Statement of Al Lubrano
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and
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On Behalf of
The National Association of Manufacturers

Before
The Senate Finance Committee

"U.S.- China Economic Relationship"

June 23, 2005

Mr. Chairman and members of the Committee:

I appreciate the opportunity to participate in this very important hearing. My name is Al Lubrano, and I am president of Technical Materials Inc., a small manufacturer of engineered materials systems primarily for the electronics industries. In addition to other markets we serve, we are also part of the auto industry supply chain and sell to many of the major auto manufacturers' biggest suppliers. We are located in Lincoln, Rhode Island. I am also the Chairman of the Rhode Island Manufacturers Association which represents 200 companies in our state.

I am pleased to testify today on behalf of the National Association of Manufacturers (NAM) at this hearing regarding our trading relationship with China. The National Association of Manufacturers is the nation's largest industry trade association, representing small and large manufacturers in every industrial sector and in all 50 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 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.

As a member of the NAM's China Policy Subcommittee, I participated in the development of our 2005 China Trade Agenda, a process that included vigorous participation from both small and large NAM member companies. The fact that we developed a separate China policy is an indication of its importance to NAM members.

The entire agenda is available at www.nam.org/trade. It is a realistic agenda that seeks a trade relationship that is fully within the rules-based trading system, and is one in which market forces determine trade to the fullest degree with minimal governmental intervention – particularly by ending currency intervention, enforcing intellectual property rights, and countering subsidies.

Let me make it plain that the NAM is seeking a positive and productive trading relationship with China. China is one of most important factors in world trade and will only become more important. 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. We now need to see that China implements its obligations fully – particularly in areas such as protecting intellectual property.

China is the largest single bilateral trade factor affecting manufacturing. In 2004, we had a global trade deficit in manufactured goods of $490 billion. Two-thirds of that total is with Asia and over one-third is with China. China's exports are not only having a significant direct effect on many U.S. producers, but also are exerting downward pressure on prices at a time when domestic costs are rising. A large number of U.S. manufacturers cannot pass on their production costs because of the so-called "China price." Notwithstanding the recovery in manufacturing, a number of sectors that have borne the brunt of China's emergence as an industrial power have continued to lose revenue and jobs.

Despite the significance of this, it is incorrect to view China as the principal cause of the loss of 3 million U.S. jobs in manufacturing, as some have alleged. It certainly has been a factor in that job loss, but it is not the most significant factor. The bulk of the job loss has stemmed from the general undervaluation of many currencies against the dollar – a factor which only recently has begun to be corrected, the domestic manufacturing recession that only recently ended, and domestic cost factors that are making it more expensive to produce in America at the same time that companies lack pricing power. Above-trend productivity growth has also been a factor.

Illustrating the problem, since 1994 prices in the rest of the economy have risen 20 percent, but prices of manufactured goods as a whole have fallen steadily and now stand nearly 7 percent below their 1994 level, in part because of the "China price" problem. Cost pressures, though, have continued for U.S. producers, including those from regulatory policy, excessive litigation, a tax system that disadvantages U.S. producers globally, increasing health care costs and energy prices. The NAM estimates that these domestically imposed costs account for a 22% cost disadvantage.

The largest trade factor affecting jobs was the dramatic drop in U.S. exports from 2000-2003 due to the overvalued dollar, which began its 25% run-up in 1997, peaked in 2002 and is still about 10 percent higher than when it started its run-up. It is true that the U.S. trade deficit in manufactured goods worsened by about $90 billion during the time manufacturing lost 3 million jobs, but about 80 percent of the increase in the deficit came from the collapse in U.S. manufactured goods exports.

Imports have also been a factor. Import penetration (the import share of the U.S. market for manufactured goods) has been increasing, raising imports higher than they would have been. Since 2001, for example, total import penetration of the U.S. manufactured goods' market grew 2.2 percent. China's import penetration grew 1.6 percent during this period, three quarters of the total increase. At the same time, import penetration from the rest of Asia fell only slightly – 0.2 percent. Thus it is obvious that increased Chinese import penetration has not been offset by decreased import penetration on the part of other Asian countries.

China Trade Deficit

Last year U.S. merchandise imports from China were $197 billion , while exports to China were $35 billion, resulting in a trade deficit of $162 billion – the largest with any country in the world (See Exhibit 1). U.S. imports from China are now almost six times as large than our exports to China. Much has been said about China being our fastest growing export market, but looking at Exhibit 2, it is plain that U.S. exports to China have been on a plateau since the third quarter of 2003, and U.S. exports are losing market share in China. This is a serious problem that demands more attention than it is receiving.

