succinct but comprehensive statement of the current account problem and China's role in it. The bottom line is the problem is even worse than you have been describing today. And I just mention two points.

Because of our huge current account deficit and our own foreign investments, the United States now has to attract $8 billion of foreign capital inflow every working day to keep our economy afloat. If we do not get $8 billion of happy foreign investment coming in every working day, we will see our interest rates shoot up, our equity and housing markets tank, and the economy could even go into recession, depending on how rapidly it happens.

So the problem is huge. I am talking our global current account deficit. I regard it as the single biggest threat to the prosperity and stability of the American economy because if that $8 billion dropped to only $4 billion or $5 billion a day huge as that would still be, we could go into a dollar collapse which would cause significant adverse effects to our economy.

Second, the role of China. I agree with Dr. Keidel that we should not focus on bilateral imbalances. But the truth is the global imbalances tell the exact same story. China is now running a global current account surplus in excess of $250 billion per year. It has risen in an almost vertical line for the last 5 years. It is now exceeding 10 percent of China's own GDP. It has accounted for between a quarter and a third of all China's growth over the last several years.

In short, the global pattern with China's massive and rapidly soaring surplus tells the same story as the bilateral imbalance. So in this case, the message is the same.

I want to mention two or three analytical points that came up in the discussion and then spend most of my time answering your frustrations and the issue of what to do about it. Just two or three quick analytical points.

Several people, including the Secretary have said the renminbi at least has gone up 5 or 6 percent over the last 18 months. Yes, but no. It has gone up 5 or 6 percent against the dollar. But the fact that the Chinese still essentially peg to the dollar, and the fact that the dollar has gone down against everything else, means that the average exchange rate of the renminbi has not gone up a whit.

The stunning conclusion, in fact, is that the average exchange rate of the Chinese currency is weaker today than it was in 2001, when their current account surplus was 1 percent of their GDP, and today it is 10 percent. That increasing undervaluation of the renminbi is indeed a major factor why their trading surplus and current account surplus has soared.

Second, a very important distinction has to be made among the terms that are used as to what we want from the Chinese. The Secretary and many of you have used the term greater flexibility and then gone on to say in a second stage we want a freely floating currency.

He is right to say that in the short run they cannot float freely, for reasons of weakness of their financial market. But the key thing to us should not be a more flexible renminbi. It should be a stronger renminbi. What we want, at least in the short run, is not for them to go to a more flexible currency. They are going to manage their currency. There is no doubt that they are going to manage it day to day, minute to minute, whatever they call their regime.

What matters to us is the price of their currency. It should be much stronger. Our estimates are that to eliminate China's surplus, which they have said is their goal, would require a revaluation of about 20 percent in the trade weighted average of the renminbi which, as I said, is flat over the last 6 years. And that would imply a rise of about 40 percent against the dollar. Because if the Chinese currency goes up, other Asian currencies will go up with it. Their average will not rise as much as all of their currency values against the dollar.

But the key thing is that what counts to us is the price relationship between the Chinese currency and ours. Better if they did it in a one-step revaluation.

Now they will not go 20 or 40 percent overnight, but they could do it in a series of step level moves, like the 2 percent they did in the summer of 2005, only much bigger. It is very important to keep in mind what we want.

When we say to the Chinese we want a more flexible currency, it is easy for them to say well, the forums are asking us for a floating exchange rate, we cannot do that. And they are correct. So we have to be very clear on that point.

The third thing I want to mention is the Secretary's comment that what really is at stake here is the structural underlying feature of the Chinese economy. He is right, of course. We want to see better capital markets, improved economic reform across a wide range of issues in China.

But make no mistake. The reason the exchange rate is so weak is massive, blatant intervention, $15 billion to $20 billion per month over the last 3 years, as documented in the Treasury's own report. That is very clearly what is holding the renminbi down. Any other currency in the world, with that kind of capital inflow, would have already risen probably the 20 percent or more that we need. It is blatant intervention, call it manipulation, which is in fact the source of the huge currency imbalance.

Finally, everyone has expressed frustration, including the Secretary, including all of you, including all of us who watch this closely and have worked on it a lot. And your question, quite rightly, is what to do about it. On pages eight to the end of my statement, I suggest a five-part strategy.

First, the Treasury should tell the Chinese quietly that they will be designated a manipulator in the next report unless they make a significant down payment on the needed rise in the value of their currency. I would suggest 10 to 15 percent. This should be done before the next SED in May and before the next Treasury report in May or June.

But I would go to the Chinese and tell them very quietly, privately, that I am going to have to designate you unless you begin to play by the rules of the game. That, I think, would give the Chinese then a chance to take the requisite action without losing face, without seeming to capitulate to the foreign pressure, et cetera, et cetera. So I would do it that way.

Now, if they do not comply, then of course China should be labeled a manipulator. You have said it, Mr. Chairman, Senator Shelby, you have all said it. It is a manipulation. If it walks like a duck, call it a duck. The Chinese should be indicated on it.

Incidentally, I was struck that Secretary Paulson said I am negotiating the currency issue with the Chinese anyway. And the implication was so why designate them, which requires a negotiation? I guess I would reach the opposite conclusion. If he is negotiating with them anyway over currency, as he obviously is, why not tell the truth, indicate that they are manipulating, strengthen his position by having put out on the table the facts and the reality, be in league with this committee and the Congress instead of fighting them politely but still on opposite sides. If he is negotiating anyway, why not say they are manipulating and the law calls for a negotiation.

I do not see how it can hurt his negotiating position. I can only believe it would help it.

But my point one is go to them quietly, tell them you are going to have to do it. You cannot defend them anymore for their indefensible practices against this committee or the Congress more broadly, or the public. Please take action and I can stay on your side.

Second, the Administration should also tell the IMF and its other G–7 partners that it is going to label China a manipulator next time around and escalate this issue. That, I think, would significantly improve the support that we would get from the IMF and from the G–7 and other key countries.

The Secretary failed to mention something I think is very important. There are IMF rules. He stressed the WTO rules. There are IMF rules against competitive currency undervaluation, against manipulation. The criteria are stated very clearly: a country shall not conduct large-scale, protracted, one-way intervention of currency markets. The Chinese have violated all three.

Now those IMF rules have not been implemented with great force in the past. They have on some occasion. They should be done again. My point is, mobilize multilateral support.

Third, and very quickly, we should also go multilateral to the WTO. My Institute has published an analysis of the proposed subsidy case against currency undervaluation. It is uncharted terrain. We are not sure it would win. We might even lose. But we should certainly pursue the case. We should make every effort to pursue the multilateral approaches on both finance through the IMF and on trade through the WTO to try to resolve the issue in the most cooperative multilateral way possible.

And then finally, if none of that works, you could say well, what should we do? There are certainly a couple of things we can do. One is on finance itself. The Treasury has the right and all the ammunition necessary to enter the foreign currency markets itself and buy the foreign currency that needs to rise in value. We did it at the Plaza. We did it on the yen, as recently as 1998. We have always in the past done it in cooperation with the other country, and we certainly seek their agreement to do it.

But the Treasury has huge amounts of resources with which it could do that. Nobody could say it is protectionist. The Chinese are buying hundreds of billions of dollars of our currency to keep theirs from rising in value. If we bought a little tiny amount to try to push it in the other direction and to approximate a market outcome no one could say it is protectionist. So I think we ought to pursue that approach, if all else fails.

Then finally, as somebody said in the last discussion, the ultimate U.S. leverage is Chinese access to our market. I would hate to see us go down the road from blocking that, but frankly, I think this issue is so important that we might come to that if all else fails. And there, the Congress might have to take the bit in its mouth.

Thank you very much.

Chairman DODD. Thank you very much. Thank all of you. Appreciate your cooperation.

Senator Schumer was tied up in chairing the Joint Economic Committee and has a strong interest in this subject and will have some questions, I think, for several of you here.

Let me pick up on Dr. Bergsten's recommendations here. I guess we could call it a Plaza II, or an Asian Plaza, the proposal here. Would any of you like to comment on the suggestions and recommendations that Dr. Bergsten made?

Richard, you talked about taking some action and moving beyond this. I do not know if you had a chance to look at Dr. Bergsten's testimony, but do you have any reaction to it?

Mr. TRUMKA. I have not had a chance to look at it carefully, but anything that has a chance of working I think we ought to do it simultaneously. What we have been doing is doing nothing but dialog. When I collectively bargain, I look at all the leverage I have and I employ several different avenues at the same time, hoping to get an agreement before you have to use the ultimate weapon, which in our case is labor. As a result, I like a lot of the things he said. We would agree with all of that.

But we also ought to be taking other action to let them know that we are willing to go forward because—I think you mentioned it, Mr. Chairman, early on—by our continuous talking to them, our continuous idle threats at them and then taking no action, they look at us like a paper tiger right now. I think this is a country that understands and reads what you say and interprets it about what you are going to do, and they do not think we are serious right now.

If we have not called them a manipulator over the last 3 years, I would like to see what a manipulator is. Because everybody on the face of the earth that looks at it knows that they are manipulating their currency.

Chairman DODD. Dr. Trumka, I meant to ask—I read your testimony and the question is, what would constitute manipulation? It is a good question to ask the Treasury in a hypothetical—I really do not like hypotheticals, but what sort of thing should we be looking to as an indication of whether or not this is occurring?

Mr. Campbell, you talked about this. I raised it but you have raised it as well, and that is the credibility. Beyond everything else—and Richard Trumka just talked about the sense here. So talk about that point of view, because that just becomes just a very major point, not just in terms of your bilateral relationship with China, but others around the world, it seems to me as well. The United States has got to be—I am not looking for purity on this point, but that consistency where your credibility becomes eroded and it has a ripple effect with so many other things you engage in.

Dr. Keidel, I am going to ask you to respond as well on that point of whether or not—I know you do not want the emphasis on this point. I heard your testimony. But to what extent, because this is the subject matter and so to what extent are you concerned at all about the credibility of the United States in these efforts that we make around the world as a result of what looks like inconsistent reactions here from administration to administration?

Mr. CAMPBELL. I would agree that it does call into question our credibility around the world. But I also believe that it calls into question our credibility right here in the United States, because your constituents, your members, my members, if they do not see action, if they do not see progress on this—as I said in my statement, we say we believe in free trade. We believe that China is manipulating its currency which is causing an unlevel playing field. We ask them to stop. They do not stop, and we do not do anything as we get to the end of that process.

That destroys our credibility both globally but also here in the United States. My concern is that it will precipitate a frustrated reaction that will be very harmful, not just to the bilateral relationship but to global trade patterns generally.

Chairman DODD. Would you, by the way, before I ask Dr. Keidel to respond to that question as well, would you respond to Dr. Bergsten's suggestions from the NAM's perspective?

Mr. CAMPBELL. Yes. I have not had a chance to read them but I will read them with great interest. I will say that his first suggestion, which to me is just using whatever leverage we can to try to convince the Chinese that we are serious and they need to take action, and that is to quietly tell them that we will designate them a manipulator if we do not see significant progress before the SED in May. I think that that is a very credible suggestion.

His second and third suggestions basically were to approach this problem in a more multilateral fashion, involving the G–7 and involving the IMF. We too agree that more can be done by bringing in Europe, Japan, the International Monetary Fund to help us on this problem.

His other suggestions about going into the marketplace and buying the RMB is something I would not like to comment on. We believe very much in market forces. The Government going in there and playing in that market causes me some concerns, but I would like an opportunity to study it.

Chairman DODD. Yes, and the point that he raised as well on this, instead of focusing all our efforts on the exchange rate policy, let us talk about price. That is a different approach on this. That is really what we are talking about here is price.

Mr. CAMPBELL. Yes.

Chairman DODD. In trading, they can play that game but there is always that, market forces ought to work now and I will give you 10 percent NOW and fool around with it next time. So I hear what you are saying. I like it in the short term, but it worries me in the longer term that you are letting them off the hook on the larger question.

Do you have any comment on that?

Mr. CAMPBELL. Yes. I think that you are correct in that and that, as I say, I think playing a harder ballgame with them is what is important, and getting them to understand the benefits to their own economy from making this change. It is not that we are asking them to put themselves into disadvantage in the long term. We are asking them to advantage their economy, our economy and global trade in general. I think that that is what the focus of the discussions have been and have to continue to be.

Chairman DODD. Dr. Keidel, if you would just respond to those points. I raised the issue of the defense issue, the tenfold increase in defense spending at the expense of a lot of other things that they could be doing to help their own people, and does that concern you at all? The fact that what we are talking about here is basically subsidizing the ability of the Chinese to be able to have an economy that allows them to invest that multiple in increasing defense.

Mr. KEIDEL. Thank you very much. Let me just quickly reply to Dr. Bergsten's comments and then answer your questions.

First, as to the strength of the U.S., I would emphasize, the U.S. Federal Reserve System is more than robust enough to deal with the needs of the American economy and where interest rates will go in terms of reacting to the U.S. capital source.

I would emphasize using trade in goods and services. Dr. Bergsten continues to stress capital—the current account balance. The current account balance in China's case is use to longer—a lot of capital inflows, so you get a much bigger picture.

But my point is still the same. If you look at the global picture it has changed only in the last 2 years, and that is part of a huge instability in China's non-price, non-exchange rate system, and non-tariff barriers, which are clearly changing in the other direction as well. So we need to look at how that shakes out.

On IMF rules, I have heard that before. If you read those IMF rules very carefully about sustained, long term manipulation or intervention, that is not a criterion for saying that a country is manipulating its currency. That is a sign that you might want to look to see what a country is manipulating its currency or not. It is a different point. It says, if there is a long term intervention, go take a look. But you do not use that to decide whether a country is manipulating or not. So the Treasury report is right on the mark in how it is using the economics of this whole issue to decide what is right and what is not right for China.

In terms of buying the RMB and a market focus, I think that would not begin to work. The Chinese are sterilizing because they need stability. They could just sterilize whatever we wanted to do about it. And besides, we really do not yet have access to that market. It is not a real currency market at all. So I think that is dead on arrival.

I would also comment on something the Secretary said about four steps to getting to what we want, to allow the currency to be market based. He omitted one. He omitted an important fifth one, which is opening their short term capital accounts. China now regulates its short term capital flows dramatically. Without those free flows we do not have a market test. The pressures for appreciation now are false indicators of where that currency would go in a truly free market environment.

So we really need to be careful—those five steps, and I emphasize the fifth one in particular, we need to be very careful how we evaluate whether the exchange rate itself is really what is going on here.

What is a manipulator? A clear case of manipulation is that you have a dual exchange rate. You provide one exchange for some companies and some ministries, and you provide a different one for another. That is what China had before 1994, and that is when the Treasury rightly cited it for manipulating its currency. China unified its currency in 1994 and it has been unified ever since, and the IMF rules make a peg on legitimate currency. So we need to look at that. Yes, there can be manipulation, but the kind of thing that China is doing now is not one.

I would also comment on idea that markets here—that exchange rates can really determine the trade flows. That is like walking into a hospital and telling a doctor that the only thing he needs to cure about an immune system is white blood cell count. It is much more complicated than that. So to say that it is only currency, it is kind of like the Maine fisherman who when he eats sausage says, smells good, taste good, but once you clean it, there ain't nothing to it. It is much more complicated and a much more powerful force is in play than the exchange rate in determining the trade balance.

The credibility of the U.S. hinges just on this point. People around the world know what really is functioning here. It is structural shifts, structural changes. They look at the United States and see us focusing on the exchange rate and we lose credibility. We certainly lose it with the Chinese.

When we talk about what would be good for the Chinese economy, we lose credibility if we tell them they just need to privatize their banks, they need to open up their whole exchange rate system.

That is the kind of thing that caused the Asian financial crisis. South Korea and Thailand opened their short term capital accounts prematurely, and eventually those foreign loans at loan interest rates look pretty good because they do not have foreign exchange risk premium on them. And when they start going south you do not have the regulatory capacity to keep people from making those bad decisions. You are in trouble. China does not want to go there.

So the credibility issue for us is to deal with this issue in a balanced, complex way that does justice to the phenomenon that we are facing. The benefits to the Chinese economy, the financial sector, I have mentioned, to their money supply. Fred raises this point very well. We talk about—Dr. Bergsten, excuse me—the idea about flexibility as opposed to appreciation. Why do we do that? Because any really serious or most really serious economists are very leery of saying where a currency should be. That is really tough. And the Treasury report has an appendix that points out just exactly why that is a very dicey thing to try to do.

All economists, all good economists agree that if you are going to open your capital account and have a fixed exchange rate, you are in trouble. So if you open your capital account, you better get flexibility. So we are all very comfortable saying, China ought to have flexibility, because it deals with capital account. It is not dealing with trade. It is not the appreciation issue, but it sounds like it. It sounds good. If you can get through a briefing, you can get through a hearing, but why they are—they keep their union card, if you will excuse the expression, as an economist is by talking about flexibility, not about appreciation.

On defense spending, my organization, the Carnegie Endowment, is holding a debate here next week on PLA modernization, the People's Liberation Army modernization—a debate. We have two people from different sides of the respectable, sort of credible, view on whether PLA modernization is a threat to the U.S. So I invite all of you to come and hear that.

But the notion that China's defense spending has gone up tenfold, we are talking about percentage increases from a small number. When you consider how Chinese defense spending and its commitment to defense really declined and suffered throughout a lot of the 1980's and early 1990's, then you know that their defense spending as a share of GDP, and in particular as a share of our spending, not to mention the accumulated military firepower or force projection capability that the U.S. because of its aircraft carrier task forces, which were not built in a year, because of its basing agreements around the world, then this notion that China has suddenly increased its defense spending would be put in perspective.

So those are my quick answers. Some of it is done in more detail in my written statement.

Chairman DODD. Thank you all very, very much. As I said, there may be some submitted questions on the part of the panel.

Let me turn to Senator Shelby. I want to make sure I give my colleague a chance——

Senator SHELBY. Thank you, Mr. Chairman.

Mr. Campbell, you represent the National Association of Manufacturers. You represent so many of the big manufacturers in this country who provide a lot of industrial jobs. Have you in your last 20 or 30 years of economic history, seen anywhere before recently, the erosion of jobs like we have seen in the industrial base in the last say 10 years?

Mr. CAMPBELL. Senator, I do not want to minimize the loss of manufacturing jobs because I too understand that these are very good, well-paying jobs that provide great stability to us economically and socially. But you have to look at also some of the other factors going on. Productivity is one of the biggest issues. The average labor cost for an output of manufactured goods today is below 10 percent. That is an extraordinary testament to the productivity of American manufacturing.

The erosion of jobs is not so much a function of what has happened with China as it is a reduction in our ability to export, because our export profile has not been as robust as it needs to be.

Senator SHELBY. Why?

Mr. CAMPBELL. There are a variety of factors. For example, the cost of energy and the availability of natural gas has profoundly affected the chemical industry, which is the industry that I am from. That has caused us to shut plants here in the United States and relocate them to areas where energy costs are less and natural gas is more readily available.

Senator SHELBY. Will that have an impact on fertilizer?

Mr. CAMPBELL. Yes, it will. That is why we were so pleased that Congress did pass legislation in the last Congress regarding exploration in the outer continental shelf to get us greater access to natural gas.

So it is a very broad set of policies that have to be looked at in regard to manufacturing, not just the imbalance of trade with China. We have got to get our energy——

Senator SHELBY. You cannot blame it on one thing.

Mr. CAMPBELL. No, sir; it is too complex.

Senator SHELBY. But trade has got to have something to do with it.

Mr. CAMPBELL. It does. It absolutely does. But it is a very, very complex situation.

Senator SHELBY. Dr. Bergsten, if we go along like we are doing and we continue to have these trade imbalances with China and others, the current account, nothing happens, not in 2 years, 4 years, 5 years, what is that going to do to our economy?

Mr. BERGSTEN. It will do three or four things. One is that our foreign debt will continue to pile up. It is already in excess of $3 trillion and it is rising rapidly. We have to service that debt. More and more of our national income will be paid to foreigners. We will be a poorer country.

Senator SHELBY. That means an erosion in our standard of living.

Mr. BERGSTEN. Exactly. Our national income will be lower than it otherwise would be.

Second, the eventual adjustment will have to come because we cannot keep borrowing $8 billion a day, the nine, then ten. And even if it is a gradual adjustment, the higher base from which it comes means the more we have to cut back on our domestic spending in order to make room to improve that.

Third, and in a way most critical, we are bound to run into a crisis. We are already way beyond the typical crisis threshold. The U.S. current account deficit now is more than double the previous record back in the middle of 1980, after which the dollar dropped

50 percent in the next 3 years. No one can say exactly when it will happen or what will trigger it, but unless all economic history is repealed, as long as we stay on this path, the numbers keep rising, the foreign financing requirement continues to grow, the net foreign debt continues to soar, there will be a crisis.

Finally—and this is a point that came up actually from Mr. Campbell—erosion of our ability to maintain an open trade policy. I am a very strong supporter of free trade, as all of you know. My studies over 40 years suggest that the most erosive element in being able to maintain an open trade policy in this country is when we run a hugely overvalued currency and a massive deficit, because then the domestic politics of trade policy shifts dramatically. As Mr. Campbell said, it would be hard for the NAM to keep supporting free trade measures if the deficit keeps soaring and they are priced out of their national competition by a misaligned currency.

So unless we bring that back into trade, there is no way I think we are going to be able to maintain an open trade policy. So the cost will be huge if we do not really get at it.

Senator SHELBY. Irreparable damage.

Mr. BERGSTEN. Irreparable damage, even potential crises, with pervasive effects on the global financial and trade systems as well as on our own economy; yes, sir.

Senator SHELBY. Senator Dodd, I have a number of questions for this panel that I would like to submit for the record.

Chairman DODD. Absolutely, we will do that.

We have kept you a long time and I apologize. But it is tremendously valuable to have your testimony. You are very knowledgeable and I am very impressed at how much knowledge you bring to a complex subject that we all recognize and are aware of that. But clarity on this subject matter is something that people are screaming for.

To make your point again, Richard, people are out there paying a price and are very worried about what the future means to this country if we do not begin to do something about it.

So we thank you very, very much, all of you, for being here. I thank Senator Shelby and the other members of the Committee.

This Committee will stand adjourned until further call of the chair.

[Whereupon, at 1:15 p.m., the hearing was adjourned.]

[Prepared statements supplied for the record follows:]

U.S. TREASURY DEPARTMENT OFFICE OF PUBLIC AFFAIRS

EMBARGOED UNTIL 10 a.m. (EST) January 31, 2007
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TESTIMONY OF TREASURY SECRETARY HENRY M. PAULSON
ON THE REPORT ON INTERNATIONAL ECONOMIC AND EXCHANGE RATE POLICIES
BEFORE THE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

Mr. Chairman, Senator Shelby, and members of the committee, thank you for the opportunity to have this dialogue with you today on an issue of vital importance to American workers and the American economy.

As you know, the foreign exchange report recently issued by the Treasury reviews developments in international economics and the exchange rate policies of a number of our key trading partners.

Let me first take a few minutes to talk about the important and multi-faceted relationship we have with China. Getting it right is vitally important to the citizens of both our nations – and the world – and will be for many years to come. Since the economic relationship between our two countries is an important part of the overall relationship, I have focused intensely on China from the day I was confirmed. It is my job to press for opportunities for American businesses and American workers. The successful management of our economic relationship with China will benefit the United States, and China, greatly.

The United States and China share many strategic interests. These range from national security, to economic growth and trade, to the health of our environment. As a growing leader on the world stage, China must be a full participant in the rules-based world economy.

Recognizing this, the President and Chinese President Hu established the Strategic Economic Dialogue (SED) to manage the economic relationship between our two nations on a long-term basis. The SED should help us make progress on fundamental long-term structural economic issues, as well as on very pressing short-term issues. It is not a scripted ceremony. It is a serious, focused discussion of the economic issues that matter most.

The SED provides a mechanism through which, for the first time in our relationship, our government can speak with a single voice on economic issues to the highest levels of the Chinese government, on a regular basis. The Dialogue is goals-based and designed to keep both sides moving forward on the goals we establish. By meeting regularly, we can actively monitor the progress we're making. By making progress on critical, immediate issues such as currency reform, we will build confidence to deal with important longer term economic issues such as the structural challenges China faces.

China's currency policy is a key factor in our economic relationship. China does not yet have the currency policy we want it to have and that it needs. Treasury's foreign exchange report clearly states that China's cautious approach to exchange rate reform exacerbates distortions in its domestic economy and impedes the adjustment of international imbalances. I look forward to discussing the report with you during this hearing.

We are actively pressing the Chinese to introduce greater currency flexibility and undertake wider market reform. We are seeing some results. China abandoned its pegged exchange rate in July 2005, and began to introduce some flexibility. Since last July, the pace of appreciation has been more than three times as fast as it had been in the first year after the initial renminbi reform. Foreign currency trading, once conducted entirely by the Chinese government, is now conducted almost entirely by commercial banks. China has introduced financial instruments to hedge foreign exchange risk. And the Chinese government has begun to allow increased fluctuations in the currency.

This is welcome progress, but we need to see much more. Although China is moving faster, it is still not moving fast enough.

Nor is currency flexibility enough. A major objective of my two remaining years as Treasury Secretary will be pressing the Chinese government to advance toward the goal of a renminbi whose value is freely set in a competitive marketplace, based upon economic fundamentals.

I will work with the Chinese government to develop the market infrastructure they need for a freely floating currency. This involves several key steps. First, the government should progressively widen the band that limits the daily movement of the exchange rate. Widening the band will help businesses and financial institutions learn to operate with a fluctuating currency. Second, the central bank should progressively reduce its intervention in the foreign exchange markets. Third, China must develop the fundamental components of a capital market – a bond market and a yield curve – to absorb inflows and outflows of foreign exchange and provide ways to hedge against exchange risk. And fourth, China's central bank must set clear policy targets to avoid inflation and thereby provide confidence in the value of the Chinese currency.

I want to be clear: Increased flexibility in the short run is absolutely necessary, but it is not sufficient. My goal is to make significant progress toward a fully market-determined, floating Chinese currency.

The message I delivered to Chinese decision-makers in the first meeting of our Strategic Economic Dialogue in December is that they are not moving quickly enough to make their currency more flexible. While they agree they need to introduce currency flexibility and move to a floating exchange rate, they are not moving quickly enough for the United States or the rest of the global community. And they are not moving quickly enough for their own good.

The Chinese leaders believe there is risk in moving too quickly, when in fact, as I argued to them, the greater risk is in moving too slowly. China may in some respects be a developing country, but it is also a large and powerful country. The international community will run out of patience with China unless the pace of its reform accelerates.

Reform of China's currency policy is a crucial issue for China and for the United States. And, Mr. Chairman, the need for reform in the Chinese economy goes beyond currency. Currency movement alone will not eliminate the distortions in the Chinese economy nor significantly reduce China's trade surplus. China needs to restructure its economy so that household consumption – rather than exports and excess investment – powers growth. This is the only way China can grow without generating huge trade surpluses.

To do this, Chinese policy must address the reasons why Chinese households feel compelled to save so much and spend so little. Only 20 percent of the 800 million people who live in rural areas have health insurance. The basic government pension covered only 17 percent of Chinese workers in 2005. And only 14 percent of the population is covered by unemployment insurance. China must invest in its people by strengthening the health care system and the social safety net. And Chinese households need financial products that insure against risk and finance major expenditures. The Strategic Economic Dialogue addresses all of these issues.

I believe that the openness of the U.S. economy to competition and our participation in international trade are key to economic growth, higher wages, and increased opportunities for U.S. workers. And we are pressing China to follow our example of openness. I am working to ensure that China's growth and expanding market create maximum opportunities for the United States.

China must live up to its WTO commitments. It must protect and vigorously enforce intellectual property rights. It must increasingly open its markets to foreign competition – for its own good as well as for ours. And it must introduce greater transparency in regulation and observe the rule of law. Through the Strategic Economic Dialogue, and through the various economic dialogues that we have with China, the Administration will continue to press very hard in all of these areas.

Mr. Chairman, America's economy and workers benefit significantly from our trade with China. China is our fourth-largest export market. Our exports to China have increased more than 350 percent over the last decade – six times the growth of our exports to the rest of the world. And nearly half of our exports to China are capital goods, including high-value-added goods such as civilian aircraft, electrical machinery, and medical devices.

I believe strongly that a healthy Chinese economy, growing without large external imbalances, is of vital interest to the people of the United States, to the people of China, and to the global economy as a whole. More currency flexibility in the short term and a fully market-determined, floating RMB in the intermediate term are essential to accomplish that goal. So is restructuring the Chinese economy so that domestic consumption demand – not exports – fuels China's growth. Broad structural changes are necessary to have a major impact on our trade deficit with China.

The next round of the SED will take place here in Washington in May. I understand that your constituents are very concerned about the impact of our relationship with China on their jobs and their livelihoods. I want to work with you as I prepare for these discussions. China is a big and important part of the world economy. It needs a currency whose value is determined in an open, competitive marketplace, and an economy that supports more balanced, stable growth.

I look forward to working with the members of this distinguished committee on the many important issues we have before us. And I now welcome your questions.

Report to Congress on
International Economic and Exchange Rate Policies
December 2006

This report reviews developments in international economic and exchange rate policies, focusing on the first half of 2006,[1] and is required under the Omnibus Trade and Competitiveness Act of 1988 (the "Act").[2, 3] This report also updates the special Appendix to the May 2006 Report on International Economic and Exchange Rate Policies and includes two additional appendices highlighting key issues in the evaluation of currency misalignment and foreign exchange reserve accumulation.

Major Findings:

- The U.S. economy has continued to grow at a healthy pace, although moderating in the most recent quarters. The Administration's economic forecast for the FY2008 budget projects continued moderate growth over the next four quarters, and the labor market is expected to remain strong with little change in employment growth or the unemployment rate. The Administration forecast is similar to the consensus of private economic forecasters.

- The world economy grew by 4.9 percent in 2005, and the IMF projects growth of about five percent in 2006 and 2007, which would make the 2004 to 2007 period the fastest growing in over 30 years. Growth in developing Asia has been particularly strong, exceeding 8.5 percent this year.

- Global imbalances remain a key issue on the international economic agenda. They arise because of large growth disparities in major countries, differences in the relative attractiveness of investment in their economies, and divergent patterns of saving and investment. Reducing global imbalances, in a manner that sustains global growth, is a shared responsibility requiring complementary actions by a large number of countries.

- Europe and Japan each need to achieve higher rates of growth of domestic demand on a sustained basis. The pace of domestic demand growth in the Euro-area has firmed over the last year. However, the pace of domestic demand growth in Japan has slowed sharply in 2006, and was negative in the third quarter. For a global rebalancing of growth to occur, higher rates of domestic demand growth are needed on a sustained basis.

- The largest oil exporters can help ensure that robust global growth is sustained in several ways, such as: (1) by increasing expenditure on oil production capacity, (2) by judiciously increasing expenditure that enhances their economic potential and diversifies their

[1] More recent significant developments are also discussed if information is available.
[2] The Act states, among other things, that: "The Secretary of the Treasury shall analyze on an annual basis the exchange rate policies of foreign countries, in consultation with the International Monetary Fund, and consider whether countries manipulate the rate of exchange between their currency and the United States dollar for purposes of preventing effective balance of payments adjustments or gaining unfair competitive advantage in international trade."
[3] The Treasury Department has consulted with IMF management and staff in preparing this report.

economies, and (3) where appropriate, strengthening their macroeconomic tools and monetary policy implementation including by moving toward more flexible exchange rates.

- The United States already has made substantial progress to reduce the federal fiscal deficit, which has fallen from 3.6 percent of GDP in FY 2004 to 1.9 percent of GDP in FY 2006, a net improvement of 1.7 percent of GDP in two years. But further progress is needed. Personal saving, which moved into negative territory in 2005, needs to rise as well.

- China is the world's third largest trading nation and a global economic leader. It also has a very high saving rate, a growing dependency on exports to drive economic growth, and a very large and growing current account surplus. China's economy needs a more balanced pattern of growth that is more consumption-based, with a flexible exchange rate regime and a modernized financial sector.

- Secretary Paulson and China's Vice Premier Wu Yi, chaired the first Strategic Economic Dialogue in Beijing on December 14 and 15. The agreed goals of the dialogue include balanced, sustainable growth in China, without large trade imbalances, which will aid China's successful integration into the global economy. Important pieces of that equation include exchange rate flexibility, intellectual property rights protections, increasing the role of consumption in the economy and opening up the service sector. China's currency policy is a core issue in the China - United States economic relationship.

- In the first half of 2006, China continued with modest capital account liberalization, *inter alia*, of the programs that allow Chinese investors to make portfolio investments overseas and foreign investors to make portfolio investments in China. In addition, China has taken further steps to strengthen and reform its financial sector to accommodate currency and interest rate fluctuations.

- During the first half of 2006, the authorities took further steps to reform the currency market and RMB flexibility increased compared to the last six months of 2005. This increased flexibility, however, is considerably less than is needed.

- China's cautious approach to exchange rate reform continues to exacerbate distortions in the domestic economy and impede adjustment of international imbalances. Clamping down on exchange rate fluctuations has increased pressures in other parts of the economy.

- The Department of the Treasury concluded that no major trading partner of the United States met the technical requirements for designation under the terms of Section 3004 of the Act during the period under consideration.

U.S. Macroeconomic Trends

The U.S. economy continued to grow at a healthy pace during the four quarters ending in the third quarter of 2006, although growth slowed somewhat in the most recent quarter. Job gains also moderated through the first 11 months of 2006, but the unemployment rate remained low by historical standards. Inflation – both in the headline numbers and in core measures – has started to ease. Energy prices dropped significantly in the late summer and early fall, and there were associated declines in retail gasoline prices. The Federal Reserve held its short-term interest rate target unchanged from July through December after raising the federal funds rate at every policymaking meeting since mid-2004. With the economy moderating and inflation stabilizing, yields on longer-term securities eased, and in the third quarter of 2006, the yield on 10-year U.S. government securities was noticeably below the Federal Reserve's policymaking rate. The Administration's economic forecast for the FY2008 budget projects continued moderate growth over the next four quarters, and the labor market is expected to remain strong with little change in employment growth or the unemployment rate. The Administration forecast is similar to the consensus of private economic forecasters.

Real GDP grew at an annual rate of 3.4 percent over the first three quarters of 2006, matching the pace recorded over the three years ending in 2005. Growth moderated in the third quarter of 2006 to a 2.2 percent seasonally adjusted annual rate after rising at a 2.6 percent annual pace in the second quarter of the year. The pace of expansion was restrained by a sharp decline in residential investment. However, consumer spending growth rose to 2.9 percent in the third quarter of 2006 from 2.6 percent in the second quarter. A jump in purchases of durable goods, chiefly motor vehicles, contributed to the pickup. Nonresidential investment also strengthened notably in the third quarter.

Housing starts fell about 15 percent in October of 2006 to a seasonally-adjusted annual rate of 1.486 million, and were 27.4 percent below October 2005. Building permits issued for future construction also declined, and were down 5.2 percent in October 2006 to 1.553 million units. That was the weakest permits figure in six years. New home sales were off 25.4 percent in October from a year earlier and readings on housing market sentiment on the part of homebuilders as reported by the National Association of Home Builders are weaker. As measured in the GDP accounts, residential investment decreased 11.1 percent at an annual rate in the second quarter of 2006 and fell an additional 18.0 percent in the third quarter.

Other types of investment have strengthened, however. Real business investment in equipment and software rebounded in the third quarter of 2006, rising at an annual rate of 7.2 percent after dipping by 1.4 percent in the previous quarter. Real business fixed investment in structures rose at a 16.7 percent pace on top of a rapid 20.3 percent annual rate gain in the second quarter 2006.

Nonfarm payroll employment increased by 132,000 in November, and job growth so far this year is averaging nearly 150,000 per month, down from 165,000 in 2005. Since the employment trough in August 2003, the economy has generated more than 6.2 million jobs, or 160,000 per month. The unemployment rate edged up from a 5-1/2 year low of 4.4 percent in October to 4.5 percent in November, and the labor force participation rate rose slightly to reach its highest level in nearly 3-1/2 years.

Consumer price inflation started to slow following large energy-led increases earlier in the year. Headline consumer prices fell for a second straight month in October, bringing the twelve-month change to 1.3 percent – the smallest year-over-year increase since mid 2002. Energy prices, which were largely responsible for recent declines, were down 11.3 percent in October 2006 compared to October 2005. Core consumer prices (excluding the volatile energy and food categories) have also started to ease but still increased 2.7 percent over the twelve months ended in October 2006 compared to 2.1 percent a year earlier.

At its most recent meeting, in December 2006, the Federal Open Market Committee (FOMC) maintained the federal funds target interest rate at 5.25 percent, its highest level since March 2001. The pause occurred after 17 straight hikes of 25 basis points each in the current cycle of monetary tightening, which began in late June 2004 when the federal funds rate was at one percent. Despite the magnitude of that tightening, the level of the Treasury ten-year yield remained relatively stable over this period. After dipping slightly below four percent in June 2005, the yield fluctuated in a slightly higher range of about 4.5 percent through the remainder of 2005 and into early 2006. It rose to as high as 5.25 percent in late June, and has since trended lower, to about 4.5 percent currently.

The federal budget deficit in FY2006 was $248 billion, about $71 billion less than in FY2005. The July 2006 Mid-Session Review Budget projects the deficit will continue to shrink, down to $127 billion in FY2011, or 0.7 percent of GDP.

The Administration's most recent economic outlook, prepared in November, is close to the consensus economic forecasts of professional forecasters and shows continued strength in the economy in the coming year. Real GDP is projected to rise 3.1 percent and 2.9 percent during 2006 and 2007, respectively. That is similar to the U.S. historical average over the last 20 years. More recent private forecasts also suggest moderating growth in the near term.

World Economic Conditions

The world economy grew by 4.9 percent in 2005, and the IMF projects growth of about 5 percent in 2006 and 2007, which would make the growth from 2004 through 2007 period the fastest growing three-year period in over 30 years.[4] The IMF also expects some rebalancing of growth across advanced countries, even though growth rates in developing and emerging market economies are expected to remain above seven percent. In developing Asia, the IMF expects economic growth to exceed 8.5 percent this year and next. Against this positive backdrop in emerging countries, U.S. growth is expected to moderate, as discussed above, while growth in Europe rises from its relatively low level over the last few years. This modest rebalancing of growth, to the extent it materializes, would represent a favorable development that would likely stimulate U.S. export growth and help maintain strong global growth in the coming year. However, it is not certain that the growth acceleration in Europe will be maintained beyond

[4] See the IMF's *World Economic Outlook*, http://www.imf.org/external/pubs/ft/weo/2006/02/index.htm; forecasts of aggregate GDP growth use PPP weights.

2006. Japan is already decelerating in 2006. Some recent forecasts project modest deceleration in both Japan and the Euro Area in 2007.[5]

Core inflation measures, which exclude food and energy prices, are running at less than three percent, and recent declines in oil prices have pushed headline inflation below core inflation. Non-energy commodity prices remain at or near all-time highs, with October metals prices rising by 80 percent y/y, but the IMF expects these price increases to moderate going forward.[6]

Financial conditions have tightened this year with the Federal Reserve, European Central Bank (ECB), and Bank of Japan (BoJ) raising short-term interest rates. But conditions remain generally supportive for continued global growth. For example, after the recent volatility in emerging markets in May and June, the spread that emerging market countries paid on their external debt over 10-year U.S. Treasuries temporarily rose to 240 basis points in late June before retreating to 200 basis points in late November.[7] Also, many successful emerging market countries have used benign global liquidity conditions to reduce debt generally, relying more on local currency debt, and increasing reserve holdings (reserves covered about 70 percent of yearly imports in 2005 compared to 50 percent in 2001).[8] Moreover, financial markets expect further tightening by the ECB and BoJ to be gradual and contingent on inflation developments going forward.

Nevertheless, some analysts remain concerned that the benign global liquidity conditions described above will subside, and that greater risk aversion will cause a global economic slowdown. The moderation in the U.S. housing market is attracting attention overseas because analysts question whether U.S. consumers will spend less generally, and whether slower consumption growth will negatively impact other countries' exports and slow economic growth overseas. At this point, it is difficult to determine how much of any slowdown in U.S. consumption growth will be offset by higher growth in investment spending and exports, thus sustaining overall U.S. economic growth, and how much reduced consumption growth will lead to reduced imports from other countries.

Global Imbalances

Much has been written about the large U.S. current account deficit, which through the first three quarters of 2006 totaled $656 billion or 6.7 percent of GDP.[9] The U.S external deficit has been growing since 1991, with about half of the increase occurring in the 1990s (3.6 percent of GDP) and the other half occurring since 2000 (3.1 percent of GDP).

A variety of views has been put forth as explanations for the growth in the current account deficit, including: the persistence of more rapid growth of domestic demand in the United States

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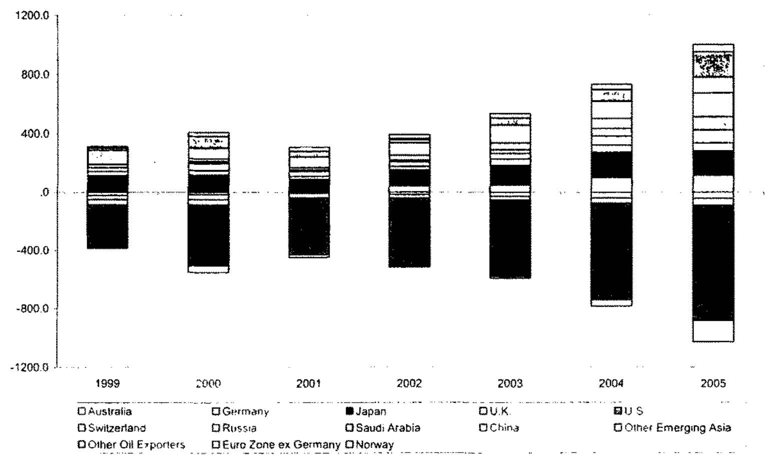
[5] For example, OECD Economic Outlook, November 28, 2006.
[6] CRB metals index (sub-index of five markets): copper scrap, lead scrap, steel scrap, tin and zinc
[7] As measured by JP Morgan EMBIG+ spread.
[8] See Table 35, page 248 in the Statistical Annex of the IMF's *World Economic Outlook*, and see also Annex 1.1 of it's the IMF's *Global Financial Stability Report* that discusses the nature of financial flows to developing countries.
[9] The U.S. current account deficit for all of 2005 was $791.5 billion or 6.4 percent of GDP.

than in major trading partners and other G7 economies;[10] weak consumption and high saving rates in Asia with the excess of saving over investment channeled mainly to the United States; the comparative attractiveness of U.S. financial markets with respect to instrument depth and liquidity and market execution which has influenced the behavior of asset prices and consumption/saving patterns; and rising oil and other commodity prices which have resulted in large wealth transfers. Throughout the 1990s and the current decade, the U.S. current account deficit has risen during times of both an improving and a deteriorating fiscal situation.

The counterpart to a growing U.S. current account deficit is growing current account surpluses in other parts of the global economy. The economies with the largest external surpluses in 2005 were the oil exporters[11] ($325 billion), followed by Japan ($167 billion), China ($161 billion), and Germany ($ 113 billion). The surpluses of oil exporters and China continued to rise in 2006, while those of Japan and Germany stabilized. A reduction in the U.S. current account deficit, by definition, implies an equivalent reduction in one or more countries' external surpluses or an increase in one or more countries' external deficit. There cannot be change in the United States without a corresponding change elsewhere. For this reason, the United States and G7 partners have emphasized the "shared responsibility" for the adjustment of global external imbalances, as well as the importance of ensuring that global growth is not jeopardized in the adjustment process.

Major Current Account Balances
(Billions of Dollars)



[10] Over the period 1995-2005, domestic demand grew an average 3.7 percent annually in the United States. Average growth of domestic demand in Japan over the same period was 1.2 percent and in the Euro-area was 2.0 percent. Average growth of domestic demand in key U.S. export markets, weighted by export shares, was 3.2 percent.

[11] Defined as the top seven oil exporters: Saudi Arabia, Russia, Norway, Iran, Venezuela, the UAE, and Kuwait.

With respect to "shared responsibility", Europe and Japan each need to achieve higher rates of growth of domestic demand on a sustained basis. The good news is that over the past year the pace of domestic demand growth in the Euro-area has firmed. However, for a global rebalancing of growth to occur, rates of domestic demand growth in Japan and Europe need to be elevated and sustained. Current projections for 2007 or 2008[12] raise questions about whether this is happening. Doubts also remain over how much, if at all, past structural reforms in Europe and Japan have translated into meaningful changes in their respective long-term potential growth rates. One key will be Germany's future investment pattern. Germany's investment/GDP ratio fell from 22 percent in the early 1990s to 17 percent in 2005 – the fall in the ratio translates into a very large $140 billion difference in current German investment.