Imports, however, have continued to surge, and in the first quarter of 2005 were 30 percent above the same period of a year ago. Rapidly rising imports of textiles were part of the reason, but there were also significant increases in machine tools, electric machinery and plastics. Based on first quarter numbers, we are on track to have a $220 billion trade deficit with China for 2005 – up nearly $60 billion from last year.

As Exhibit 3 shows, if the recent rates of export and import percent growth continue, the U.S. bilateral trade deficit with China would be nearly $500 billion in five years – larger than our manufactured goods trade deficit with the whole world last year. The mathematics of a deficit when imports are nearly six times as large as exports are quite compelling.

The problem is still manageable, if it is addressed now, within world trade rules, to address the factors that are pushing such a growing trade imbalance, including China's undervalued currency that confers an artificial advantage to its products and distorts trade flows. The NAM rejects protectionism. We must avoid damage to the entire global trading system because we have failed to address problems in our trading relationship with China in a positive way. We must act to see that China follows global rules – particularly those set by the World Trade Organization and the International Monetary Fund.

Effect of China on Many U.S. Companies

As I said earlier, China's emergence as a leading world economy has meant significant new opportunities for many NAM members, including increased export and investment, and these should be nurtured. Other companies, however, see prices of Chinese products so low that it is difficult for them to see how they can compete. Yet others see their customers moving to China and cannot find new ones to replace them.

I have seen this in my own company. As I said, we are a small manufacturer of engineered materials systems with about 200 employees in Lincoln, Rhode Island. As a result of fierce Chinese competition, fueled partially by the undervalued yuan and possible other unfair trade practices, I have seen many of our customers lose their business because their customers have sought refuge in one of two strategies: either simply moving production to China or forcing purchasing from lower-cost Chinese manufacturers. It is common for our customers to tell us that their customers will only pay the "Chinese price." And I am afraid we are just at the beginning of the process, with matters threatening to get much worse.

On the other hand, we are not without distinct advantages in U.S. production. Right now, my company is selling high technology precious metal plated material systems to stamping companies in China that are unable to procure the high quality product they need from a Chinese or other regional local supplier and therefore are buying from us. Our technology and innovation have kept us ahead of the curve with some of our customers, but it is not going to be enough if we don't address the problems in our trade with China.

Revaluation of the Chinese Yuan to Reflect Economic Fundamentals

No other factor can distort trade as much as currencies that are manipulated to establish artificial advantages in trade. China devalued its currency by about 30 percent in 1994 and has maintained that value for the last ten years -- despite a huge increase in production capability, productivity, quality, production range, foreign direct investment inflows, and other factors that would normally be expected to cause a currency to appreciate.

When NAM first raised this issue with regard to China more than two years ago, many didn't agree the currency was undervalued, but today the undervaluation is virtually universally recognized. Appended to my statement is an NAM staff listing of a partial compilation of officials and institutions that express this view. (Appendix I)

Economists estimate that the yuan is undervalued by as much as 40 percent. This undervaluation effectively taxes U.S. exports and subsidizes imports from China, feeding the growing bilateral trade deficit. This undervaluation exacerbates our trade deficit with China and makes U.S. goods less competitive in third country markets. Furthermore, the undervalued yuan makes foreign investment in productive capacity in China cheaper and more attractive, thus artificially distorting investment in China – including domestic Chinese investment.

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 began to hold its currency down, its global currency reserves were only $30 billion. In 10 years they have spent over $660 billion to keep the yuan from rising. Reserves grew a phenomenal $230 billion in the last twelve months – to a total accumulation of $691 billion, or an amount approaching half of China's entire annual output of goods and services (See Exhibit 4).

The $200 billion that China added to its reserves in 2004 significantly exceeded China's entire increase in GDP that year. Yet China has no choice but to continue this huge reserve buildup so long as it insists on maintaining a sharply undervalued currency.

It should be noted that, while a currency peg *per se* does not contravene International Monetary Fund (IMF) requirements, IMF Article IV proscribes "manipulation of exchange rates to gain unfair competitive advantage over other members" - and this includes "protracted large-scale intervention in one direction in the exchange market." With foreign currency reserves of $691 billion, China's action is clearly incompatible with the intent of IMF Article IV. It is also inconsistent with its obligations in the WTO to avoid frustrating trade liberalization through exchange rate action and to avoid impairment of trade benefits.