China is the world's third largest trading nation and already a global economic leader. It also has an extremely high saving rate, near 50 percent, and a growing dependency on exports to drive economic growth. In the first six months of 2006 China's current account surplus reached $92 billion, or around eight percent of GDP compared to 7.1 percent of GDP in 2005 as a whole. China needs a more balanced pattern of growth. A more consumption-based growth model that includes a modernized financial sector and a flexible exchange rate regime would contribute significantly to a global rebalancing.

The largest oil exporters have been significant beneficiaries of the robust pace of global growth the last several years. They have a large interest in helping to ensure that robust global growth is sustained. They can do so in several ways: (1) by increasing expenditure on oil production capacity, (2) by judiciously increasing expenditure that enhances their economic potential and diversifies their economies, and (3) where appropriate, by strengthening their macroeconomic tools and monetary policy implementation including by moving toward more flexible exchange rates.

And finally, the United States must continue to do its part, especially with respect to increasing national saving. The national saving rate reflects both corporate and household saving rates as well as government claims on saving (sometimes called "dissaving" when government budgets are in deficit). The United States already has made substantial progress on reducing government claims, with the federal fiscal deficit having fallen from 3.6 percent of GDP in FY 2004 to 1.9 percent of GDP in FY 2006, a net improvement of 1.7 percent of GDP in two years. But further progress is needed. Personal saving moved into negative territory in 2005, following a steady decline from a post-war peak of 11.2 percent in 1982.[13]

The United States is well positioned to participate in an upswing in foreign global growth, should it be sustained. Studies of absolute and comparative productivity growth show the U.S. manufacturing sector to be very competitive internationally, with exports increasing 18.5 percent in the 12 months through September 2006. Overall, the ratio of U.S. exports to U.S. GDP is nearing its historical high, set in 1998.

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[12] See OECD Economic Outlook, November 28, 2006.
[13] The average personal saving rate over the period 1950-2005 was 7.3 percent. The rate peaked in 1982 at 11.2 percent, then fell by four percent in 1982-87. It leveled off in 1987-92, and then resumed declining in 1993, falling eight percent further over the next 13 years.

The United States International Accounts[14]

- *U.S. Balance of Payments Data*

U.S. Balance of Payments and Trade

($ billions, SA, unless otherwise indicated)

	2004	2005	2005				2006		
			Q1	Q2	Q3	Q4	Q1	Q2	Q3
Current Account:									
Balance on goods	-665.4	-782.7	-183.3	-188.2	-198.7	-212.5	-208.0	-210.6	-218.6
Balance on services	54.1	66.0	15.2	16.2	17.0	17.7	16.8	17.5	18.3
Balance on income 1/	27.6	11.3	3.6	2.0	7.8	-2.2	-2.5	-2.2	-3.8
Net unilateral current transfers	-81.6	-86.1	-27.2	-23.2	-9.5	-26.2	-19.5	-21.9	-21.5
Balance on current account	-665.3	-791.5	-191.7	-193.3	-183.4	-223.1	-213.2	-217.1	-225.6
Current Account as % of GDP	-5.7	-6.4	-6.3	-6.3	-5.8	-7.0	-6.6	-6.6	-6.8
Major Capital Flow Components (financial inflow +)									
Net Bank Flows	44.4	-8.9	-32.5	13.0	-7.0	17.6	-48.4	41.1	-3.8
Net Direct Investment Flows	-111.0	100.7	-.7	-25.7	74.8	52.3	-16.0	-.9	-19.0
Net Securities Sales	656.6	669.2	148.7	120.5	186.3	213.8	203.6	116.1	165.4
Net Liabilities to Unaffiliated Foreigners by Non Banking Concerns	-26.8	-14.1	13.0	37.2	-9.2	-55.1	28.8	-6.1	30.2
Memoranda:									
Statistical discrepancy	85.1	10.4	57.7	44.0	-72.2	-19.1	43.4	64.9	49.7
Change in Foreign official assets in the United States	387.8	199.5	19.0	74.6	34.0	71.9	75.7	75.9	80.8
Trade in Goods									
Balance	-665.4	-782.7	-183.3	-188.2	-198.7	-212.5	-208.0	-210.6	-218.6
Total Exports	807.5	894.6	214.2	222.6	224.9	232.9	244.5	252.8	262.1
of which:									
Agricultural Products	62.9	64.9	15.6	16.5	16.3	16.5	17.4	18.3	na
Capital Goods Ex Autos	331.6	362.7	85.9	90.1	90.6	96.1	100.1	102.3	na
Automotive Products	89.2	98.6	23.6	23.7	25.2	26.1	26.4	26.2	na
Consumer Goods Ex Autos and Food	103.1	115.7	28.2	28.4	29.1	30.0	31.2	31.5	na
Industrial Supplies and Materials 2/	204.0	233.1	56.4	58.9	58.8	59.0	63.9	68.9	na
Total Imports	1472.9	1677.4	397.5	410.8	423.7	445.4	452.5	463.4	480.7
of which									
Petroleum and Products	180.5	251.9	53.2	58.3	67.3	73.2	72.1	79.3	na
Capital Goods ex Autos	343.5	379.2	90.7	95.3	95.8	97.5	101.1	103.9	na
Automotive Products	228.2	239.5	57.9	58.7	60.3	62.6	64.6	64.6	na
Consumer Goods Ex Autos and Food	373.1	407.3	100.8	101.8	101.0	103.8	106.1	107.7	na

1/ Including compensation of employees
2/ Including petroleum and petroleum products
Source: BEA, Bureau of Census

The U.S. current account deficit was $863 billion (at a seasonally adjusted annual rate, or "saar"), or 6.6 percent of GDP, in the first half of 2006, compared with $813 billion, or 6.4 percent of GDP, in the second half of 2005. Viewed over a longer period, the U.S. current account balance declined, as a percent of GDP, from a one percent surplus in the first quarter of 1991 to a four percent deficit in the fourth quarter of 2000. Then, after a cyclically induced narrowing in 2001, it resumed its decline to reach a seven percent deficit in the fourth quarter of 2005, before easing from this peak in the first three quarters of 2006.

Although services constitute around 30 percent of U.S. exports of goods and services and around 15 percent of U.S. imports of goods and services, the balance of trade in services is relatively small, being around a $5 billion a month surplus over the past several years, and is relatively

[14] The IMF annually reviews U.S. economic performance and policies through the IMF Article IV surveillance process. The last Article IV surveillance review took place in July 2006. The IMF Article IV Staff Report and the results of the IMF Executive Board's discussion of the U.S. Article IV review can be found at http://www.imf.org/external/pubs/ft/scr/2006/cr06279.pdf. In addition, the IMF discusses U.S. economic policies and performance in the context of its twice yearly World Economic Outlook reports. These can be found at http://www.imf.org/external/pubs/ft/weo/2006/02/index.htm.

stable. As a consequence, movements in the trade balance reflect in the main movements in the balance of trade in goods.

In the first half of 2006, the United States exported $995 billion (saar) in goods and imported $1,832 billion, with a resulting $837 billion deficit on trade in goods.[15] Exports of goods increased 13.9 percent in the first half of 2006 compared to the first half of 2005, while imports increased 13.3 percent. As strong as export growth has been, it has not been sufficient to narrow the gap between imports and exports. As highlighted in the May Report to Congress on International Economic and Exchange Rate Policies, U.S. exports must grow more than 50 percent faster than imports just to keep the trade deficit unchanged.

Non-automotive capital goods constituted 40.7 percent of merchandise exports in the first half of 2006. Consumer goods constituted 23.3 percent and non-automotive capital goods constituted 22.4 percent of merchandise imports. Petroleum and petroleum product imports accounted for 16.5 percent of merchandise imports. The value of petroleum and petroleum product imports as a percent of total imports of goods has risen from 10 percent in the second half of 2003. The rise in the U.S. oil bill is an important factor in the growth in the U.S. trade and current account deficits.

Canada, Mexico, China, Japan, Germany and the U.K. remain the largest trading partners of the United States. Canada purchased 23.0 percent of U.S. exports, Mexico 13.3 percent, Japan 6.0 percent, China 5.0 percent, and the U.K. 4.3 percent in the 12 months through June 2006. Canada accounted for 17.3 percent of U.S. imports, China 14.7 percent, Mexico 10.4 percent, Japan 7.9 percent, and Germany 5.9 percent in 2005.

Country	Exports Jul05-Jun06	Country	Imports Jul05-Jun06
Total, All Countries ($Bil)	967.0	**Total, All Countries ($Bil)**	1781.2
	Percent of Total		**Percent of Total**
Canada	23.0	Canada	17.3
Mexico	13.3	China	14.7
Japan	6.0	Mexico	10.4
China	5.0	Japan	7.9
United Kingdom	4.3	Federal Republic of Germany	4.9
Federal Republic of Germany	3.8	United Kingdom	3.0
South Korea	3.1	South Korea	2.5
Netherlands	2.9	Venezuela	2.1
France	2.4	Taiwan	2.0
Taiwan	2.3	Malaysia	2.0
Singapore	2.2	France	2.0
Memo		**Memo**	
Euro Area	15.0	Euro Area	13.4
OPEC	3.8	OPEC	7.9

Source: Bureau of the Census

Prices of imported goods (nsa) increased 7.3 percent in the year through the second quarter of 2006. Non-petroleum import prices rose 1.5 percent over this period, while petroleum import prices increased 37.5 percent. Export prices rose 3.4 percent over this period. The most recent

[15] Sums may not be exact due to rounding.

trough in import and export prices occurred roughly at the beginning of 2002. Since then non-petroleum import prices have risen 8.2 percent and export prices 13.3 percent.

Foreign demand for U.S. financial assets remains strong. A major item financing the U.S. current account deficit has been net private foreign purchases of long-term U.S. securities, which totaled $884.1 billion in the twelve months ending October, 2006. (Included in these were net private foreign purchases of long-term Treasury securities amounting to $146.5 billion and net private foreign purchases of U.S. corporate bonds amounting to $435.0 billion.) Net purchases by foreign official institutions were $175.2 billion over the same period.

Foreign investors owned $2.1 trillion of Treasury securities at the end of June 2006, or 51.9 percent of the public debt not held in Federal Reserve and U.S. Government accounts. This compares with $2.0 trillion, at the end of December 2005. Foreign official institutions held $1.3 trillion in Treasury securities at the end of June 2006, as they did at the end of June 2005. There are around $20 trillion in U.S. securities of all kinds outstanding.

Net International Investment Position

The U.S. net international investment position (NIIP) widened (with direct investment valued at the market value of owner's equity) to a minus $2.5 trillion (20.4 percent of GDP) at the end of 2005, the latest date for which data are available, from $2.4 trillion (20.9 percent of GDP) at the end of 2004. A $1.1 trillion valuation adjustment, reflecting strong appreciation of foreign stocks relative to U.S. equity, offset almost all the $785 billion widening attributable to financial flows and the $394 billion widening due to exchange rate changes. The NIIP (with direct investment valued at current cost) was a negative $2.7 trillion (21.6 percent of GDP) at the end of 2005 compared to a negative $2.4 trillion (20.2 percent of GDP) position at the end of 2004.

The United States continues to earn approximately the same amount on its foreign investments that it pays out on foreigners' investments in the United States, even though the value of foreigners' investments in U.S. assets is around $2.5 trillion greater than the value of the U.S. investment in foreign assets. Net earnings on direct investment have been large enough to offset outflows of income payments on other forms of international investment. U.S. residents earned $18 billion more on their investments abroad than they paid out on foreign investments in the United States in 2005. Net payments have turned into marginal outflows in the four quarters ended September 2006.

The NIIP is a critical measurement in analyzing the sustainability of the current account deficit. A growing negative NIIP must stabilize as a percent of national output in the long run or it would become impossible to service the external debt out of current or future production. It is generally believed that a stable NIIP as a percentage of GDP requires that the balance on trade in goods and services be close to zero.[16]

[16] The magnitude of the balance depends, among other things, on relative rates of return. For example, U.S. residents earn a higher rate of return on their foreign assets than residents of foreign countries earn on their U.S. assets. If this were to remain the case through the indefinite future, then the NIIP could stabilize with the United States running a deficit on trade in goods and services. There is, however, no clear reason for this interest rate advantage to continue indefinitely.

- *The U.S. Current Account in Historical Perspective*

A surplus on the capital and financial accounts is, by balance of payments accounting definition, the counterpart to a current account deficit. These flows finance the net capital formation that is equal to the excess over domestic saving. The growth of the U.S. current account deficit over more than a decade has been linked to high levels of domestic U.S. capital formation compared to domestic U.S. saving. Perceived high rates of return on U.S. assets, based on sustained strong productivity growth especially relative to that of the rest of the world, sound U.S. economic performance, a welcoming U.S. investment climate, and the deepest and most liquid capital markets in the world have all combined to attract foreign investment. In turn, sustained external demand for United States assets has allowed the United States to achieve levels of capital formation that would have otherwise not been possible, and robust growth in investment has been critical to non-inflationary growth of production and employment.

The U.S. Dollar

The dollar ended the first half of 2006 7.4 percent lower vs. the euro at $1.2795 and 2.8 percent lower vs. the yen at ¥ 114.45 than at the start of the year. For most of the first half of 2006, the exchange rates of the dollar vs. the euro and the dollar vs. the yen moved similarly.

- Initially, the market focused on interest rate differentials that remained favorable to the dollar.

- The Bank of Japan ended its quantitative easing policy and returned to its Zero Interest Rate Policy (ZIRP) in March, setting the stage for an eventual move toward removal of monetary accommodation. The European Central Bank (ECB) also raised interest rates in March.

- By mid-April, market participants increasingly looked toward the prospect of an end to the Federal Reserve's tightening cycle and an erosion of the dollar's interest rate advantage. Some took the view that adjustment of global imbalances would require substantial exchange rate changes.

In late May and early June the market's focus then shifted back to interest differentials, and talk of global imbalances faded. The euro retained much of the gains it had made in late April and early May, but the yen depreciated back to levels seen in late 2005.

- Some higher than expected U.S. economic indicators, notably on inflation, led to a resurgence in market expectations of higher interest rates. The FOMC raised interest rates at both its May and June meetings.

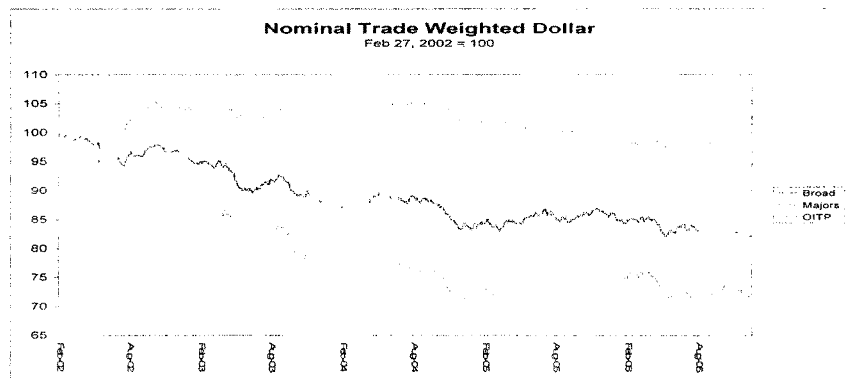
- Also concerned about inflation risks in the Euro area, the ECB raised it key policy rate in June, August, and October, narrowing the dollar's yield advantage vs. the euro. A number of other central banks, including some in emerging market countries, raised interest rates.

- Market concerns about the withdrawal of liquidity by central banks prompted a liquidation of risk positions globally in late May and June.

- The Bank of Japan maintained the ZIRP through the end of the first half and made clear that further removal of monetary accommodation would be very gradual.

On balance, the dollar largely traded in narrow ranges against the euro and yen, with low volatility, throughout most of this year, despite changing fundamentals. In recent trading (i.e., late November), however, the dollar depreciated beyond the limits of its trading range vs. the euro

The Federal Reserve's nominal trade-weighted dollar index declined by 3.2 percent in the first half of the year. The dollar depreciated by 5.4 percent vs. the major currencies component of the index and by 0.6 percent vs. the currencies of other important trading partners (OITP).



Country Analyses

Argentina

Pursuit of Argentina's goal of increasing its foreign exchange reserves to reduce external vulnerabilities has resulted in a de facto managed float.

The peso depreciated 1.8 percent nominally against the dollar during the first half of 2006, from 3.03 to 3.09 pesos to the dollar. The peso depreciated 6.9 percent from end-June 2005 to end-June 2006, from 2.89 to 3.09 pesos to the dollar. However, given current high inflation rates, in real terms, the peso appreciated by 0.8 percent from end-2005 through June 2006.

Argentina repaid its entire $9.9 billion in IMF obligations in January of 2006. Since then, the central bank has been able to rebuild its stock of foreign reserves back to pre-IMF repayment levels. At the end of June 2006, central bank reserves stood at $25.5 billion, down from $28.0 billion at end-2005. Argentina's access to international capital markets has been reduced as a result of its 2005 debt restructuring, and reserves are currently being accumulated to give the country a cushion against external shocks.

Argentina's reserve accumulation has fueled monetary growth and inflationary pressures. Annual inflation reached 11.0 percent at end-June 2006 compared to 12.3 percent at year end 2005 and 9.0 percent at end-June 2005. Nominal interest rates on repo transactions rose in the first half of 2006 to eight percent from six percent at the end of 2005. The increase was not, however, outpaced by inflation, producing some rise in real interest rates. Argentina's benchmark sovereign debt traded 385 basis points over U.S. Treasuries at end-June 2006 versus 504 basis points at end-2005.

On an accumulated basis, foreign direct investment into Argentina rose 10.7 percent to $4.7 billion from the end of 2004 to the end of 2005. Argentina had a $3.2 billion seasonally adjusted current account surplus in the first half of 2006, equivalent to 3.1 percent of GDP compared to 1.8 percent in the first half of 2005. During the first half of 2006, the United States had a trade surplus with Argentina of $224 million compared to a deficit of $100 million in the first half of 2005. This reflected, in part, export supply restrictions of the Argentine government designed to control inflation. Export taxes currently in place to boost fiscal performance are also placing downward pressures on Argentina's export performance.

Real GDP increased at a seasonally adjusted annual rate of 7.2 percent during the first half of 2006 versus 9.7 percent in the second half of 2005.

Capital controls remain in effect on currency inflows. Residents are limited in the amount of foreign currency they can bring into the country. Non-residents are required to keep dollars in the country for a minimum of one year, with 30 percent held on deposit in an interest-free account at the central bank.

Brazil

Brazil has a flexible exchange rate regime and relies on inflation targeting to guide monetary policy. The real continued to strengthen during the first half of 2006, appreciating 7.3 percent in nominal terms, from 2.33 to 2.16 reals to the dollar (although the real effective exchange rate depreciated by 0.95 percent). The real has appreciated by 82 percent relative to the dollar since reaching a low in October 2002, likely reflecting both overshooting during the 2002 crisis and a structural improvement in export competitiveness. Although the external accounts continue to be in surplus, they have narrowed in 2006 on the back of the real's continued recovery. On a seasonally adjusted basis, Brazil's current account surplus was $4.3 billion (0.9 percent of GDP) in the first half of 2006, down from $7.3 billion (1.7 percent of GDP) in the second half of 2005, while the trade surplus fell from $23.4 billion (5.3 percent of GDP) to $21.3 billion (4.7 percent of GDP) over the same period. The U.S. trade deficit in goods with Brazil narrowed from $4.6 billion in the first half of 2005 to $3.8 billion in the first half of 2006.

Slowing net exports contributed to a deceleration of the Brazilian economy during the second quarter of 2006. Beginning in the fourth quarter of 2005, the economy began to pick up steam, growing by 4.7 percent at a seasonally adjusted annualized rate. By the first quarter of 2006, the economy grew by 5.2 percent at an annual rate. However, a slowdown in export volumes and continued strong growth of imports resulted in a deceleration in real GDP growth in the second quarter of 2006 to 1.8 percent.

The strong real has aided the disinflation process in Brazil. The inflation outlook improved over the past year, with year-on-year inflation at 4.0 percent in June, within the targeted "tolerance range" of 2.5 percent to 6.5 percent. The same range has been targeted for 2007. The central bank increased net international reserves to $62.7 billion by June 2006 compared to $53.8 billion in December 2005. The central bank has a broad objective of increasing reserves in the medium run to make the economy less vulnerable to shocks, but it does not commit to a specific numerical target. In December 2005, Brazil repaid its $15.5 billion in IMF obligations.

Brazil has taken several steps this year to liberalize its foreign exchange market. In July 2006, Brazil loosened its repatriation requirements for exporters, enabling them to keep up to 30 percent of their export revenue abroad as long as they wish and the remaining 70 percent for up to a year. Previously, exporters were required to repatriate all of their foreign currency earnings within seven months of their receipt. Repatriation requirements for foreign exchange generated by financial market operations and Treasury purchases were also lengthened to a year. Brazil also will now allow the registration of foreign capital not previously eligible for registration, enabling foreign companies to remit profits and dividends related to this capital abroad.

Mexico

Mexico has a flexible exchange rate regime. During the first half of 2006 the Mexican peso depreciated nominally by 5.8 percent, from 10.6 to 11.3 pesos to the dollar. The J.P. Morgan trade-weighted effective exchange rate index for the peso depreciated by 5.8 percent during the same period. The depreciation during the first half of the year reversed much of the peso's gains since 2004 and reflected uncertainty associated with the presidential elections on July 2 as well as narrowing interest-rate spreads with the United States.

Rising oil prices continued to contribute to a rapid accumulation of Mexico's international reserves. Reserves grew by $10 billion during the first half of the year, reaching $79 billion by the end of June. Pemex, the state-controlled Mexican oil company, is obligated by law to sell its foreign currency earnings to the Bank of Mexico to service the country's foreign debt. Reserves accumulate, therefore, when the foreign currency obtained by the Bank of Mexico is greater than foreign debt payments. The Bank of Mexico follows a transparent rule for selling these reserves. Every 13 weeks, the Bank of Mexico retains half of the reserves accumulated during that period and sells the other half evenly over the ensuing three months. The stated goal of this transparent procedure is to prevent uncertainty in the financial markets and minimize discretionary actions by the financial authorities.

Mexico's seasonally adjusted current account deficit was 0.4 percent of GDP in the second quarter of 2006 compared to a deficit of 0.9 percent of GDP in the second quarter of 2005. The current account deficit was easily financed by foreign direct investment. Mexico's trade surplus with the United States for the first half of 2006 was $31.3 billion, up from $24.3 billion in the first half of 2005. Mexico is the second largest supplier of oil to the United States, and the rise in the U.S. trade deficit reflects rising oil prices.

A resurgence of automobile and agriculture exports caused the economy to grow briskly in the first six months of 2006. Real GDP increased at annual rates of 6.6 percent and 5.6 percent during the first and second quarters, respectively. At the same time inflation approached the Bank of Mexico's three percent target in the first half of 2006, although it has edged up in subsequent months. Year-on-year headline inflation was 3.2 percent in June, compared with 3.3 percent in December 2005. The December reading was Mexico's lowest year-end inflation since the 1960s.

Mexico does not maintain controls on most external capital inflows and outflows. It does, however, maintain some restrictions against certain types of foreign investment, such as the establishment of foreign bank branches within Mexico.

Venezuela

Venezuela maintains a pegged exchange rate. The nominal exchange rate was held at 2,147 bolivars to the dollar at end-June 2006, unchanged from end-December 2005 and end-June 2005. The J.P. Morgan trade-weighted real effective exchange rate index for the bolivar appreciated by 6.4 percent during the first half of 2006.

Oil accounts for about one third of Venezuelan GDP, roughly 90 percent of the country's exports and close to half of government revenues. High oil prices have not only supported highly expansionary fiscal policies, but have accounted for the rising current account surplus and foreign reserve accumulation. The stock of central bank reserves increased to $31.2 billion by end-June 2006 compared to $29.6 billion at end-2005 and $28.1 billion at end-June 2005. Reserve accumulation is contributing to monetary expansion and inflationary pressures. High inflation with a fixed exchange rate has contributed to real exchange rate appreciation, eroding competitiveness, evidenced by continued strong growth of imports.

The monetary base expanded by 53 percent from the end of the first quarter of 2005 through the end of the first quarter of 2006. Annual inflation was 11.8 percent at end-June 2006 compared to 14.3 percent at end-2005. Venezuela's benchmark sovereign debt spread was 228 basis points over U.S. Treasuries at end-June 2006 versus 318 basis points at end-2005.

For the first half of 2006, net FDI inflows were -$3.2 billion versus $0.8 billion for the first half of 2005, and net portfolio flows were -$8.1 billion versus $1.6 billion in the first half of 2005. Venezuela had a $15.2 billion current account surplus in the first half of 2006 versus a $14.9 billion surplus in the second half of 2005 and a $10.6 billion surplus in the first half of that same year. For 2005, the current account balance was $25.5 billion, or 18.2 percent of GDP. Venezuela's rising current account surplus can be attributed to higher world oil prices. During the first half of 2006 the U.S trade deficit with Venezuela was $14.5 billion, up from $13 billion in the first half of 2005. The higher U.S.-Venezuela trade deficits primarily reflect increasing oil prices; about 11 percent of U.S. oil imports come from Venezuela. Real GDP increased at a seasonally adjusted annual rate of 6.5 percent during the first quarter of 2006 versus 15.6 percent during the fourth quarter of 2005. Real GDP rose by 9.3 percent in 2005.

Venezuela maintains extensive controls on capital inflows and outflows. These controls require exporters to surrender their foreign exchange earnings to the government at the official exchange rate.

The Eurozone

Eurozone quarterly growth increased to an average annualized rate of 3.0 percent during the first three quarters of 2006 from 1.9 percent during the same period in 2005. Domestic demand strengthened in the second quarter with a very strong increase in domestic investment. During the first half of 2006, imports followed suit, increasing 18 percent from the first half of 2005 compared to export growth of 13 percent. The combined effect caused the Eurozone's current account deficit to widen slightly from 0.26 per cent of GDP in the first half of 2005 to 0.3 percent in the first half of 2006. The Eurozone's trade surplus with the United States increased $2.2 billion during the first half of 2006 compared with the same period in 2005 to $45 billion.

Over the first half of 2006, the euro appreciated 7.8 percent against the dollar to $1.278. The Eurozone's moderate inflation relative to that of its major trading partners, however, helped contain real effective exchange rate appreciation to only 3.1 percent. The ECB has not intervened in foreign exchange markets since November 2000 and the value of Eurozone foreign exchange reserves increased by only $1.7 billion between December 2005 and June 2006 reaching $169.1 billion.

Although CPI-measured inflation has fallen below the ECB's two percent ceiling to 1.6 percent in October, the ECB remains hawkish citing inflationary concerns. The ECB has raised its key policy rate (the minimum bid rate on main refinancing operations) five times from a December 2005 level of 2.25 percent to 3.25 percent in December, 2006.

Germany

Germany's GDP increased at an annualized rate of 3.4 percent over the first three quarters of 2006 compared with 1.9 percent growth during the same period in 2005. During this period, investment increased at an average 7.4 percent annualized rate compared to 2.6 percent during the same period in 2005. Strong growth induced a healthy, 19 percent, increase in imports outpacing a 12 percent increase in exports during the first six months of 2006 compared with the same period in 2005, with the current account surplus narrowing somewhat from five percent of GDP during the first half of 2005 to 4.2 percent in first half of 2006. Germany's trade surplus vis-à-vis the U.S. increased by $15 million during the first six months of 2006 to $24.4 billion.

The Netherlands

The Netherlands posted a $25.6 billion current account surplus in the first half of 2006, which represented an increase to 10.5 percent of GDP from 6.4 percent of GDP in the second half of 2005. For the first half of 2006, the current account surplus is largely explained by the trade surplus (96 percent), balance on services (14 percent), and balance on income (eight percent), which offset a deficit on current (outward) transfers (-18 percent). For the full 2005 year, the current account surplus was 7.7 percent of GDP. Merchandise exports in the first half of 2006 grew by 15.3 percent over the same period in 2005 while merchandise imports grew 16.7 percent. The U.S. trade surplus with the Netherlands grew to $6.8 billion in the first half of 2006, up $258 million from the same period in 2005.

GDP growth was estimated to be 2.7 percent (annualized) over the first half of 2006, driven by the growth in investment, government consumption, and net exports. Headline inflation was 1.8 percent in June (y/y) while core inflation was 0.8 percent.

Spain

Spain's GDP increased 3.8 percent, at an annual rate, in the first half of 2006 from 3.6 percent in the second half of 2005. Consumption and investment increased 2.7 percent and 7.3 percent, respectively, over this period. Spain faces a risk of overheating given strong domestic demand and record low unemployment. Unemployment fell sharply to 5.5 percent in the second quarter of 2006 from 12.7 percent in the second quarter of 2005. Spain's CPI increased 4.0 percent y/y in June 2006, which was up from 3.2 percent y/y in June 2005. The IMF estimates the output gap to be close to zero.

Rapid growth of investment over the past decade has sustained growth in domestic demand and been the principal factor in a widening current account deficit. Gross fixed capital formation rose 7.0 percent in the first half of 2006 from the second half of 2005. Investment represented over 30 percent of GDP and the current account deficit reached $54.7 billion, or 9.3 percent of GDP in the first half of 2006. In the first half of 2006, goods imports increased 14.9 percent over the same period in 2005 while goods exports increased 12.9 percent. Spain's bilateral surplus on trade in goods with the United States was $11.3 billion in the first half of 2006, $346 million higher than during the same period last year.

Switzerland

Switzerland posted a $31.8 billion current account surplus (15.8 percent of GDP) in the first half of 2006, up from $26.3 billion (15.1 percent of GDP) in the same period in 2005. The trade surplus declined $1 billion (from $2 billion to $1 billion) in the first half of 2006 compared to the corresponding period in 2005, while the surplus in the services account increased $2 billion to $13 billion during the same period. The surplus on trade in goods accounted for only 3.5 percent of the current account surplus in the first half of 2006. On the other hand, the surplus on trade in services, including financial services, accounted for 43.1 percent, while the surplus on net income receipts, including net receipts from foreign investment, accounted for 61.1 percent of that period's current account surplus. The net transfers balance was in deficit over the period, reducing the current account surplus by 7.7 percent. Goods exports increased by 17 percent in the first half of 2006 over the corresponding period in 2005, while imports grew 18.7 percent over the same period, but the trade balance contributed only 2.6 percent to the overall current account surplus. The U.S. trade surplus vis-à-vis Switzerland was $73.3 million in first half of 2006, up from a deficit of $1.2 billion from the corresponding period in 2005.

As a small open economy, Swiss economic conditions are heavily influenced by conditions in the Eurozone, Switzerland's major trading partner. Monetary policy was tightened during first half of 2006, following the ECB's policies, and the Swiss Franc appreciated 0.8 percent against the euro and 6.2 percent against the dollar; however, its nominal effective exchange rate remained unchanged and the IMF's index for the real effective exchange rate of the Swiss Franc appreciated 1.1 percent. Foreign exchange reserves remained relatively stable at $36.2 billion during the period. The Central Bank did not intervene in the foreign exchange market during the first half of 2006, but does intervene occasionally to "counteract market disturbances."

GDP growth was estimated to be 2.9 percent (annualized) during first half of 2006. Consumption and (fixed) investment grew 1.6 percent and 5.6 percent, respectively on an annualized basis during the same period, while net exports grew 8.1 percent in first half of 2006 compared to first half of 2005. During the first half of 2006 headline inflation was 1.56 percent y/y while core inflation was 0.8 percent y/y.

Norway

Norway is a major oil and gas exporter. Its current account surplus during first half of 2006 was $29.4 billion (17.5 percent of GDP), up $2.2 billion from $27.2 billion (14.2 percent of GDP) in the second half of 2005. Merchandise exports were up 25.2 percent over the same period last year while imports increased 15.1 percent. The U.S. trade deficit with Norway in first half of 2006 was $2.4 billion, down from $2.5 billion in first half of 2005. The Norwegian kroner appreciated 7.8 percent against the dollar during the period while the IMF's nominal and real effective exchange rate indices for the kroner appreciated 1.4 percent and 2.4 percent, respectively. Foreign exchange reserves grew $2.6 billion to $49.0 billion during first half of 2006, slightly faster than during the corresponding period in 2005. Norway's Central Bank does not intervene in foreign exchange markets to influence the kroner, but management of the Government Pension Fund (GPF) portfolio has some of the characteristics of intervention. In the process, it may influence the kroner.

Most of Norway's oil and gas revenue is invested overseas through the GPF and, at end-June 2006, the GPF's market value was $241 billion (86 percent of 2005 GDP) and growing rapidly. The return on the GPF's investment can be used for current government consumption while the principal remains as a retirement fund for future generations.

GDP increased 1.7 percent (at an annual rate) during the first half of 2006 compared to the second half of 2005. Consumption grew by 4.6 percent (annualized) during the same period while fixed investment (annualized) declined 1.9 percent Headline inflation was 2.1 percent (annualized) during the period while core inflation was 0.9 percent.

Russia

Strong growth in exports, boosted by high oil prices, helped increase Russia's current account surplus to $56.5 billion (not seasonally adjusted, or "nsa") in the first half of 2006 from $42.8 billion in the first half of 2005. As a share of GDP, the surplus rose to 11.3 percent in the 12 months through June from 11 percent during the comparable period in 2005. The bilateral trade balance with the U.S. amounted to a surplus of $7.5 billion in the first half of 2006; this compared with $5.9 billion in the first half of 2005. In addition, the shift to net private sector inflows that began in the second half of 2005 accelerated in the first half of 2005, as direct investment rose sharply and portfolio investment outflows slowed. As a result, the balance of payments' financial accounts, exclusive of changes in reserves, shifted to a surplus of $9.4 billion during the first half 2006 from a deficit of $2.9 billion in the first half 2005.

The increase in capital inflows, together with central bank intervention to moderate the pace of exchange rate appreciation, boosted total international reserves to $250.6 billion at the end of June from $182.2 billion at the end of 2005. Net of valuation changes, reserves rose $62.4 billion during the first half of 2006, compared with an increase of $61.5 billion for all of 2005. In addition, the balance of Russia's oil stabilization fund rose to $76 billion at the end of June from $43 billion at the end of 2005. Limited sterilization of the central bank's foreign exchange market intervention has resulted in continued rapid growth in the money supply, as M2 (using the monetary survey definition) rose 38.0 percent in the 12 months through June compared with 36.3 percent in 2005.

The central bank continues to manage closely the exchange rate in an effort simultaneously to meet inflation targets and to limit real exchange rate appreciation. The ruble appreciated six percent against the dollar during the first half of 2006. The IMF's nominal trade-weighted index of the ruble appreciated 3.1 percent in the first half of 2006 while its real trade-weighted index[17] appreciated by 4.2 percent. This compared with nominal appreciation of 2.5 percent and real appreciation of 9.3 percent for the full-year 2005. The ruble has remained little changed against the dollar since the end of June, rising by only 0.2 percent.

The ruble's appreciation (together with smaller increases in administered prices) helped slow the increase in the CPI from 10.9 percent y/y in December 2005 to 9.0 percent y/y in June. CPI rose again to 9.6 percent y/y by August, however, compared with the end-2006 inflation target of 8.5 percent. Real GDP increased 6.5 percent y/y during the first half of 2006, little changed from 6.4 percent in 2005. Output growth has been supported by strong household spending and fiscal easing as the government is spending a larger share of oil revenues ahead of the 2007-2008 election cycle.

South Africa

South Africa's flexible exchange rate responded quickly to changing economic conditions over the first half of 2006. The rand, typically classified as one of the "commodity" currencies, was relatively strong against the dollar from January to May. However, from mid-May to mid-June it depreciated 22 percent on the heels of a drop in precious metals prices and cooling investor interest in emerging markets. Bond and equity prices also fell. The Central Bank believed that rand weakness and rising fuel prices pushed inflation expectations above the upper end of the inflation target range (3-6 percent), and increased its policy interest rate 50 basis points in both June and August. Actual inflation was 4.8 percent in June, within the target range.

[17] The IMF's CPI-based index.

Robust domestic demand, supported by a 25 percent y/y increase in the extension of credit to the private sector in the second quarter following a similar increase in the first quarter, contributed to above trend real GDP growth of 4.2 percent in the first quarter (q/q, sa), and 4.9 percent in the second quarter.

Strong domestic demand also contributed to a current account deficit that averaged an estimated 6.1 percent of GDP in the first two quarters of 2006. South Africa's imports from the United States increased 27 percent (about $750 million) in the first half of this year relative to the same period in 2005, while South Africa's exports to the United States were little changed. Portfolio inflows financed most of the current account deficit. Foreign exchange reserves rose more than $3 billion in the first half of 2006 to almost $24 billion (4.3 months of imports) at the end of June.

Egypt

Since January 2005, the Central Bank of Egypt (CBE) has used partially sterilized interventions in the foreign exchange market to maintain a de facto peg of the Egyptian pound against the dollar. In the six months ending in June 2006, the pound-dollar exchange rate stayed within a narrow one percent range, while the CBE's net international reserves increased by five percent, to $22.9 billion. Net reserves grew by 20 percent for the year ending in June, contributing to 15 percent growth in reserve money and 13 percent growth in broad money (M2).

The CBE has made gradual progress towards the goal of a floating exchange rate regime, abandoning the formal peg against the dollar in early 2003, and launching an inter-bank foreign exchange market in December 2004. The CBE has announced that it will adopt a formal inflation targeting regime to guide monetary policy.

During the fiscal year ending in June 2006, Egypt's current account narrowed to a projected 1.7 percent of GDP, down from 3.3 percent of GDP in the year ending June 2005. Driven by higher prices, exports of oil and natural gas increased by 93 percent in the year ending June 2006, to constitute 55 percent of total exports. By contrast, non-energy exports declined by four percent, and Egypt's projected trade deficit remained above 11 percent of GDP. The stress of nominal appreciation on non-energy sectors would be eased if ongoing structural reforms increased productivity growth in these sectors. Egypt had a deficit of $713 million on trade in goods with the United States from January through August 2006, down from a deficit of $830 million during the same period last year

Reforms, increased privatizations, and the robust regional economy helped Egypt attract large capital inflows for the second straight year. The overall financial account surplus (excluding reserve accumulation) was a projected 3.3 percent of GDP in the year ending June 2006, compared to 3.8 percent of GDP in the year ending June 2005. Net foreign direct investment reached a record $6.1 billion in the year ending June 2006.

The Egyptian economy, which grew five percent in 2005, has continued to perform strongly in 2006. Increased economic activity and ample growth in liquidity contributed to consumer price inflation of 6.4 percent y/y in June, compared to 4.7 percent y/y inflation during the same period in 2005.

Saudi Arabia

The riyal has been unofficially pegged to the dollar since 1986 (officially since 2003), so interest rates largely followed recent increases in the United States. The Gulf Cooperation Council (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the U.A.E.) has set a goal of establishing a formal monetary union by 2010, although the relationship of the new currency to other currencies has not been announced.

With Saudi Arabia's large current account surplus and fixed exchange rate, the net foreign assets of the Saudi Arabian Monetary Agency rose to $176 billion from $152 billion during the first six months of 2006, providing approximately 30 months of import cover. Gross liquid reserves rose by a much smaller amount over the same period, increasing to $30 billion from $26 billion.

Saudi Arabia is one of the most oil-dependent economies in the world, with oil accounting for around 50 percent of GDP and almost 90 percent of export and government revenue. With high oil prices over the past few years, real GDP growth has averaged close to six percent, with average nominal GDP growth just under 20 percent.[18] Despite this strong growth, 2005 CPI inflation remained below one percent in 2005 and is projected to be about 1.5 percent in 2006, reflecting small changes in the prices of imported goods and the large share of administered prices in the CPI basket.

Oil export revenues continued to increase on the back of high oil prices, rising from $110 billion in 2004 to a projected $197 billion in 2006. The surge in oil export revenue led to an increase in the current account surplus from 20.7 percent of GDP in 2004 to an estimated 31 percent in 2006. Finally, the bilateral trade surplus with the United States has grown substantially, reaching $20.4 billion in 2005, compared with $15.7 billion in 2004, and surplus of $14.4 billion recorded in the first eight months of this year.

The government's financial position improved as revenue from oil rose by $46 billion to $134 billion in 2005 and is projected to reach $150 billion in 2006. The budget surplus was approximately $57 billion in 2005 (18 percent of GDP) and is projected to exceed $60 billion in 2006. The government is using much of that surplus to reduce government debt, which is expected to be reduced to 17 percent of GDP in 2006. Based on historical experience, these surpluses are likely to diminish over time as the government increases spending; the government projects domestic spending to rise by 20 percent in 2006.

Singapore

The Monetary Authority of Singapore (MAS) uses the exchange rate as its operational monetary policy tool to control inflation. MAS manages the Singapore dollar (SGD) against an undisclosed basket of currencies and since April 2004 has operated on a policy of "modest and gradual"

[18] Using actual 2004 and 2005 rates and projected 2006 rates.

appreciation against this basket.[19] In the first half of 2006, the SGD appreciated 4.7 percent against the U.S. dollar, compared with 1.1 percent appreciation in the second half of 2005. JP Morgan's nominal and real trade-weighted indexes of the SGD appreciated 1.8 percent and 5.2 percent, respectively, in the first half of this year.[20] The faster pace of appreciation of the real trade-weighted index in the first half of 2006 reflected a slight pick-up in inflation in the first few months of the year.

CPI inflation was a relatively modest 1.3 percent (y/y) in the first half of 2006, although higher oil prices are beginning to have a stronger impact on overall consumer prices. The economy expanded by 3.0 percent (saar) in the second quarter of this year, compared with 7.6 percent in the first quarter. The second quarter deceleration was largely due to weaker manufacturing sector growth, although manufacturing has more recently shown signs of a rebound.

High savings rates and declining investment have driven large and growing current account surpluses in Singapore. In the first half of 2006, the current account surplus reached 31 percent of GDP, compared with an overall 2005 surplus of 28.5 percent of GDP. Singapore's gross national savings rate of around 45 percent of GDP is among the world's highest and reflects an extremely high corporate savings rate (estimated by the IMF at 25-30 percent of GDP[21]). The government also records large fiscal surpluses.[22] Household savings are on par with international levels. Meanwhile, domestic investment, at around 20 percent of GDP, remains well below savings. Corporate profits and government savings – including profits from government-linked companies – are often invested overseas. Gross capital formation declined markedly in the early part of the decade – from 33 percent of GDP in 2000 to 16 percent in 2003 – as a result of several factors, including a property market slowdown, the bursting of the IT bubble in 2000-01, and the SARS outbreak of 2003.

Reserves increased by $12 billion in the first half of this year, reaching $129 billion, or about seven months of import cover. Singapore has a large bilateral merchandise trade deficit with the U.S., which reached $2.7 billion over the first half of the year. This was slightly lower than the bilateral trade deficit of $3.0 billion in the first half of 2005.

India

India's economy grew 9.7 percent annualized in the first half of 2006 after 8.5 percent growth in 2005 due to strong activity in the manufacturing and services sectors. Strong domestic demand and increases in fuel prices put upward pressure on wholesale price inflation which was 5.1 percent y/y in June, up from 4.5 percent y/y in December. In response, the Reserve Bank of India (RBI) twice increased its reverse repo policy rate by 25 basis points, in January and June. The RBI characterizes its monetary policy as seeking price stability while ensuring adequate

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[19] MAS manages the exchange rate within an undisclosed band. Its policy options are to (1) change the midpoint of the band to allow for a one-off adjustment, (2) change the band's slope to signal a possible turning point in the monetary policy cycle, or (3) widen the band.
[20] The trade weights in the JP Morgan NEER and REER indexes are based on Singapore's 2000 bilateral trade in manufactured goods.
[21] IMF No. 06/150. Singapore: 2005 Article IV Consultation, May 2006 http://www.imf.org/external/pubs/ft/scr/2006/cr06150.pdf.
[22] The IMF projects, however, that its overall surplus of six percent of GDP in 2005 will fall to four percent in 2006.

credit to productive sectors of the economy to support growth. It targets short-term interest rates and monitors trade-weighted exchange rates over the medium term.