Administration Response

The NAM has been working with the Administration for two years to find the most effective way to obtain a change in China's currency practices. During this period, the Administration has gradually – but significantly -- raised the visibility of the issue. There is no question that the Administration has realized the central importance of a revaluation and more flexible structure for the yuan. As noted in the appendix, other governments concur.

Just this Monday, at a press conference with European leaders around the U.S.-EU Summit in Washington, President Bush said that they had agreed that:

> "China should work to do something with her currency so that the trade between our respective countries is fair. That's all we want. We just want there to be a level playing field. The people in Europe can compete, and the people in the United States can compete if we have fair rules and fair trade."

We agree. We are pleased at the leadership evident in the Administration's message to the Chinese government on their currency practices. The Treasury Department's semiannual report delivered to Congress in May 2005, stated that "China is now ready and should move without delay in a manner and magnitude that is sufficiently reflective of underlying market conditions." Secretary Snow's remarks and the report put China on notice that "If current trends continue without substantial alteration, China's policies will likely meet the statute's technical requirements for designation." We welcome this indication that, absent a significant move on the part of China by October, Treasury will cite them for currency manipulation in its semiannual report to Congress. This sends an important signal to the Chinese government and to American business that October is a date certain for a change in China's currency practice or Treasury will take firmer action.

In this regard, we would also like to recognize an additional important point made by Secretary Snow, one that the NAM has been making for some time: that any step taken by China in this regard must be a significant one, in Secretary Snow's words "this has to be significant, it has to be material, it has to be real, it has to be a step that gets the yuan into a close alignment with underlying market realities."

Will A Revalued Yuan Have Any Effect?

As I said earlier, Mr. Chairman, there is virtually universal agreement that the Chinese currency is undervalued, yet recently it has become popular to say that a revaluation will have no effect and may even be harmful to the United States. These arguments, however, do not match either the actual experience of U.S. industry losing business to China or economic analysis. There are six common arguments, and these are discussed in the NAM staff analysis appended to my statement. (Appendix II)

The analysis shows that a yuan revaluation, depending of course on its size, would lessen or remove China's artificial price advantage in the U.S. market, would reduce the rate of growth of U.S. imports from China by market mechanisms, and would tend to boost U.S. exports to China – while also benefiting the Chinese economy and doing no harm to U.S. capital markets.

The NAM has not been pressing for currency reform in China because we believe it is a silver bullet – there are no silver bullets. But we believe that it is an essential component of addressing our deficit with China. It would slow import growth, boost exports, and result in a trade balance that is moving to a more sustainable level. We don't need to have a trade surplus with every country. With some we have surpluses, others deficits, but our deficit with China is one that needs to be reigned in, without protectionism, bringing it into better balance, to a more sustainable level.

Mr. Chairman, we understand that any change in exchange rates is a complex process that will allow some sectors to be more competitive and remain producing in the United States while for others it will have little or no effect. We agree with Prof. Rogoff, who is also testifying on this panel, that "while having more flexible exchange rates in Asia won't turn around America's deficit overnight, they will provide a more flexible global environment for imbalances to unwind."[1]

Strengthening and Enforcement of Intellectual Property Laws

Next to the exchange rate, the most serious problem NAM members have with China is its failure to curb intellectual property theft – particularly copyright piracy and product counterfeiting. I have a personal experience with this problem. A company with whom we do business, a leader in the production of very highly technical products, whose president is a colleague of mine, told me a couple of years ago that they were urged to move a portion of their production to China by a colleague of his. He was told that he "had to be there." However, they chose not to make the move to China. When I talked with him further about this, he relayed that while his colleague's company was finishing construction on their plant in China, an identical plant was put up only one-half mile away producing his product. The comment to my colleague was, "Thank God you didn't go there." His company had been robbed blind.

[1] Rogoff, Kenneth. "America's current account: a deficit of judgment," Global Agenda, 2005.

China has become the world's epicenter of counterfeiting, costing U.S. companies billions of dollars and thousands of legitimate jobs, and threatening consumer health and safety. Because of this, our members have pressed us to do more, and the NAM, with the U.S. Chamber is currently co-secretariat of the Coalition Against Counterfeiting and Piracy (CACP).

Despite bilateral and multilateral agreements with China to protect intellectual property rights, China's record of enforcement has been inadequate and seriously flawed. China has been taking positive steps; the laws are better, and there is at least a higher degree of official attention to the enforcement of those laws at the central government level. But it is enforcement that counts and China seriously fails in that regard. It is each WTO member's obligation to provide effective protection for intellectual property.