The RBI manages the exchange rate without a pre-announced target or a band. The rupee depreciated by 2.1 percent against the dollar in the first half of 2006, while in real trade-weighted terms the effective exchange rate, as calculated by JP Morgan, depreciated by 3.7 percent. In the first half of 2006, foreign exchange purchases by the Reserve Bank of India totaled $15.6 billion as compared with $10.9 billion in the first half of 2005. India's foreign exchange reserves, on the other hand, increased more strongly, by $25 billion in the first half of 2006, exceeding the $7.2 billion increase in the first half of 2005. Foreign exchange reserves increases reflected interest earnings and exchange rate changes as well as net transactions in foreign exchange.

The current account deficit was $7.6 billion sa (2.0 percent of GDP) in the first half of 2006, wider than the $2.4 billion figure (0.7 percent of GDP) in the first half of 2005. The deficit was driven by strong growth of oil, steel, and machinery imports associated with robust domestic growth. The U.S. bilateral trade deficit with India was $5.7 billion in the first half of 2006, which is $764 million larger than in the first half of 2005. Capital inflows continue to finance the current account deficit. Net foreign direct investment and portfolio inflows were $7.6 billion in the first half of 2006 compared to $7.0 billion in the first half of 2005. Foreign institutional investment inflows in the first half of 2006 continued to support net portfolio inflows of $3.8 billion, while foreign direct investment was also $3.8 billion.

Japan

The current economic recovery, which has become the longest in Japan's post-war history, may finally have allowed Japan to escape from a decade of persistent deflation. Economic growth has accelerated modestly from less than 0.3 percent in the first year of the recovery (2002) to an average of 2.2 percent in the first three quarters of 2006. Growth this year has largely been reliant on net exports and business investment, with private consumption contracting in the most recent quarter and below year-ago levels. Consumer prices (the CPI less fresh food) were rising at a rate of 0.1 percent y/y in October 2006, while other price indices, such as the GDP deflator, continued to fall.

High oil prices have helped contain Japan's trade and current account surpluses. Over the first half of 2006, Japan's trade surplus fell to $33.8 billion compared to $41.4 billion in the same period in 2005 as the value of imports grew by 23 percent, well outpacing export growth (16.1 percent y/y). The U.S. bilateral deficit with Japan, however, widened by $1.4 billion to $43.1 billion in the first half of the year compared with the same period of 2005, despite U.S. shipments to Japan expanding at a faster rate than imports (8.0 percent y/y versus 5.2 percent). As a share of GDP, Japan's current account surplus through the first three quarters of 2006 is running at about the same 3.7 percent level that it did in 2005.

On July 14, the BOJ raised interest rates to 0.25 percent from effectively zero. This marked the start of the first monetary policy tightening cycle in more than 16 years. The lead-up to the BOJ's increase in official interest rates, which began with an exit from quantitative easing in

March, initially contributed to some increased volatility in foreign exchange markets. However, volatility has moderated since mid-year.

Over the January to June 2006 reporting period, the yen strengthened 2.9 percent versus the dollar, closing at ¥114.51 on June 30. Persistent Japanese deflation since 1998, which has only recently dissipated, has led to a substantial depreciation of the yen in real terms. BOJ data indicate that the yen is now at its weakest level in real trade-weighted terms in more than 20 years. The Japanese authorities, however, have not intervened in the foreign exchange market since March 2004 when the yen was around ¥109 per dollar.[23] Gold and foreign exchange reserves totaled $885.6 billion at the end of October 2006, up from $864.9 billion at the end of June and $846.9 billion at end-December 2005.

South Korea

South Korea's economy continues to perform well with real GDP growing at a 4.9 per cent seasonally-adjusted annual rate in the first half of 2006, after posting 4.0 percent growth in 2005. Private forecasters project real GDP growth in the 4½-5 percent range both this year and next. In addition, core consumer price inflation stands below the center of the central bank's target range of about 2.5 -3.5 percent. South Korea's flexible exchange rate regime, under which the won has appreciated steadily since 2003, has contributed significantly to containing inflation. Despite substantial real appreciation of the South Korean won over this period, growth of South Korean exports has remained strong, expanding in excess of 15 percent over the year through the second quarter of 2006.

For the future, the Korean government has set an ambitious reform agenda to enhance productivity and income growth to offset expected declines in the labor force as Korea's population ages. That agenda includes liberalizing the financial sector and increasing its integration into the global financial system and opening the services sector to domestic and foreign competition.

The Bank of Korea tightened monetary policy over the reporting period to limit the risk of overheating and to contain the inflationary impact of high oil prices. The Bank of Korea raised the call money rate target from 3.25 percent to 3.75 percent from October to December 2005, and to 4.5 percent by August 2006. The won appreciated 6.6 percent in nominal terms against the dollar over the first half of 2006 and almost 25 percent from the end of 2003 to the end of June 2006. The magnitude of average daily fluctuations in the won/$ exchange rate is comparable to that of the euro against the dollar. The won has also appreciated in real effective terms, strengthening five percent in the first half of 2006 and 24 percent from its end-2003 level.

Core consumer price inflation remains subdued, rising 2.2 percent y/y in October 2006, below the bottom end of the Bank of Korea's 2.5-3.5 percent target range. Starting in January 2007, the Bank will target headline inflation using the same target band.

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[23] The Japanese Ministry of Finance announces its total foreign exchange intervention at the end of each month, and publishes the dates and amounts of intervention at the end of each quarter. See http://www.mof.go.jp/english/e1c021.htm.

Despite South Korea's strong export performance, the current account surplus declined during the reporting period due to high oil prices and rapid real import growth. The current account surplus fell from $7.4 billion (1.9 percent of GDP) in the second half of 2005, to $0.3 billion (0.1 percent of GDP) in the first half of 2006. Foreign exchange reserves increased $10 billion in the first half of 2006, reaching $224 billion, about equal to South Korea's total foreign debt.

China[24]

In the first half of 2006, China's economic growth accelerated slightly, despite administrative measures taken to slow investment. And, despite the Chinese authorities' stated goal of rebalancing growth towards domestic consumption, output growth continued to rely heavily on investment and net exports. In fact, despite the goal of reducing the country's external surplus, China's global merchandise trade surplus rose to $80 billion, or roughly seven percent of GDP, in the first six months of this year. The Chinese currency, the renminbi (RMB), appreciated by 0.94 percent against the dollar in the first half of 2006. Chinese authorities took several steps to develop the foreign exchange market, and average daily fluctuations of the RMB were twice as large in the first half of 2006 as in the last half of 2005, although the degree of flexibility is still low by comparison to other major currencies. Overall, Chinese authorities continue a cautious, measured approach toward economic reform with a goal of minimizing the risks of instability. Lack of monetary policy autonomy due to limited exchange rate flexibility presents a major obstacle to rebalancing growth and improving the efficiency of financial intermediation.

Unexpectedly high growth numbers in the first half of 2006, despite measures taken to slow investment, prompted authorities to impose additional tightening measures to rein in economic activity. Real GDP growth accelerated from 9.9 percent in 2005 to a seasonally-adjusted annual rate of 10.3 percent in the first quarter of 2006, and 11.3 percent in the second quarter. The acceleration in growth was in part spurred by a goods trade surplus in the first half of this year that was nearly 50 percent larger than in the corresponding period in 2005, despite the revaluation of the RMB in July 2005 and continued modest appreciation through the first half of 2006. Continued strong growth in investment also contributed to the acceleration in growth, with fixed asset investment up 30 percent.

A burgeoning trade account has given rise to an increasingly large current account surplus. In fact, the current account surplus has risen from 1.5 percent of GDP in 2001 to four percent of GDP in 2004 and up to seven percent of GDP in 2005. In the first half of 2006, the current account balance rose further to around eight percent of GDP.

In response to the acceleration of growth in the first half of 2006, the People's Bank of China (PBOC) implemented a series of tightening measures. Required bank reserve ratios were increased twice (by a total of one percentage point) and renminbi-denominated commercial lending rates were raised twice (by 0.54 percent overall). The authorities also imposed

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[24] The latest IMF Article 4 report on China discusses these issues, especially exchange rate issues, in great detail. See http://www.imf.org/external/pubs/ft/scr/2006/cr06394.pdf

administrative measures aimed at dampening investment including re-evaluation of planned projects, restrictions in property markets, and guidance to banks to lend less.[25]

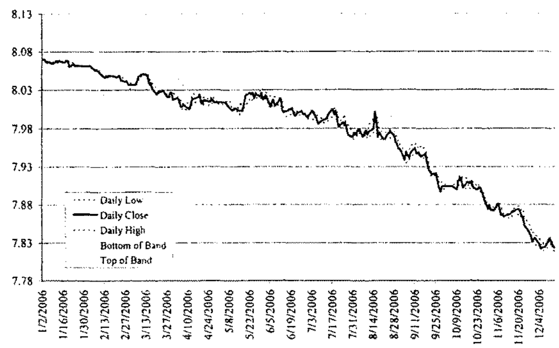
The authorities have begun to liberalize the exchange rate regime and the operation of exchange rate markets. On July 21, 2005, the government ended the RMB's eight-year peg against the dollar, and introduced a new exchange rate regime described as "a managed floating exchange rate regime based on market supply and demand with reference to a basket of currencies." The RMB was allowed to fluctuate up to 0.3 percent on either side of a central rate set daily and was initially revalued by 2.1 percent against the dollar.

During the first half of 2006, the authorities took further steps to reform the currency market. In January 2006, authorized banks – including some foreign banks – were allowed to act as market makers for spot trading of foreign exchange. Previously, all trades had been with the State Administration for Foreign Exchange (SAFE), with relatively high fees.[26]

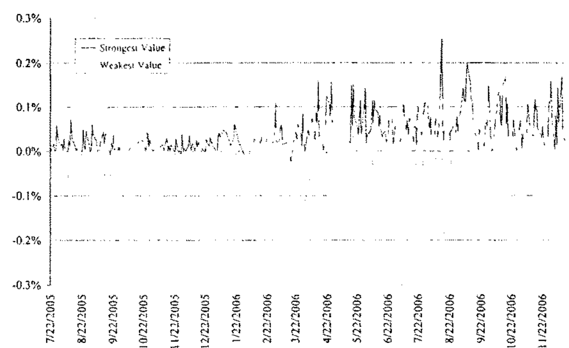
RMB flexibility with respect to the dollar increased significantly in the first half of 2006 relative to the last six months of 2005, although it remains small in comparison with other currencies with flexible exchange rate regimes. Measures of flexibility include average daily movement, maximum one-day movements, and net value changes over a period of time. In terms of average daily movement in the second half of 2005, the RMB fluctuated 0.02 percent around the central parity rate in daily trading. This average daily fluctuation increased to 0.03 percent in the first half of 2006, and further to 0.05 percent since June 2006. In the second half of 2005, the RMB's largest single intra-day fluctuation from the central parity rate was 0.07 percent, while on May16, 2006, the fluctuation reached 0.15 percent. Since June, the most the RMB has diverged from the central parity rate in one day is 0.17 percent on August 14. This is the closest that intra-day fluctuation has come to the bounds of the 0.3 percent fluctuation band. Finally, the RMB gained 0.5 percent against the dollar in the second half of 2005 and gained 1.0 percent against the dollar in the first half of this year. In total, starting with the initial revaluation on July 21, 2005, the RMB has appreciated by 5.88 percent as of December 14, 2006.

[25] Some banks with overly rapid loan growth were required to purchase $31 billion in below-market rate bonds issued by the PBOC.
[26] An additional innovation in January was that the "central parity rate" would be set each morning before market opening based on a weighted average of the prices that market makers were offering. This allows further scope for daily movement, as the central parity rate can theoretically change by any amount each morning. The 0.3 percent band still applies to movements within a day's trading.

2006: Daily RMB-to-US Dollar



Intra-Day RMB fluctuations from the Daily Reference Rate



Continued strong investment demand for renminbi means that an inflexible RMB faces continued market pressure. In order to maintain the managed float, the central bank intervenes in the foreign exchange market, exchanging RMB for foreign currency and accumulating foreign exchange reserves. In 2005, the average monthly accumulation was $17.4 billion. Reserve accumulation accelerated in the first half of 2006, averaging $20.4 billion monthly. From July to September of 2006, reserve accumulation slowed to an average of $15.6 billion per month. On October 13, 2006, the PBOC announced that its foreign exchange reserves totaled $987.9 billion at the end of September. On November 6, China's state television reported on an evening news program that reserves reached $1 trillion in October. In order to reduce the expansionary impact of reserve accumulation on the money supply, the PBOC "sterilizes" foreign currency purchases by issuing PBOC bonds, through swaps and repurchase agreements, and by periodic increases in the required reserve ratio of banks. In the first half of 2006, PBOC sterilization operations averaged $10.8 billion monthly, about 60 percent of foreign exchange purchases for the period.

China's cautious approach to exchange rate reform continues to exacerbate distortions in the domestic economy and impede adjustment of international imbalances. With capital flows increasingly mobile into and out of the Chinese economy, limited exchange rate flexibility cedes a great deal of control of monetary policy to foreign monetary authorities and international investment sentiment. Use of higher interest rates to slow credit growth and enforce bank lending discipline is also constrained by the effect that higher interest rates have in spurring greater capital inflows. Clamping down on exchange rate fluctuations in the belief that this is prudent has in fact increased pressures in other parts of the economy.

Limited exchange rate flexibility has also become an obstacle to the broader goal of reducing economic imbalances enunciated by China's leaders. Premier Wen's speech before the National People's Congress in March underscored that among the main goals of the 11th Five-Year Plan were rebalancing growth towards domestic consumption and improving investment efficiency. Soon after, PBOC Governor Zhou outlined a five-point plan to address the growing current account surplus, and President Hu reiterated these points during his visit to Washington in April 2006. The plan aims to increase domestic demand, reform social security (to reduce required saving), increase exchange rate flexibility, widen market access for foreign firms, and boost China's imports (through further trade liberalization). Limited exchange rate flexibility impedes the rebalancing of Chinese growth away from exports towards consumption and away from coastal areas towards the interior. Failure to let the exchange rate adjust also impedes the reduction of China's current account surplus and foreign reserve accumulation.

Chinese officials have repeatedly stated that the exchange rate will gradually become more flexible and that there will not be any surprise adjustments. They contend that greater flexibility cannot be achieved overnight and that progress is ongoing. Indeed, Chinese officials continue to enact measures that are preconditions for greater exchange rate flexibility, including steps to liberalize the capital account, reform the financial sector, enhance the foreign exchange market, and develop new financial products.

In the first half of 2006, China continued with modest capital account liberalization, including in the pilot programs that allow Chinese investors to make portfolio investments overseas and foreign investors to make portfolio investments in China. From April to November 2006, the China Banking Regulatory Commission (CBRC) granted one asset management company and 15 banks – including foreign banks – a total of $13.1 billion in quotas to provide overseas investment services for Chinese residents, as part of the Qualified Domestic Institutional Investors (QDII) program to allow pooling of RMB funds to be invested overseas. However, only a small proportion of the allotted QDII quota has been used to date. In August 2006, the China Securities Regulatory Commission (CSRC) expanded the number of institutions qualified to invest in local shares as Qualified Foreign Institutional Investors (QFII) by reducing the minimum size for institutions and shortening the required holding period for investments. Also in April 2006, foreign exchange regulations were liberalized to allow Chinese firms and residents to buy more foreign assets. Individuals can now convert up to $20,000 worth of RMB to take out of China.

China has taken steps to improve its financial sector to be able to adapt to currency and interest rate fluctuations. Since the beginning of 2004, China has promoted foreign investment in its banking system by selling more than $20 billion worth of strategic stakes to foreign bankers, securities firms, and institutional investors. Further, institutional investors have bought $30 billion worth of stakes in four of China's five largest banks through public listings in Hong Kong. The higher disclosure requirements of listing in Hong Kong and the presence of foreign investors will likely increase market pressure for the banks to improve their risk management capabilities and corporate governance systems.

China has expanded the availability of financial instruments for managing and hedging foreign exchange and other financial risk. The foreign currency market maker system introduced in January allows for deeper spot market trading and increased transactions between banks. In March, the Chicago Mercantile Exchange (CME) announced its plan to allow Chinese financial institutions to electronically trade CME foreign exchange and interest rate products through the China Foreign Exchange Trading System platform[27], pending regulatory approval by the CFTC. In August, the CME also began selling RMB futures contracts on its U.S. platform. In April 2006, 54 foreign and domestic banks operating in China were authorized to trade foreign exchange swaps. In September, the China Financial Futures Exchange was established in Shanghai, which will start by launching mainland stock futures. However, foreign currency hedging opportunities were restricted when the authorities banned onshore banks from trading in offshore non-deliverable forwards.

The Department of the Treasury engages intensively with Chinese economic policy makers on economic issues of both bilateral and global importance. China' exchange rate policy, its effect on Chinese domestic and external imbalances, and China's financial sector are particular focal points of that engagement. Recognizing that resolving imbalances in China requires reform across many economic sectors, Treasury convenes the Joint Economic Commission with the Chinese government as well as a Financial Sector Working Group to promote mutual understanding and guidance.

Additionally, Secretary Paulson was appointed by President Bush to be the U.S. co-chair of the newly formed Strategic Economic Dialogue (SED) with China's top economic leaders, a forum for addressing critical economic issues and planning for long-term cooperation. The first SED was held in Beijing on December 14 and 15. It was agreed that discussions will be conducted on development of efficient innovative service sectors and on ways to improve health care. A bilateral investment dialogue will be launched with exploratory discussions to consider the possibility of a bilateral investment agreement, enhancing cooperation on transparency issues, and launching a joint economic study on energy and environment. The two countries are committed to invigorating ongoing work within the U.S.-China Joint Commission on Commerce and Trade on high-tech trade, intellectual property rights, and market economy status/structural issues. Utilizing other existing mechanisms, both sides agreed to increase bilateral cooperation on more efficient and environmentally sustainable energy use, facilitation of personal and business travel, development assistance, and multilateral development bank lending. Finally, both sides agreed that NYSE and NASDAQ should open offices in China, that China will participate in the government steering committee of the FutureGen project, and that the United States will support China's membership in the Inter-American Development Bank. Both sides

[27]This interbank foreign exchange trading platform is a government owned, but technically independent arm of SAFE, which is controlled by the PBOC.

concluded an agreement on facilitating financing to support U.S. exports to China and agreed to re-launch bilateral air services negotiations.

China's currency policy is a core issue in the China-United States economic relationship. More flexibility in China's exchange rate will help it achieve more balanced economic growth, enhance the effectiveness of monetary policy, safeguard the health of the financial sector and promote over time an orderly reduction of external imbalances.

Taiwan

Taiwan has experienced sluggish domestic demand growth and low or negative inflation rates since a sharp decline in fixed investment spending led to recession in 2001. Strong export growth has allowed Taiwan to achieve annual real GDP growth rates between 3-6 percent since the recession ended, but at the cost of increased dependence on external demand.

That pattern persisted in the first half of this year, as slowing exports and continued weak domestic demand brought a sharp deceleration in economic growth, from 7.8 percent (saar) in the second half of 2005 to just 1.5 percent in the first half of 2006. Net exports, which accounted for more than half of all growth since the 2001 recession ended, contributed just 0.3 percentage points in the first half of this year. Inflation remained very low, and negative by some measures, during the January-June reporting period. Consumer prices excluding food and energy rose 0.3 percent year-on-year in June and 0.2 percent through September (according to the most recent available data), while the GDP deflator declined 1.2 percent year-on-year in the second quarter.

Taiwan's current account surplus narrowed slightly to $10.3 billion (5.8 percent of GDP) in the first half of 2006, down from $10.7 billion (6.2 percent of GDP) in the second half of 2005, as a declining trade surplus outweighed growth in the income surplus and a declining services deficit. Net financial outflows from Taiwan totaled $11.9 billion during the first half of 2006, up from a $9.4 billion net financial outflow during the second half of 2005. The main component of net financial outflows during the first half of 2006 was $14.0 billion in net portfolio outflows, as Taiwanese residents increased their purchases of foreign assets and foreign portfolio inflows slowed.

Recent net financial outflows have roughly offset Taiwan's current account surplus, reducing pressure on Taiwan's managed floating exchange rate regime. As a result, net accumulation of foreign exchange reserves, which averaged nearly $29 billion a year from 2001 to 2005 and totaled $19 billion the first half of 2005, slowed to $1.1 billion in the second half of 2005 and $2.7 billion in the first half of 2006. Taiwan's reserves totaled $260.4 billion in June 2006, rising to $261.6 billion in September.

The Taiwan dollar (NT$) remained within the 31-35/US$ trading range in which it has fluctuated for the past five years. After ending 2005 at 33.29/US$, the NT$ appreciated 2.6 percent to 32.44/US$ at end-June, but has since depreciated by 2.3 percent to 33.22/US$ as of October 30, 2006.

Malaysia

Malaysia has begun to edge toward a more flexible exchange rate regime, allowing a modest appreciation of the ringgit against the dollar this year and permitting increased volatility in day-to-day currency movements, after abandoning its fixed U.S. dollar peg in July 2005. However, Malaysia's large and growing current account surplus still suggests that macroeconomic imbalances in the economy need to be addressed.

Malaysia, a net oil exporter, has had current account surpluses in excess of eight percent of GDP since the late 1990s, even before the run-up in oil prices began. Higher oil prices helped push the surplus up to $20.0 billion, or 15.2 percent of GDP, in 2005, and to an annualized $21.0 billion, or 14.4 percent of GDP in the first half of 2006. Malaysia's non-oil current account surplus has been growing, at least through last year. The current account surplus excluding mineral fuel exports came to 1.8 percent of GDP for the first three quarters of 2005 (according to the most recent available data), up from 0.4 percent of GDP in 2004.

The swing in Malaysia's current account surplus from large deficits in the mid-1990s to large surpluses since 1998 reflects a dramatic decline in private investment since the 1997-98 Asia crisis. Private sector fixed investment fell from more than 31 percent of GDP in 1996-97, to 7.6 percent of GDP by 2003 and has only recently begun to recover, to 8.8 percent of GDP in 2005. The reasons for the sustained weakness in Malaysian private investment, which fell more sharply and rebounded more weakly than in other crisis-hit Asian countries, are not well understood. As explanations for the sluggish recovery of private investment, some analysts cite weak Malaysian corporate sector profitability, due in part to excess investment during the pre-crisis period, and financial market imperfections that limit external financing for smaller firms. Those factors may be fading in importance, as Malaysian investment spending has shown signs of recovery over the past 2½ years.

Malaysia has recorded solid economic growth and low-to-moderate inflation over the past several years despite weak investment spending. Real GDP grew 5.2 percent in 2005, led by consumption and external demand. Growth accelerated to 6.8 percent (saar) in the first half of 2006, on stronger public and private fixed investment. (Malaysia's quarterly national accounts data do not break out public and private investment.) Higher fuel, transport and food prices pushed overall consumer price inflation steadily higher over the course of 2005 and into 2006. CPI inflation peaked in March 2006 at 4.8 percent y/y, its highest level since 1998, before subsiding to 3.3 percent y/y in August.

After abandoning its fixed exchange rate of 3.8/$ in July 2005 and revaluing to 3.75/$, the ringgit gradually weakened over the remainder of 2005 and ended the year at 3.779/$, a net appreciation of only 0.6 percent. The ringgit moved over a wider range in the first half of 2006, appreciating 5.7 percent to 3.575/$ by May 17. The general sell-off of emerging market assets in May and June led the ringgit to weaken to 3.639/$ at the end of June, for a gain of 2.7 percent in the first half. The ringgit had been relatively stable since the end of June until recent increases in the growth outlook pushed the ringgit up almost three percent in the first week of December. Average daily ringgit fluctuations against the dollar have also risen this year, to 0.17 percent through September compared to 0.05 percent for the second half of last year. Nevertheless, daily volatility of the ringgit remains below that of the South Korean won and well below that of such major international currencies as the euro.

Malaysian authorities' exchange rate policy has been to "lean against the wind" – intervening to strengthen the currency when it was depreciating, as in the last half of 2005, and accumulating foreign reserves when the currency was appreciating. Malaysia's authorities intervened heavily in the first half of the year in response to upward pressure on the currency. However, this policy was relaxed in early December, and the ringgit was allowed to appreciate at a faster pace at a time when there was broad appreciation of Asian currencies against the dollar. Foreign exchange reserves, which had declined by nearly $10 billion in the fourth quarter as the central bank intervened to offset large capital outflows and to limit ringgit depreciation, rose by more than $8 billion in the first half of 2006, to $78.7 billion (60 percent of 2005 GDP) at the end of June. Attempts to contain upward pressure on the currency may have constrained the central bank's monetary policy. The central bank did raise overnight interest rates modestly from 2.7 percent to 3.5 percent in three steps starting in December.

Malaysia has gradually relaxed most of the controls on capital flows imposed when the ringgit was pegged in 1998. Remaining controls include: offshore trading of the ringgit remains prohibited; limits on foreign portfolio investment by residents are still in place; and restrictions on local or foreign currency-denominated credit extended from residents to non-residents or vice versa.

Statement of Richard L. Trumka
Secretary-Treasurer
American Federation of Labor and Congress of Industrial Organizations

Before the Senate Committee on Banking, Housing, and Urban Affairs

"The Treasury Department's Report to Congress on International Economic and Exchange Rate Policy and the U.S.-China Strategic Economic Dialogue"

January 31, 2007

Mr. Chairman, Members of the Committee, I'm delighted to have the opportunity to testify today on exchange rate policy and strategic economic dialogue with China on behalf of the ten million working men and women of the AFL-CIO and the ten unions of the Industrial Union Council.

As you know, these issues go right to the heart of the economic challenges facing America's working families and our middle class, and we in the labor movement feel a certain amount of urgency to develop and implement concrete solutions sooner rather than later. We are working closely with allies in the domestic manufacturing sector, as well as with many American farmers and ranchers, to draw attention to the job, wage, and community impacts of currency misalignments and to urge effective solutions.

Unfortunately, it often appears that this Administration does not share our sense of urgency. We hope that Congress will step into the void left by the Administration's failure to act, and we welcome this hearing as a crucial first step in that direction.

In December, the Treasury Department issued its 2006 Report to Congress on International Economic and Exchange Rate Policy (IEERP). The Report finds that "no major trading partner of the United States met the technical requirements for designation [as a currency manipulator] under the terms of Section 3004 of the [Omnibus Trade and Competitiveness] Act [of 1988] during the period under consideration."

The relevant portion of the 1988 Act states that: "The Secretary of the Treasury shall analyze on an annual basis the exchange rate policies of foreign countries, in consultation with the International Monetary Fund, and consider whether countries manipulate the rate of exchange between their currency and the United States dollar for purposes of preventing effective balance of payments adjustments or gaining unfair competitive advantage in international trade."

The 2006 IEERP report finds that China's current account surplus rose to "around 8 percent of GDP" in the first half of 2006, up more than fivefold from 2001. It also notes that China's foreign exchange reserves "reached $1 trillion in October," adding around $200 billion in reserves just in the last twelve months. The U.S. trade deficit with China will reach about $230 billion in 2006, up about 15 percent since last year, and the Economic Policy Institute has estimated that the growing bilateral deficit with China has displaced more than one and a half million jobs since 1989.

Now, either there is something wrong with the criteria Treasury is using to determine currency manipulation, or there is something wrong with the Treasury Department's math.

In a recent Policy Memorandum, economists Josh Bivens and Rob Scott of the Economic Policy Institute laid out three clear criteria for determining whether or not a country is manipulating its currency: "First, does it have a high and rising bilateral trade surplus with the United States? Second, is its *global* current account surplus (the broadest measure of its trade and income flows) high and rising? Third, does it possess a high and rising accumulation of international reserves?" [1]

Table 1 below (reprinted from EPI) compares China's current position to nine past instances when the Treasury Department found that nations were manipulating the value of their currency vis-à-vis the dollar for competitive gain. "On each front," write Bivens and Scott, "the current position of China well exceeds the previous threshold that led to a finding of manipulation."

Table 1. Currency manipulation found nine times in the past

		Trade surplus w/U.S. annual rate (US$ billions)	GDP	Trade surplus w/U.S. annual rate (% of GDP)	Global Current Account most recent year (US$ billions)	(% GDP)	Accumulation of reserves 12-month change (US$ Billions)	Total reserves (Months of imports)
Taiwan	Oct-88	17.4	97.8	17.8%	18.1	18.5%	31	28.0
	Apr-89	13.9	122.9	11.3%	10.2	8.3%	-	-
	May-92	9.8	179.1	5.5%	12.0	6.7%	14	17.0
	Dec-92	10.5	179.1	5.9%	12.0	6.7%	13	18.0
South Korea	Oct-88	9.4	120.5	7.8%	**10.0**	8.3%	7	-
	Apr-89	9.0	157.1	5.7%	14.3	9.1%	9	**3.0**
	Oct-89	**8.1**	169.0	4.8%	14.2	8.4%	9	-
China	May-92	12.7	369.7	3.4%	12.2	**3.3%**	14	10.0
	Dec-92	16.7	409.1	4.1%	13.5	3.3%	6	8.0
Current position of China								
China		203.8	2,259.2	9.0%	160.8	7.1%	207	12.9

Bold indicates lowest level with finding of manipulation.

Historical data source: U.S. Treasury Report to the Congress on International Economic and Exchange Rate Policy
Current data source: U.S. International Trade Commission and the International Financial Statistics Database of the International Monetary Fund.

Many respected academic experts have also weighed in on this issue. The bipartisan, Congressionally appointed U.S.-China Economic and Security Review Commission (USCC), in its 2006 report, found that China's currency manipulation "harms American

[1] L. Josh Bivens and Robert E. Scott, **"China Manipulates Its Currency—A Response is Needed."** Economic Policy Institute Policy Memorandum #116, September 25, 2006.

competitiveness and is also a factor encouraging the relocation of U.S. manufacturing overseas while discouraging investments in U.S. exporting industries." The Commission also found that the currency manipulation "distorts the trading relationship between the United States and China. ... American small and medium-size enterprises are particularly disadvantaged by having to compete for U.S. market share with Chinese exporters who enjoy the subsidy of an artificially undervalued renminbi."[2]

Ben Bernanke, Chairman of the Federal Reserve Board, in his prepared remarks to the Chinese Academy of Social Sciences, dated December 15, 2006, wrote that China's undervalued currency provides an "effective subsidy . . . for Chinese firms that focus on exporting rather than producing for the domestic market." He outlined some of the advantages for China of allowing the renminbi to appreciate, including encouraging a shift toward domestic consumption and social services, as well as improving long-term financial stability.

China's currency manipulation also impacts other trading partners, who feel pressured to keep their currencies competitive with the renminbi in order to avoid a competitive disadvantage in the U.S. market. Bivens and Scott write, "There is a cost to developing nations from the Chinese currency peg. By pursuing mercantilist exchange rate policies, China has robbed market share from smaller developing countries and forced many into managing their own exchange rates with the goal of matching China's competitive position. Many of them would prefer a more flexible currency regime but cannot allow themselves to get priced out of competitiveness in the U.S. market through China's manipulation."[3]

As the Automotive Trade Policy Council pointed out recently, Japan has also intervened aggressively and repeatedly in currency markets to gain an unfair trade advantage, spending nearly $450 billion to keep the yen undervalued since 2000. Not only did the Treasury Department fail to cite Japan as a currency manipulator during this time, but according to John Taylor's recent book, *Global Financial Warriors,* Treasury officials implicitly sanctioned the Japanese interventions. We find this extremely troubling.

I know the Treasury Secretary is no longer here, but I would like to ask Secretary Paulson and his staff exactly what it would take for Treasury to find that a country had in fact manipulated its currency, and – perhaps more important – what it would take to move beyond yet another round of endless diplomacy and strategic dialogue to concrete action and results.

This is not an academic exercise for the union members I represent. The difference between currency manipulation and a market-equilibrium exchange rate is the difference between having a job and watching your factory shut its gates. It is the difference between having health insurance for your kids – or not. And, for our country, it may be

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[2] U.S.-China Economic and Security Review Commission, "2006 Report to Congress," November 2006, pp. 6, 53. Report is available at:
http://www.uscc.gov/annual_report/2006/06_annual_report.php .

[3] L. Josh Bivens and Robert E. Scott, **"China Manipulates Its Currency—A Response is Needed."** Economic Policy Institute Policy Memorandum #116, September 25, 2006.

the difference between having a healthy middle class – or sitting back and watching as economic divisions tear us apart.

And, tearing us apart they are. The fact is domestic manufacturers and their workers are forced to compete with a currency that experts estimate is undervalued by as much as 40 percent. As one manufacturer told the U.S.-China Commission, "it's like being in a 100-yard race, except the other team gets to start at the 40-yard line." The Chinese currency regime also sets the pace for others in the region.

In June 2005, then-Secretary Snow testified to the Senate Finance Committee that "if current trends continue without substantial alteration, China's policies will likely meet the technical requirements of the statute for designation ... Concerns of competitiveness with China also constrain neighboring economies in their adoption of more flexible exchange policies. China's rigid currency regime has become highly distortionary

Given the raw economic data on trade imbalances and reserve accumulation, it certainly appears that current trends have not only "continued without substantial alteration," they have accelerated.

Therefore, we were bitterly disappointed that Treasury found no manipulation again this year, and we were underwhelmed by the announcement of the "Strategic Economic Dialogue" (SED) as a response to the "global imbalances" that the report did concede.

On paper, the SED promises a "forum for addressing critical economic issues and planning for long-term cooperation." Issues to be addressed include developing efficient innovative service sectors, health care, cooperation on transparency issues, and a joint economic study on energy and environment, among other things.

This SED offers too little, too late. The proposed forum, dialogue, and cooperation are grossly inadequate, given the magnitude of the economic problems we face with respect to China. Beyond its limitations with respect to currency manipulation, the SED does not even begin to address a separate and equally serious economic concern: the egregious and widespread repression of workers' rights in China. The breadth of the SED needs to be expanded, as does its core content.

We continue to be frustrated that this Administration fails to raise the issue of workers' rights violations with the Chinese government in any effective or high-level forum. None of the highest-level economic U.S. dialogues with the Chinese government include workers' rights as part of their public agenda (neither the Joint Commission on Commerce and Trade, nor the SED, address the issue publicly).

Violation of workers' rights is just as much an economic issue as currency manipulation, violation of intellectual property rights, or illegal subsidies. We estimate that hundreds of thousands of U.S. jobs are lost because the Chinese government brutally suppresses the rights of Chinese workers to form independent unions and bargain collectively for their fair share of the wealth they create.[4]

Promoters of permanent normal trade relations (PNTR) and China's accession to the WTO argued that unfettered trade and investment would be the best way to raise living standards and promote human rights in China.

Unfortunately, the five years since China's accession to the WTO have not borne out this prediction. Instead, increased trade and investment have coincided with continued harsh violations of workers' rights, rising worker unrest, and a "strike hard" campaign against dissent by the Chinese government. Far from "exporting American values" to China, American companies have been complicit in this abuse and have profited from it.

Legal protections for wages, benefits, and hours are routinely violated in the private sector, and shoddy enforcement of health and safety standards costs workers' lives in China's export industries.

Faced with growing worker unrest, the Chinese government continues to choose violence and repression as tools of control, and has made only cosmetic gestures towards legal reform. Reforms to China's trade union law in 2001, while ostensibly designed to protect union organizing in the growing private sector and strengthen workers' rights, maintain the single government-controlled labor organization's strict legal monopoly over all trade union activity in China.

We are baffled and frustrated at our own government's failure to protect the interests of American workers and businesses, and insist that the Chinese government honor its international obligations as a member of the International Labor Organization and the United Nations. The Congress has given the executive branch numerous tools to provide leverage in this area, including Section 301, which explicitly defines egregious violation of workers' rights as an unfair trade practice. Yet the Administration refuses to apply these tools.

Time for Action

I don't mean to sound cynical, but I'm starting to feel like Bill Murray in the movie *Groundhog Day*. Every year, I or one of my colleagues is invited to testify on these important economic issues. Every year, the trade deficit worsens, more jobs are lost, and the economic pressures on workers and the middle class continue to grow. And every year, someone from the Administration responds with pledges of increased dialogue and cooperation.

In 2004, the AFL-CIO, along with a group representing several dozen U.S. industrial, service, agricultural, and labor organizations, formed the China Currency Coalition. On September 9, 2004, the Coalition filed a Section 301 petition alleging that China's currency manipulation was an unfair trade practice under U.S. trade law.

[4] See the Section 301 petition filed by the AFL-CIO in June 2006: http://www.aflcio.org/issues/jobseconomy/globaleconomy/chinapetition.cfm .

The petition laid out China's international obligations under World Trade Organization (WTO) and International Monetary Fund (IMF) rules and documented the extent of the manipulation, as well as its impact on American workers and businesses. Finally, the petition asked the Bush Administration to "seek authorization in the WTO through expedited dispute settlement" to offset the subsidy and take measures to offset the disadvantage caused by the currency manipulation for U.S. exports to China.

The Bush Administration summarily rejected the petition within a few hours of its filing – apparently without taking the time to read the several hundred pages of analysis, documentation, statistics, and tables. (I commend the full petition to you: it can be downloaded, along with its supporting materials, at: http://www.chinacurrencycoalition.org/petition.html .)

A bipartisan group of 35 U.S. Senators and Representatives refiled the petition on April 20, 2005, only to have it rejected again.

The Bush Administration never challenged the factual findings of the petition, only claimed that dialogue and engagement with China would be more effective than accepting the petition.

Then-Treasury Secretary John Snow said in a press conference held earlier in the year: "China acknowledges [that it is best for the global system, for the United States, and for China to move to a flexible exchange regime] and is making progress toward this goal." He boasted of the "extensive" talks under way: "I have held extensive meetings and consultations with the Chinese economic team both here in Washington and in Beijing." And he touted the progress being achieved: "With steady progress clearly being made, the most effective way at this time to achieve the goal of a flexible, market-based exchange rate in China is to maintain the *persistent engagement* we have established rather than through a trade petition" (emphasis added).

Then-USTR Robert Zoellick promised strategic leverage would be used to pressure China: "America's policy of leveraged engagement gives us constructive new ways to press for real results in China.... Under U.S. law, the first two criteria that China must meet to be considered as a 'market economy' are: the extent to which the currency of China is convertible; and the extent to which wage rates in the foreign country are determined by free bargaining between labor and management.... *These statutory criteria, together with China's strong interest in being recognized as a market economy under U.S. laws, provide us with significant leverage on labor, currency, subsidy and other issues, and we plan to use it"* (emphasis added).

John B. Taylor, at the time Under Secretary for International Affairs at Treasury, quoted President Bush in a speech on October 21, 2004: "As President Bush recently said, ... "So I'm saying to places like China, you treat us the way we treat you. You open up your markets just like we open up our markets. And I say that with confidence because we can compete with anybody, any time, anywhere so long as the rules are fair."

So many promises, so few results.

The Bush administration has refused to hold the Chinese government to its international obligations on trade, currency manipulation and human rights, and has denied American businesses import relief they are entitled to under the law.

The AFL-CIO believes that the Bush Administration needs to move beyond "bilateral consultation" and continued dialogue to address the urgent problems in the U.S.-China trade and economic relationship. Certainly, the Administration needs to initiate WTO dispute resolution immediately in several areas to ensure that China meets its obligations in a timely and effective way – including currency manipulation and violation of workers' rights. The Administration should clarify without delay that countervailing duty remedies can be applied to non-market economies.

But Congress cannot wait for this Administration to act.

We urge Congress to give immediate consideration to the Fair Currency Act, which we expect to be introduced shortly (this is a newly updated version of H.R. 1498, introduced in the last Congress by Representatives Ryan and Hunter, also introduced last year in the Senate by Senator Bunning).

I would like to thank Senators Stabenow and Bunning for their leadership in addressing this important issue. This bill clarifies the definition of currency manipulation, identifies currency manipulation as an illegal subsidy, and ensures that countervailing duty laws can be applied to non-market economies. It does not apply exclusively to China, but is broadly applicable. It is a crucial first step in addressing the urgent economic problems we face today.

I thank the Committee for the invitation to appear here today, and I look forward to your questions.

Testimony of Michael Campbell

Chairman, President and Chief Executive Officer,

Arch Chemicals, Inc.

On Behalf of

The National Association of Manufacturers

Before

The Senate Committee on Banking, Housing, and Urban Affairs

"The Treasury Department's Report to Congress on International Economic

And Exchange Rate Policy (IEERP)

And the U.S.-China Strategic Economic Dialogue."

January 31, 2007

Mr. Chairman and Members of the Committee:

I appreciate the opportunity to participate in this very important hearing today. My name is Michael Campbell, and I am the CEO of Arch Chemicals, headquartered in Norwalk, CT. We are a global manufacturer of biocides, pool chemicals and other specialty chemicals. I am currently the Vice-Chairman of the National Association of Manufacturers and the Chairman of the NAM's U.S.-China Business Relations Task Force. I am also a member of ACTPN (Advisory Committee on Trade Policy and Negotiations) and the ACTPN China Task Force.

I am pleased to testify today on behalf of the National Association of Manufacturers (NAM) at this hearing regarding the Treasury Department's Report to Congress and the U.S.-China Strategic Economic Dialogue. The National Association of Manufacturers is the nation's largest industrial trade association, representing small and large manufacturers in every industrial sector and in all 50 states. We seek a vibrant, globally competitive manufacturing industry in the United States.

No other trade subject comes close to commanding the attention that China is getting from NAM companies. China is simultaneously the greatest concern of many of our import-competing members and the fastest-growing global market for large and small exporters and for many companies that operate internationally. China has emerged within a short span of two decades as a strong international competitor in a wide range of manufactured products and a key market for U.S manufactured exports.

The NAM seeks a positive and mutually-productive trading relationship with China that reflects market forces as closely as possible. China's emergence as a leading world economy has meant significant new opportunities for many NAM members, including increased exports and investment.

However, these opportunities are not fully realized by all NAM members. Some of our members see prices of Chinese products so low – sometimes even lower than the cost of the raw materials -- that it is difficult for them to see how they can compete. Others see their customers moving to China and cannot find new ones to replace them.

The NAM worked hard to support China's membership in the World Trade Organization (WTO), and we remain fully supportive of that membership. Bringing China into the WTO required it to begin following the same trade rules as the rest of the world and to open its markets more fully. It has now been over five years since China joined the WTO and it is important that China implements its obligations fully – both in the WTO and in the International Monetary Fund (IMF).

The NAM's concerns with China cover a range of issues, including protecting intellectual property rights, maintaining a currency value that reflects the strength of the Chinese economy and ending prohibited government subsidization of industry. We are also concerned that we are seeing a growing Chinese industrial policy that favors domestic producers, making it more difficult for foreign firms to participate in the Chinese economy.

CHINA'S UNDERVALUED YUAN

On the issue of China's currency, manufacturers large and small are united. We may come from different points of view but we have all agreed that the Chinese government needs to allow greater flexibility in the value of the yuan. In September 2006, the NAM Board stated:

> "The Executive Committee reaffirms the NAM's policy as being that China's currency manipulation is a serious problem and that China

> should let the renminbi appreciate significantly. This represents a consensus of the full Board and a priority objective of the NAM."

There is no question that China's undervalued currency is having a very significant effect on U.S. manufacturers. NAM took the lead in pointing out the problem this was causing in U.S. trade and global imbalances as well as in Chinese efforts to develop a robust domestic economy. This is now almost universally-recognized, including by the IMF, the World Bank, many finance ministries and most economists. Chinese leaders have recently publicly acknowledged the importance of trade surplus reduction. Both Vice Premier Wu Yi and Minster of Commerce Bo Xilai have pledged to reduce China's trade surplus in 2007. Chinese officials have acknowledged the undervalued yuan as part of the problem and have been taking small steps to address the issue. But, clearly, much more must be done regarding their currency.

How much is the yuan undervalued? Without a market for that currency, we just don't know, but estimates are generally in the 20% range, some more, some less. The best measure of the amount of upward pressure on the yuan is the value of the foreign currencies – mostly dollars – the Chinese government has to buy in order to suppress the yuan's value.

In 1994, when China devalued its currency against the U.S. dollar from 5.8 to 8.7, its global currency reserves were only $30 billion. (China held the yuan at 8.28 from1995 until July 21, 2005.) In the twelve years from 1994 to 2006, China has spent $1 trillion to keep the yuan from rising, reflected in their accumulation of foreign currency reserves.

To put that in proportion, that amount is about 40 percent of China's total annual production of goods and services – GDP. That is a tremendous distortion of trade and of China's economy.

Even with the yuan's 6.5 percent increase since July of 2005, there has been no letup in the growth of China's foreign currency reserve increases. China is continuing to accumulate foreign currency reserves at a rate of about $20 billion a month. Once that rate slows sharply, the value of the yuan will be seen as closer to clearing the market.

The NAM recognizes that China cannot move to a floating currency at the present time, but there can be significantly more appreciation and flexibility using the current mechanism. Our goal is to see the currency moving closer to what a market value would likely be, with the eventual goal of a freely-floating currency.

This is not to say that progress has not been made – it has; but more needs to be achieved. Without greater progress, action could be taken that could do serious damage not just to our bilateral relationship, but also to our own economy and the world's as well.

EFFECT OF YUAN APPRECIATION

Would a considerably stronger Chinese yuan have beneficial effects? Unmistakably yes. Yes for U.S. manufacturing; yes for global imbalances; and yes for the Chinese economy.

Our exports to China grew almost one-third last year, making China our fastest-growing large market. Last year also marked the first in a long time that China's imports from the

United States grew faster than China's imports from the world. Did the revaluation of the yuan so far play a role in this? I don't know for sure – but it certainly did not hurt. And continued yuan appreciation would certainly contribute toward maintaining or increasing the rate of growth of U.S. exports to China.

The huge U.S. trade deficit with China is continuing to grow. When final data are in for last year, it will be seen that the deficit with China was about $230 billion. But even here something may be happening, as the deficit grew 15 percent, compared with an average increase of 25 percent in recent years. Now I am not implying that this is great news, but it is the first time we have seen a slowing in the growth rate of our deficit with China. Here again, it is possible that the currency's revaluation is beginning to have some influence.

It is nonetheless true that many NAM member companies have indicated that the appreciation so far is not large enough to change matters significantly. Not infrequently, companies have told NAM staff that a 15 percent shift could change their competitive situation dramatically. Others say their problems go beyond that.

Some commentators have stated that Chinese wages are so low that no amount of currency appreciation would make a difference. They overlook the fact, however, that labor costs are only one factor in the production process. U.S. manufacturers are highly efficient, with strong labor productivity. In fact, Census Bureau production data show that production worker wages and benefits on average are only 11 percent of the cost of U.S. manufactured goods – with 89 percent of the production cost being materials, energy, overhead, marketing, distribution, profits, taxes, and the like. We do recognize that U.S. manufacturers need to work with our own government to make the U.S. manufacturing environment a competitive one. However, the idea that low Chinese labor rates trump all is not true.

The undervalued yuan is also having an effect on the currencies in the rest of Asia. A number of key Asian countries, including Japan, Korea, Thailand and Malaysia have all publicly stated their concerns about their competitiveness with China given the yuan's current value. They are all basically looking over their shoulders at the Chinese, fearing that China's controlled currency could destroy their competitiveness globally. This is also spilling over and having negative effects on negotiations in the Doha Round.

So we have now arrived at the point where everyone agrees the yuan needs to appreciate to address serious global imbalances, even the Chinese government. It is no longer a matter of if, but when – and how rapidly. This matter of timing is very important, as the U.S. government has been meeting with Chinese officials for over three years on this issue. Frustration is growing and support for free trade is waning.

THE TREASURY REPORT TO CONGRESS

Treasury's Report to Congress has a role in this process. The NAM has consistently called on the Treasury Department to cite China for currency manipulation, as discussions have seemed to bear little fruit. We were encouraged by the Treasury Report of May 2006 in which Secretary Snow stated that: "China's rigid currency regime has become highly distortionary...The current system poses a risk to China's economy, its trading partners, and global economic growth...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." Secretary Snow basically got the ball down to the one yard line and put China on notice that significant progress had to be seen in order to avert citation in the next report.

The NAM has believed the citation of China under the Treasury report should be viewed as a positive step, similar to citing countries, including China, under the "Special 301" reports the U.S. Trade Representative produces annually with regard to intellectual property rights protection. Citing a country for currency manipulation would not in itself compel a change, but would provide a strong and highly visible signal that the U.S. Government believes it is important for the currency to change.

Citation under the report is also an important signal to the International Monetary Fund, which has surveillance of international exchange rates as one of its primary functions. IMF officials have already noted that it would be incongruous for it to cite China for currency manipulation if the U.S. Treasury says to the contrary.

Failing to cite China under the currency report mandated by the Trade Act of 1988 has undermined public confidence that the U.S. government is leaving no stone unturned to move China's currency. It doesn't contribute to a sense of fairness in global trade to point out that the Chinese currency is undervalued, they must do something about it, but if they don't, we can't or won't do anything about it.

In contrast to the May report, the last Treasury Report in December 2006 was virtually silent on China. We understand fully and did not criticize the Administration for doing that. It was not possible for Secretary Paulson to start working within the new Strategic Economic Dialogue (SED) to engage China on changes to its economy and currency and then immediately return to Washington and cite them for currency manipulation. I think the Congress shared that view as well.

With regard to the next Treasury report, due in the first half of this year, it would be premature to speculate what will happen in the coming months or what the report will say. Secretary Paulson asked for time to let the efforts made at the SED to work. We will certainly be following progress on this issue and revisit it mid-year.

STRATEGIC ECONOMIC DIALOGUE

Mr. Chairman, you also asked me to comment on the Strategic Economic Dialogue (SED) and I would be happy to do so. The Strategic Economic Dialogue is an excellent idea. One of the most important aspects of the SED is working with top Chinese officials to foster the understanding that the shift from an export-led economy to a domestic-led economy must take place more rapidly, and that a more realistic currency valuation is an important part of that process.

Progress through mutual consultations is always the preferred method. It is important, however, that China not view the establishment of this dialogue as an excuse not to move more quickly on its currency.

We hope that the SED will help shift the balance from those within the Chinese government who feel that China must move slowly on its currency, to those that understand a more rapid appreciation is necessary to achieve internal domestic and international goals. It should be acknowledged that the 6.5% appreciation we have seen in the yuan is welcome movement. But China's trade surplus continues to grow globally and its export sector continues to boom. It is important that in our dialogue, U.S. officials continue to stress the need for greater movement.

In September 2006, Secretary Paulson addressed our Board of Directors and indicated that the Chinese currency issue was a top priority in his work with the Chinese government in the SED. At that same Board meeting, we considered whether or not to support legislation that would make currency manipulation subject to U.S. countervailing duty law. The majority of Board members, after discussion, decided not to support this legislation. There are those who have indicated that this lack of support indicated that the NAM has backed off from the currency issue. That is not the case.

The Board felt that the bill would not move the Chinese government nor was it likely to provide effective relief for affected companies. It is important to note, however, that the Board was unified in stating that the Chinese currency was a concern and that progress needs to occur, as indicated in my earlier quote from the Board statement.

The Board called for the creation of a board-level U.S.-China Task Force to work with the Administration and Secretary Paulson in particular on SED issues, especially currency. This task force comprises executives from companies spanning the whole spectrum of views on how to approach China's currency.

I chair this Task Force and, in early December, we met with Secretaries Paulson and Gutierrez and U.S. Trade Representative Ambassador Schwab prior to their trip to Beijing for the first SED meeting. In our extensive meeting with Secretary Paulson, we made it very clear that manufacturers wanted to see significant progress in the appreciation of the yuan or we risked actions that could do serious damage to our bilateral relationship. We came away convinced of his determination to get the job done, and an understanding of his particular approach.

The Board also stated that while time is given for this approach to work, many NAM members can make a credible case that they are being harmed seriously by unfair trading practices on the part of Chinese exporters. The Board noted that this situation is particularly serious for smaller firms that are unable to utilize costly U.S. trade remedies to obtain relief. As a result they called for an effort to find ways to make trade remedies more readily available and affordable to smaller firms.

CONCLUSION

In conclusion, I would like to point out that China is one of the most important factors in world trade and will only become more important as time goes by. We as American manufacturers must take advantage of the opportunities offered by the large, emerging market in China, as well as be adaptive and innovative to maintain our competitiveness globally.

However, confidence that our government will insist that our trading partners live up to their commitments is extremely important. No other factor can distort trade as much as currencies that are manipulated to establish artificial advantages in trade. An exchange rate reflecting market forces would shift the competitive equation so that some Chinese industries would remain extremely competitive, while others would find their artificial advantage diluted. U.S exports would also grow more rapidly, helping to bring about a more sustainable trade position.

We applaud Secretary Paulson for his efforts in the Strategic Economic Dialogue and the NAM China Task Force will continue to work with the Administration to ensure that China's currency more accurately reflects the strength of the Chinese economy and provides U.S. manufacturers an opportunity to compete on a level playing field.

We also applaud this Committee's interest in China's currency and in seeing that all major currencies are market-determined. The NAM thanks you, Mr. Chairman, for holding this important hearing, and we look forward to continuing to work closely with you, other members of the committee, and the committee's excellent staff.

The Treasury Department's Currency Report, Dialogue with China and Related Topics

Albert Keidel
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www.CarnegieEndowment.org/Keidel
Written Testimony
U.S. Senate Banking Committee Hearings
January 31, 2007

The Treasury Department's Currency Report of December 12, 2006 (the Treasury Report) presented a number of valuable findings, but a few of its findings are questionable. In short, the Treasury Report significantly understates its legitimate criticism of Germany and Japan, while it characterizes China in ways not helpful for policy making that serves America's best interests—in particular the goal of improving American international competitiveness. In reviewing its findings, I am also able to answer the questions asked of me in the invitation to testify.

I want to emphasize at the outset how important the Treasury Department's new strategic high-level dialogue with China could be for American international competitiveness. But I also want to stress that for the dialogue with China to play this role, the U.S. government must use the dialogue wisely and not allow it to be distracted by issues which are not germane to and may even be harmful to attaining medium-term and long-term gains in U.S. competitiveness.

1. The Treasury Report's understated criticism of Germany and Japan

Looking at the correct statistical indicator, which is global trade in goods and services, and ignoring oil exporters in the Middle East, I want to emphasize that as a share of the U.S. trade deficit, running many years and even decades, global trade surpluses by Germany, Japan and the rest of non-China Asia have been very large and continue to be large. In contrast, until two years ago, China's trade surplus was very small. I'll come back to China in a minute. The main point is that if we review the overall medium-term situation, our search for causes of U.S.

lopsided imbalances needs to focus more on Germany and Japan—as the Treasury report does weakly—and less on China.

At this point I want to point out an important lesson in thinking about these issues. I want to give what is in effect a user "WARNING ALERT" on trade statistics. When the U.S. Commerce Department reports each month how big the U.S. trade deficit is and says which countries make up what share of that deficit, we should ignore that part of the announcement, because it is meaningless for assessing which countries are responsible for our deficit. A country could have a surplus with the U.S. and a deficit with the whole world. The bilateral–two-way–balance with the U.S. says nothing by itself about how much a country contributes to our deficit.

This is especially true of China, which processes and re-packages large volumes of goods from other countries for final shipment to America. Interestingly, this lesson also cuts the other way. The United States has bilateral trade surpluses with both the Netherlands and with Singapore, so we might be tempted to say these two countries do not contribute to America's trade deficit. Not so. Both countries have large global surpluses—Singapore especially so. It is not hard to imagine Singapore sending the bulk of its manufactured exports to China, for finishing and packaging there, before having them shipped to America from a Chinese harbor as last port of call. In this case, which country contributes more to the U.S. deficit? Clearly it is Singapore. But you cannot know this from the Commerce Department data.

In other words, America has a large deficit with the global supply chain, not with any particular country where goods happen to stop on their way. While America buys from the global supply chain, other countries sell to the global supply chain. If we look at which countries are running long-term big-time surpluses with the global supply chain, it is Germany, Japan and the rest of non-China Asia. This deserves much greater attention in the Treasury Report.

Let me point out what I think is a second important lesson in understanding these issues. I want to challenge our thinking about the U.S. trade deficit a bit. We may look on the U.S. deficit as a problem, but in fact, the U.S. trade deficit is essential for the global economy. Poor countries need markets. America wants to promote healthy growth and development in poor countries – not with foreign aid, not with subsidized loans – but through trade. Somebody has to buy poor-country products. America is playing that role in the world. Other major industrialized countries are not helping out – especially Germany and Japan. To put it a bit impolitely, Germany and Japan are slackers. Instead of running modest deficits and sharing the global development burden with America, Germany and Japan are themselves feeding off our deficit. They shouldn't need to do that. But that is what they are doing.

America needs to pressure Germany and Japan to join this essential program of development support—running global deficits to promote poor-country growth. To do this, Germany and Japan should spur their own domestic demand, especially consumption. This is in fact an important message stressed in the Treasury report. It is the first real country-specific conclusion in the Treasury report's bulleted summary, and for good reason. This is almost certainly the most important finding in the report – but the reader wouldn't really know it, because the report's treatment of this finding is muffled and understated. It is polite. I would recommend that it not be so polite. The health of the world economy is too important for us to go so easy on our friends.

People say, "But Germany and Japan have freely floating foreign exchange markets. Their currencies must be at the right levels." This misses the point. Exchange rates won't fix this problem. I have taught graduate courses on the Japanese economy and lived in Europe and researched Europe's economy, so I am familiar with their situation. Germany and Japan run

Table 1
Global Surplus in Goods and Service as Share of U.S. Trade Deficit (%)

	U.S.	Japan	Germany	China	Euro Area	Netherlands
1990	-100	33	65	14		16
1991	-100	192	-6	41		40
1992	-100	226	-7	14		35
1993	-100	140	12	-17		26
1994	-100	99	12	8		21
1995	-100	77	21	12		25
1996	-100	20	26	17		23
1997	-100	45	29	40		23
1998	-100	44	22	27	85	14
1999	-100	26	4	12	23	7
2000	-100	18	0	8	3	4
2001	-100	7	9	8	17	5
2002	-100	12	20	9	32	4
2003	-100	15	19	7	29	7
2004	-100	15	22	8	27	8
2005	-100	10	20	17	15	7
2006*	-100	7	19	20	7	8

* First half of 2006
Source: IMF, International Financial Statistics, 1990-2006 and Janurary 2007.

surpluses because they have structured their economies, and their financial systems, to save rather than consume. This is especially true with regard to the high levels of corporate savings in both economies – something the Treasury report points out very clearly. Exchange rates won't fix this. Germany and Japan need to change those structures. And America needs to strongly encourage them to do so.

It is true, Germany and Japan host our troops and military bases on their soil—but that should not be a Treasury report concern. This is what I consider the most valuable finding in Treasury's report, put in my own blunt language: From the perspective of global economic leadership and the need to correct for lopsided imbalances – Germany and Japan, as fully industrialized countries with per-capita GDP levels more than twenty times China's, are slackers and have been for a long time. This needs to change. The Treasury Report needs to say so clearly.

2. The Treasury Report's mixed and at times problematic treatment of China

The report spends considerable effort evaluating China's economy, its foreign trade, its foreign exchange reserves, and its exchange rate. The report's chronicle of China's recent reforms is useful, and the statistical presentation is accurate. However a number of unsubstantiated assertions mischaracterize China's current situation in ways that distort our understanding of the competitive challenge China presents to America.

As background, let us review China's trade surplus. And please remember, this is China's global surplus, not the Commerce Department's bilateral surplus with America—which tells us nothing. Two years ago, in 2004, China's global trade surplus was 8 percent of America's trade deficit. Only 8 percent! The Netherlands that year had the same size global surplus as China! The Netherlands' surplus was 8 percent, too. The whole European Currency Area's surplus was 27 percent of the U.S. deficit that year, and the combined global surplus of Japan and the rest of non-China Asia was an even larger share America's deficit. In contrast, China's surplus was only 8 percent. Even so, complaints at that time about China—because of the large *bilateral* surplus reported monthly by the Commerce Department—bordered on the vitriolic.

3. Misplaced emphasis: China's currency as a "core issue" in the U.S.-China relationship

If China's trade surplus was only 8 percent of the U.S. deficit just two years ago, why is China's currency a "core issue," as the Treasury Report declares it to be? The truth is, China's currency was a core issue even back when its global surplus was so small. But while the controversy surrounding China's currency has remained at a high level, for whatever reasons, trade statistics now make the controversy appear to be more justified. China's global surplus is now quite large. What has happened since 2004? For Europe and Japan, the extraordinary surge in petroleum prices temporarily made their global surpluses seem more moderate. Please see Table 1. This shift, of course, had nothing to do with their exchange rates.

For China, the critical development over the past 5 years is that China has joined the WTO – a wrenching change to its trade relations with the world and a change that has nothing to do with China's exchange rate.

As one might expect, even before China's formal accession to the WTO, foreign and domestic investors in China geared up their export production platforms to be ready to take advantage of China's pending membership. This gave exports a head start in expressing the impact of WTO accession. And then the multi-fiber agreement ended. China's exports received another boost – again in ways that had nothing to do with the exchange rate.

At the same time, China's imports responded more slowly to WTO accession. Tariffs came down dramatically, but reductions in non-tariff barriers and fluctuations in domestic demand—especially after an anti-inflation credit tightening in late 2004—have not supported import growth fast enough to keep up with exports, although imports too are growing very fast. What is more, some import-related WTO accession components came into play with a lag—for example the provision allowing foreign firms to open up to 40 independent retail branches in China only really came into play in 2005. Implementation of these provisions is further slowed by the sometimes glacial pace of China's domestic licensing process.

Consequently, China's global surplus suddenly jumped beginning in late 2004, as exports continued to expand while credit tightening caused imports to grow less quickly. In 2005, China's surplus, instead of 8 percent of the U.S. deficit, was at 17 percent, only slightly less than Germany's 20 percent. In the first half of last year, 2006, China's surplus was slightly more than Germany's level, 20 percent for China versus 19 percent for Germany.

In the short-to-medium term, this high degree of trade-flow instability, brought about by such huge adjustments to China's trade regime, is virtually unavoidable. And it is important to point out that these dramatic changes over two short years did not reflect a sudden shift in China's exchange rate. It barely changed at all. Indeed, at this preliminary stage in China's WTO adjustments, so many parameters are changing so fast that it would be foolish to insist that trade flow adjustments have been caused by exchange rates. Let me repeat that point. China's global trade surplus has grown suddenly larger – putting it on a par with Germany's – but not because its exchange rate shifted.

How can we know whether China's trade will achieve a rough balance once WTO accession forces work themselves out? We can't know now. We will just have to wait and see. Anything could happen. China's trade balance might even eventually swing into a long-term modest deficit as the Renminbi gains hard-currency status in much of Asia. What we can know is that it would be a mistake to try to correct short-term imbalances now by forcing exchange rate adjustments. The non-exchange-rate forces are too powerful and moving too fast for such a strategy to make sense.

In sum, the Treasury Report's highlighting of China's currency as a "core issue" is an unfortunate emphasis. Stressing this issue is a kind of shortcoming in the report. In its headline summary bullets, the Treasury Report asserts that the "cautious pace" of exchange rate reform in China "impedes adjustment of international balances." Analysis supporting this assertion is lacking. The report doesn't say by how much China's behavior impedes such adjustment, but it cannot be very much. We have already seen how global imbalances have many explanations—more reliably, the global balances of Germany and Japan are good explanations. And we have also noticed that some degree of global trade imbalance – in the form of an industrialized-country deficit – is desirable. We have also seen that exchange rates are not likely to be effective in countering the short-term swings in China's trade—or longer-term swings for Germany and Japan, for that matter. So for the Treasury Report to finger China's exchange rate as a significant factor in causing undesirable global imbalances is not warranted by analysis and unnecessarily supports popular jingoist thinking on the subject.

4. Domestic demand is too strong for China's growth to be export-led

In another of its headline summary bullets, the Treasury Report states that China has "a growing dependency on exports to drive its economic growth." This kind of statement fuels the misleading thought that China's growth is export-led and that alleged instruments of its export success, like its exchange rate, must be crucial to its whole growth record. China's GDP data and the Treasury Report's own appendix indicate this is not true.

To begin with, parsing the Treasury Report's clever wording, it is useful to point out that just because something is "growing" doesn't mean that it is large or significant. It is true that in 2005, when you look at expenditure accounts for China's GDP, the contribution of net exports to GDP growth increased. But so did the contribution to growth of domestic demand—indeed, domestic demand accounted for much more of China's growth than the increase in net exports.

This point is acknowledged in the Treasury Report's own appendix—far from the summary headline bullets. In reviewing indicators for ranking countries by the impact of their exchange rate regimes, the Annex concludes that "although the contribution of China's external sector to growth is positive, growth in domestic demand is so strong that contribution of the external sector to growth appears to be modest." This is a good statement. But it is buried in an appendix. The report's headline bullet gives the wrong impression.

Indeed, the notion that China's remarkable GDP growth record depends on exports – and on exports to the United States at that – is widespread. But a quick look at recent history dispels this notion. In the latter 1990s, when the U.S. economy was booming because of hi-tech expansion, China's economy was in a growth slump caused by domestic policy developments. Conversely, as the United States went into recession in 2002—causing serious trouble for many Asian economies—China's economy had already come out of its growth slump and had accelerated GDP growth past 9 percent, on its way to 10-percent growth. Unlike other Asian economies, China didn't follow the ups and downs of U.S. demand – quite the reverse. China's growth is not export-led. The Treasury Report should make this point more forcefully.

5. The Treasury Report continues the word games involving currency "flexibility"

As in earlier similar Treasury Reports, the word "flexibility" plays a central role. There is a reason for this. Very few good economists are comfortable in declaring that a currency like China's is undervalued or overvalued. It is difficult to make a reliable calculation on this point—as one of the methodological appendixes to this Treasury Report makes clear. This is especially so in a case like China's, where so-called "market forces" don't give an accurate indication of which way the currency's "equilibrium" value should be. The glaring non-market characteristic of China's exchange rate is that it operates in an environment where short-term capital flows are heavily regulated. There is no real way to tell which way China's currency would go if capital account restrictions were lifted at the same time that the currency was allowed to float freely. There is a good possibility that the currency would depreciate rather than go up in value.

While good economists are hesitant to declare where an equilibrium currency value might be with regard to trade, when it comes to capital controls and domestic money supply, economists pretty much all agree that you need exchange-rate flexibility if you want to have both an open short-term capital account and domestic independence in setting monetary policy. So, while responsible economists shy from the word "revalue" for China, they are happy to call for "flexibility." Economists know that this only refers to arcane capital-account and monetary policy issues, but most of the world thinks it means appreciation. It doesn't.

But even the capital-account validity of the "flexibility" mantra falls apart in China's case. Take for example the Treasury Report's headline bullet asserting that "China's economy ... needs a flexible exchange rate regime." The report develops this theme again in another summary headline bullet when it says "China's cautious approach to exchange rate reform continues to exacerbate distortions in the domestic economy." What this is getting at is the notion that if a country tries to keep its exchange rate fixed—or nearly fixed—then capital inflows could threaten to increase the money supply to dangerously inflationary levels, requiring extraordinary and increasingly expensive efforts by the central bank to moderate the size of the domestic money supply. But in China's case, there is a hitch. China has fairly effective regulation of capital flows. Theory and practice both indicate that if a country can control short-term capital flows adequately, then it can keep its fixed exchange rate and still manage domestic monetary policy independently. China doesn't really need currency flexibility unless it opens up to freely flowing short-term capital, something nobody—not the IMF, not the World Bank, not the U.S. Treasury—is recommending that China do.

China agrees that—at some point in the future—it will need currency flexibility, which means the ability to shift up and down. But this will only be necessary once China has succeeded in developing its financial sector well enough to open short-term capital flows. But since it knows it cannot open its capital account now without risking a crisis like the 1997 Asian financial crisis, it knows it doesn't need to have a truly flexible exchange rate yet. It is true that

China's regulation of short-term capital flows isn't perfect. There is "leakage" of capital in or out. But China regulates its capital flows well enough so that exchange-rate flexibility is still a requirement only for the distant future.

The Treasury Department is well aware of all these relationships, and yet it continues to slip in this slippery word "flexibility" in ways that leave it caked in ambiguity. This greatly reduces the Treasury Report's transparency and usefulness.

6. China's foreign exchange build-up should not be a concern

It is worth mentioning that the Treasury Report thankfully does not point to China's seemingly large stock of foreign reserves as a problem. This is an important lesson – China's mounting foreign exchange reserves are not evidence of exchange-rate manipulation. Just in a factual sense, an appendix to the Treasury Report points out that one useful indicator of necessary reserve size is in relation to domestic money supply, especially if a country is considering opening its short-term capital account at some point. By this measure, a Treasury Report appendix table shows that China's ratio of reserves to money supply is quite reasonable and much lower than the ratio listed for many other economies in the table.

But it is also important to point out that there is a speculation game going on here—and the U.S. Congress may be an unwitting participant. When foreign, including American, speculators hear U.S. government criticism of China's reserve levels, they are encouraged to think America will force China to revalue—so they speculate more. And China's reserves go up as a result. And then there is more criticism, and then more speculative flows, and then higher reserves, and so on. This all could have a bad ending for the speculators, but it is not a sign of exchange-rate misalignment.

7. The Treasury Report finds that no country deserves designation as a currency manipulator

This is the last of the report's headline bullets, and while I don't have the knowledge to verify that this is true for other countries, I can say that I am satisfied that this is the correct conclusion to draw with respect to China.

8. The U.S. exchange rate policy is good for the U.S. economy

Interestingly, repetition of the maxim that a strong dollar is good for the United States, by always saying the same thing, ends up not saying very much at all and, importantly, ends up minimizing instability in currency markets. In this sense, a "strong dollar" policy is no policy at all. The United States has not intervened in currency markets in a long time. This is a good policy for the U.S. economy, because major currency adjustments around the world are rendered as smooth as possible. Needed adjustments occur, and some of them are large, but accompanying speculative instability is minimized.

But what do sticky structural global trade surpluses in Europe, Japan and other parts of Asia mean for the American economy? They are not really caused by exchange rates. With some variations now and again, they reflect changes in global competitiveness and demands on America to improve its competitiveness. For example, American manufacturing, faced with competition from poorer, lower-wage, economies, has and is adjusting by increasing labor productivity. This generally means layoffs. It is my understanding that U.S. manufacturing output has not declined along with the decline in manufacturing employment, and, indeed, may not have declined at all. Foreign competition at prevailing and evolving exchange rates pushes American manufacturing to reform and raise productivity in ways that offer higher incomes to those who are still left as employees after the layoffs.

The same is true of America's industrial base. Should the United States manufacture domestically every major industrial product? Production of mature, well-known products using mature well-known methods may not be viable any more in the United States. If one or another sector in America's industrial base is considered vital to national security, the right way to support it is through special subsidies or tax benefits, not by trying to shift or control relevant exchange rates. Applying such a blunt policy instrument will do more harm than good.

All these changes imply a shifting labor force structure. The challenge is to use other non-exchange-rate and non-trade regime means to facilitate labor mobility and to ensure that all jobs receive a decent wage with adequate benefits. The notion that a higher minimum wage will cost the economy jobs does not, in my understanding, hold up to scrutiny. If a particular production process or service cannot survive if it is pushed to compensate adequately, then it probably shouldn't survive. America cannot sustain so-called competitive industries and products by keeping its labor force working for sub-standard pay and benefits. China's commercial emergence highlights this truth. Does America really want to keep workers in jobs where they have to suffer a standard of living kept low by wage levels in an international competitor's labor force? No.

9. China is a legitimate competitor, so we need to look to our own domestic competitiveness

My most important point for this committee is that China is a legitimate commercial competitor. Its success does not rely on currency manipulation. And China will continue to be a legitimate commercial competitor. America's strategy has to be to focus here at home and strengthen our own fundamental competitiveness – education, labor force mobility, pension mobility, health care, and safe cities as attractive places to work so we can compete in the global market for technical and managerial talent. Visa reform would help.

Instead, if we pretend that our problems are because of China's exchange rate, or China's banking system, or China's low wages, that is like sticking our heads in the sand. Let's not turn Treasury's new china dialogue into that kind of exercise.

10. The Treasury China dialogue is a good chance to enhance our competitiveness

Treasury's China dialogue is a chance to move away from entrenched misperceptions of our competitive challenge. Instead of blaming imaginary external causes for our competitive difficulties, we need to look to ourselves and the domestic roots of our competitiveness. Treasury's new China dialogue is a terrific opportunity that has taken many years to get started. Let's not waste it on dead-end feel-good distractions like exchange-rates.

I'll give three quick examples of alternative ways that Treasury's new China dialogue could contribute to longer-term competitiveness. There are many others.

First, America has a huge competitive advantage in selling healthcare services and technology, but China's healthcare system is seriously in need of reform if it is to become the really large market it can be. This Treasury-led dialogue can find ways to help China develop its healthcare system and that potential market for American goods and services. The Treasury Report already mentions that this kind of collaboration is on their agenda.

Second, China's rural economic difficulties and growing domestic inequality have a lot to do with China's resistance to importing staple foods – instead it pressures farmers to plant grain, which not only wastes precious water but also keeps farm incomes and consumption low. Higher rural consumption could be a large factor in helping China to shift its GDP growth intensity away from high investment rates to more balanced domestic demand patterns. We need to work to allay Chinese fears that the U.S. will use food supplies as a strategic weapon and encourage Chinese purchases not just of grain but of the whole food logistical system – storage and transport – they will need. America is extremely competitive in these technologies. This is an area where a slow build-up of trust and communication could make a difference.

Finally, on intellectual property rights – the wrong approach is to say China is just unwilling to protect American property rights and then to try to use sanctions to get what we want. The real situation is that China, like so many lower-income countries, has serious IPR problems of its own—including domestic rip-offs of food and baby products that kill people. This dialogue can help strengthen U.S.-China collaboration to find ways to improve China's whole domestic IPR protection system – possibly along the lines of U.S. Chamber of Commerce programs in a number of Chinese provinces.

China's challenge is an honest one – to meet it we need to look at needed change here at home at the same time that we capitalize on this new dialogue to strengthen opportunities in China.

THE CHINESE EXCHANGE RATE AND THE U.S. ECONOMY

Statement by
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Before the Hearing on
THE TREASURY DEPARTMENT'S REPORT TO CONGRESS ON INTERNATIONAL ECONOMIC AND EXCHANGE RATE POLICY AND THE STRATEGIC ECONOMIC DIALOGUE

Committee on Banking, Housing and Urban Affairs
United States Senate

January 31, 2007

The Central Role of China in the Global Imbalances

The US global merchandise trade and current account deficits rose to $850-875 billion in 2006. This amounted to about 7 per cent of our GDP, twice the previous record of the middle 1980s[2]. The deficits have risen by an annual average of $100 billion over the past four years.

China's global current account surplus soared to about $250 billion in 2006, about 9 per cent of its GDP. China has become by far the largest surplus country in the world, recently passing Japan and far ahead of all others. Its foreign exchange reserves have also passed Japan's to become the largest in the world and now exceed $1 trillion, an

[1] Dr. Bergsten has been Director of the Peterson Institute for International Economics since its creation in 1981. He was previously Assistant Secretary of the Treasury for International Affairs (1977-81) and Assistant for International Economic Affairs to the National Security Council (1969-71). The latest of his 37 books is as co-author of *China: The Balance Sheet: What the World Needs to Know Now About the Emerging Superpower,* prepared jointly by the Center for Strategic and International Studies and the Institute for International Economics and published by Public Affairs Press in March 2006.

[2] I note with pride that, based on the work of my colleague Catherine L. Mann, I predicted precisely such an outcome for 2006 in the third paragraph of my testimony before this Committee on May 1, 2002.

enormous waste of resources for a country where most of the huge population remains very poor.

China's role in the global imbalances is even greater than these numbers might suggest. A substantial increase in the value of the Chinese currency is an essential component of reducing the imbalances but China has blocked any significant rise in the RMB by intervening massively in the foreign exchange markets, buying $15-20 billion per month for several years to hold its currency down. China has recently let the RMB rise marginally against the dollar but, since it continues to link its exchange rate to the dollar and the dollar has fallen against virtually all other currencies, the average exchange rate of the RMB is weaker now than in 2001 when China's current account surplus accounted for a modest 1 percent of its GDP. The world's most competitive economy has become even more competitive through a deliberate policy of currency undervaluation.

About one quarter of all of China's economic growth in the past two years has stemmed from the continued sharp rise in its trade surplus. China is thus overtly exporting unemployment to other countries and apparently sees its currency undervaluation as an off-budget export and job subsidy that, at least to date, has avoided effective international sanction.

By keeping its own currency undervalued, China has also deterred a number of other Asian countries from letting their currencies rise very much against the dollar for fear of losing competitive position against China. Hence China's currency policy has taken much of Asia out of the international adjustment process. This is critical because

Asia accounts for about half the global surpluses that are the counterparts of the US current account deficit, has accumulated the great bulk of the increase in global reserves in recent years and is essential to the needed correction of the exchange rate of the dollar because it makes up about 40 per cent of the dollar's trade-weighted index. The most obvious Asian candidates for sizable currency appreciation in addition to China are Japan, Taiwan, Singapore and Malaysia.

The Risks for the US and World Economies

These global imbalances are unsustainable for both international financial and US domestic political reasons. On the international side, the United States must now attract about $8 billion of capital from the rest of the world every working day to finance our current account deficit and our own foreign investment outflows. Even a modest reduction of this inflow, let alone its cessation or a selloff from the $14 trillion of dollar claims on the United States now held around the world, could initiate a precipitous decline in the dollar. Especially under the present circumstances of nearly full employment and full capacity utilization in the United States, this could in turn sharply increase US inflation and interest rates, severely affecting the equity and housing markets and potentially triggering a recession. The global imbalances probably represent the single largest current threat to the continued growth and stability of the US and world economies.

The domestic political unsustainability derives from the historical reality that dollar overvaluation, and the huge and rising trade deficits that it produces, are the most accurate leading indicators of resistance to open trade policies in the United States. Such overvaluation and deficits alter the domestic politics of US trade policy, adding to the number of industries seeking relief from imports and dampening the ability of exporters to mount effective countervailing pressures. Acute trade policy pressures of this type, threatening the basic thrust of US trade policy and thus the openness of the global trading system, prompted drastic policy reversals by the Reagan Administration, to drive the dollar down by more than 30 percent via the Plaza Agreement in the middle 1980s, and by the Nixon Administration, to impose an import surcharge and take the dollar off gold to achieve a cumulative devaluation of more than 20 percent in the early 1970s.

The escalation of trade pressures against China at present, despite the strength of the US economy and the low level of unemployment, is the latest evidence of this relationship between currency values and trade policies. With deep-seated anxieties over globalization already prevalent in our body politic, and the failure of the Doha Round to maintain the momentum of trade liberalization around the world, continued failure to correct the currency misalignments could have a devastating impact on the global trading system.

The Policy Implications

It is thus essential to reduce the US and China imbalances by substantial amounts in as orderly a manner as possible. The goal of US adjustment should be to cut our global current account deficit to 3-3 ½ percent of GDP, about half its present level, at which point the ratio of US foreign debt to GDP would eventually stabilize and should be sustainable. China's goal, already accepted in principle by its political leadership but without any significant policy followup, should be to totally eliminate its global current account surplus and stop the buildup of foreign exchange reserves.

The United States should take the lead in addressing the imbalances by developing a credible program to convert its present, and especially foreseeable, budget deficits into modest surpluses like those that were achieved in 1998-2001. Such a shift, of perhaps 3-4 percent of our GDP, would reduce the excess of our domestic spending relative to domestic output and the shortfall of our domestic savings relative to domestic investment. Fiscal tightening is the only available policy instrument that will produce such adjustments. Hence I strongly recommend that the new Congress take effective and immediate steps in that direction.[3]

China needs to adopt policies to promote an opposite adjustment, reducing its uniquely high national saving rate by increasing domestic consumption. China can do so most easily through higher government spending on health care, pensions and education. Such new government programs are needed for purely internal reasons anyway because of the unrest in China that has resulted from the demise of state-owned enterprises that provided these benefits in previous times. They would reduce the precautionary motive for household saving in China and boost private as well as government demand, contributing importantly to the needed international adjustment.[4]

Large changes in exchange rates will also have to be a major component of the adjustment process. A change in China's currency policy, in both the short and longer

[3] See my testimonies on that topic to the House Budget Committee on January 23 and the Senate Budget Committee on February 1. I suggest there that the external imbalances are in fact the most likely source of a crisis that could force the United States into precipitous and thus unpalatable budget adjustments if preemptive action is not taken.
[4] See Chapter 2 of *China: The Balance Sheet* and Nicholas Lardy, "China: Toward a Consumption-Driven Growth Path," Washington: Institute for International Economics, October 2006.

runs, is in fact by far the single most important issue in US-China economic relations. The short-term success of the new Strategic Economic Dialogue will be judged largely by whether it achieves effective resolution of this problem.[5]

An increase of at least 20 percent in the average value of the RMB against all other currencies, which would imply an appreciation of about 40 percent against the dollar[6], and sizable appreciations against the dollar of other key Asian currencies, will be required to achieve an orderly correction of the global imbalances.[7] Such a change could be phased in over several years to ease the transitional impact on China.[8] It could be accomplished either by a series of step-level revaluations, like the 2.1 percent change of July 2005 against the dollar but of much larger magnitudes and with a substantial initial "down payment" of at least 10-15 percent, or by a much more rapid upward managed float of the RMB than is underway at present. An increase of 40 percent in the RMB and other Asian currencies against the dollar would reduce the US global current account deficit by about $150 billion per year.

Over the longer run, China should adopt a more flexible exchange rate that will respond primarily to market forces. These forces would clearly have pushed the RMB to much higher levels by now in the absence of China's official intervention. There is some

[5] The Strategic Economic Dialogue also has the long-term potential to foster a more constructive relationship between the two countries that will inevitably lead the world economy over the coming years and perhaps decades. It thus begins to implement the "G-2" concept proposed in my "A New Foreign Economic Policy for the United States" in C. Fred Bergsten and the Institute for International Economics, *The United States and the World Economy: Foreign Economic Policy for the Next Decade*, Washington: Institute for International Economics, 2005, pp. 53-4.

[6] See William R. Cline, *The United States as a Debtor Nation*, Washington: Institute for International Economics, 2005, especially Table 6.2 on page 242.

[7] I have studiously refrained from mentioning the very large Chinese bilateral trade surplus with the United States, which should not be a primary focus of policy because of the multilateral nature of international trade and payments. At present, however, the bilateral imbalance is a fairly accurate reflection of the global imbalances and is thus more relevant than usual.

[8] See Morris Goldstein and Nicholas Lardy, *A New Way to Deal with the Renminbi*, Financial Times, January 20, 2006.

justification, however, for China's fears that an abrupt move to a freely floating exchange rate now, particularly if accompanied by abolition of its controls on financial outflows, could trigger capital flight and jeopardize its economy in view of the fragility of its banking system. Full-scale reform of China's exchange rate system will have to await completion of the reform of its banking system, which will take at least several more years. Hence the adoption of a flexible exchange rate regime in China, which is essential to avoid re-creation of the present imbalances in the future, can be only a second stage in the resolution of the currency problem and the immediate need is for a substantial increase in the price of the RMB (especially against the dollar).[9]

A US Strategy for China's Currency

It is obvious that China is extremely reluctant to make the needed changes in its currency policy. It is equally obvious that US efforts on the issue over the past three years, whether the earlier (and recently resumed?) "quiet diplomacy" of the Administration or the threats of Congressional action or the new Strategic Economic Dialogue, have borne little fruit to date. A new US policy is clearly needed.

One cardinal requirement is for the Administration and Congress to adopt a unified, or at least consistent, position. To date, there has been something of "good cop (Administration) – "bad cop" (Congress, e.g., the threat of the Schumer-Graham legislation) bifurcation between the two branches. China has exploited these differences, essentially counting on the Administration to protect it from the Congress – a bet that, to date, has paid off.

[9] This two-step approach was initially proposed by my colleagues Morris Goldstein and Nicholas Lardy, *Two-Stage Currency Reform for China*, Financial Times, September 12, 2003.

I would therefore suggest a new five-part strategy for US policy on the currency issue.

First, it is clear that China has aggressively blocked appreciation of the RMB through its massive intervention in the currency markets and that the Treasury Department has severely jeopardized its credibility on the issue by failing to carry out the requirements of current law to label China a "currency manipulator."[10] The Treasury report of May 2005 indicated that "... if current trends continue *without substantial alteration* (italics added), China's policies will likely meet the statute's technical requirements for designation." The report of May 2006 sharply criticized China for its currency policies, clearly suggesting that there has been no "substantial alternation" in those practices, but inexplicably failed to draw the obvious conclusion of its own analysis.[11] The latest report, submitted last month, was much milder. Treasury has thus been reducing its criticism of China's currency practices even as the RMB has become increasingly undervalued and China's external surpluses have soared.

The Treasury policy needs to be changed sharply and quickly. The Administration should notify the Chinese immediately that, if China fails to make a significant "down payment" appreciation of at least 10 percent by the time of the next meeting of the Strategic Economic Dialogue in May and prior to the release of Treasury's next semi-annual report, it will be labeled a "manipulator." This would trigger an explicit US negotiation with China on the currency issue.

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[10] See Morris Goldstein, "Paulson's First Challenge," *The International Economy,* Summer 2006.

[11] Treasury and the IMF have justified their inaction on the grounds that there is insufficient evidence that China is manipulating its exchange rate with the "intent" of frustrating effective current account adjustment. This is of course ludicrous because it is highly unlikely that China (or any country) would admit such a motive and it is impossible to discern any other purpose for the policy.

Second, the Administration should notify its G-7 partners and the IMF that it plans to make such a designation, in the absence of major preventive action by China, with the goal of galvanizing a multilateral effort on the issue and reducing its confrontational bilateral character. The objective of that international effort, hopefully spearheaded by the IMF through its new "multilateral surveillance" initiative, should be a "Plaza II" or "Asian Plaza" agreement that would work out the needed appreciation of the major Asian currencies through which the impact on the individual countries involved (including China) would be tempered because they would not be moving very much vis-à-vis each other.[12] The Europeans have an especially large incentive to join the United States in such an initiative because their own currencies will rise much more sharply when the dollar experiences its next large decline if China and the other Asians continue to block their own adjustment (and perhaps to head off the incipient United States-China "G-2" implied by the Strategic Economic Dialogue).

Third, the Administration (with as many other countries as it can mobilize) should also take a new multilateral initiative on the trade side by filing a WTO case against China's currency intervention as an export subsidy. As Chairman Ben Bernanke indicated in his highly publicized speech in Beijing last month, in connection with the first Strategic Economic Dialogue, China's exchange rate intervention clearly represents an effective subsidy (to exports, as well as an import barrier) in economic terms. It should be addressed as such.[13]

[12] See William R. Cline's "The Case for a New Plaza Agreement," Washington: Institute for International Economics, December 2005.
[13] This idea is analyzed in Gary Clyde Hufbauer, Yee Wong and Ketki Sheth, *US-China Trade Disputes: Rising Tide, Rising Stakes,* Washington: Institute for International Economics, August 2006, pp. 16-26.

Fourth, if the multilateral efforts fail, the United States will have to address the China currency issue unilaterally. Treasury can pursue the most effective unilateral approach by entering the currency markets itself. It is impossible to buy RMB directly, because of its continued inconvertibility, so Treasury would have to select the best available proxies in the financial markets. The message of US policy intent would be crystal clear, however, and at a minimum there would be a further sharp increase in speculative inflows into the RMB that would make it even more difficult for the Chinese authorities to resist their inflationary consequences and thus the resultant pressures to let the exchange rate appreciate. (Other undervalued Asian currencies, notably the Japanese yen, could be purchased directly with immediate impact on their exchange rates against the dollar.)

The United States has of course conducted such currency intervention on many occasions in the past, most dramatically via the Plaza Agreement in 1985 and most recently when it bought yen to counter the excessive weakness of that currency in 1998 (when it approached 150:1). All those actions have been taken with the agreement of the counterpart currency country, however, and usually in cooperation with that country. This would be the essence of the proposed "Plaza II" or "Asian Plaza" agreement, as suggested above, and the multilateral approach would be preferable now as always and should be pursued vigorously by the Administration. Failing such agreement, however, the unilateral option is available and might have to be adopted.

Fifth, the Administration should quietly notify the Chinese that it will be unable to continue opposing responsible Congressional initiatives to address the issue. Congress should then proceed, hopefully in cooperation with the Administration, to craft legislation that would effectively sanction the Chinese (and perhaps some other Asians) for their failure to observe their international currency obligations.

Such unilateral steps by the United States, although decidedly inferior to the multilateral alternatives proposed above, could hardly be labeled as "protectionist" since they are designed to counter a massive distortion in the market (China's intervention) and indeed promote a market-oriented outcome. Nor could they be viewed as excessively intrusive in China's internal affairs, since they would be no more aggressive than current US efforts on intellectual property rights and other trade policy issues (including the filing of subsidy and other cases on such issues with the WTO). Such steps should therefore be considered seriously if China continues to refuse to contribute constructively to the needed global adjustments and if the Treasury Department continues to whitewash the Chinese policies by failing to carry out the clear intent of the law fashioned by this Committee almost two decades ago.