In spite of these official efforts, it is the general view that product counterfeiting and copyright piracy is not getting better, but worse. An inability or unwillingness to protect intellectual property strikes at the core of American competitiveness. If the products of our innovation and research and development are stolen, there will be little we can do to maintain our industrial base.

As a result, the NAM, in its submission to the USTR on the Special 301 out-of-cycle review of China, recommended that the Administration designate China a Priority Foreign Country and commence development of a WTO case, ideally in conjunction with the EU, Canada, Japan and other countries whose companies are also suffering from what NAM President John Engler calls China's "grand larceny on a massive scale." We need to see the law enforced, with counterfeiters thrown in jail and the volume of counterfeiting significantly reduced.

Application of Countervailing Duty Laws to China

As President of the Rhode Island Manufacturers Association (RIMA), I hear from a number of Rhode Island companies that when they try to bid for a contract against Chinese manufacturers of the same product, the Chinese price is below their cost of raw materials. This raises concerns that China's industries may benefit from a wide array of government policies that, in effect, result in subsidies. These include: government bank lending to enterprises without creditworthiness, export-based tax incentives, and the discriminatory application of tax rates and rebates.

In Beijing in September 2003, former Commerce Secretary Evans said, "There is simply no valid economic justification for many of the loans currently being extended to unprofitable businesses in China. Non-performing loans to state-run companies are a form of government subsidy." However, since 1984, the Commerce Department has not applied the countervailing duty statutes against imports from non-market economy countries such as China.

The WTO Subsidies and Countervailing Measures (SCM) agreement allows countervailing import duties to offset such subsidies. In fact, China's WTO accession agreement specifically outlines the process for assessing subsidies in China. A good deal of time was spent by former USTR Barshefsky negotiating this language.

In developing NAM's 2005 Trade and China Agendas, what emerged as very important to many of our members, especially small companies, is the need for greater focus on trade enforcement. Many companies said that, while they supported trade liberalization and recognized the general benefits, they did not see the follow-up in enforcing agreements that were negotiated. The Commerce Department policy that does not permit the application of countervailing duties to non-market economies, an action that is entirely consistent within the WTO generally and with regard to China's WTO accession agreement specifically, is a glaring example of this lack of enforcement.

The NAM supports reversal of the Commerce Department's 1984 decision in light of the SCM Agreement and the terms of China's accession to the WTO, and supports legislation that was introduced in the House by Congressmen English and Davis (H.R.1216) and in the Senate by Senators Collins and Bayh (S.593). We hope that members of the Senate Finance Committee will look favorably on this legislation.

The report just issued by the Government Accountability Office (GAO) on this subject reinforces the need for this legislation. The GAO states in its report that it would be prudent for Congress to legislate in this area, and we agree with that.

Development of Significant Export Promotion Effort Targeting China

In looking for positive ways to alleviate our trade imbalance with China, promoting the more rapid growth of U.S. exports to China certainly should be emphasized. The NAM believes there is substantial potential for Chinese economic growth to lead to a corresponding growth in the U.S. manufacturing economy. But that potential is far from realization. Of the $560 billion of goods China imported in 2004, only 8 percent were from the United States, including agricultural products. In contrast, the European Union (EU) and Japan have been significantly more successful selling into the Chinese market.

Many manufacturers are taking advantage of China's rapid economic growth to sell more of their products there. In fact, for some member companies, China is their most important foreign market for increasing export sales or local production. However, China remains a difficult place to do business and small and medium-sized companies, even those successful in other foreign markets, often have difficulty entering the Chinese market and developing profitable business relationships.

To help U.S. manufacturers reach their export potential in China, a new and greatly expanded export promotion initiative is needed. Current U.S. Government export promotion programs offer useful assistance but are not on the scale needed to make a sufficient difference in overall export trends.

The U.S. Government and the private sector must work together to launch a more ambitious program that provides more on-the-ground assistance in China and more trade outreach to potential U.S. exporters. A complete outline of NAM recommendations for this program can be found in the 2005 NAM China Trade Agenda. Our goal should be to achieve at least one-third growth in our exports to China each year. This would triple our exports in four years and quadruple them in five.

Conclusion

Mr. Chairman, I want to reiterate that the NAM wants a healthy, vibrant trade relationship with China that provides mutual benefits. But when manufacturers are telling us they are close to laying off their entire workforce and shutting their doors because of competition from China, we have to pay attention. Protectionism must be avoided. We must not take any steps that would risk reversing the open trading system that has been such a source of growth for the United States and the rest of the world, and risk a downward cycle of global trade deterioration. We must pursue approaches relying on market mechanisms and take actions consistent with the rules-based trade system.

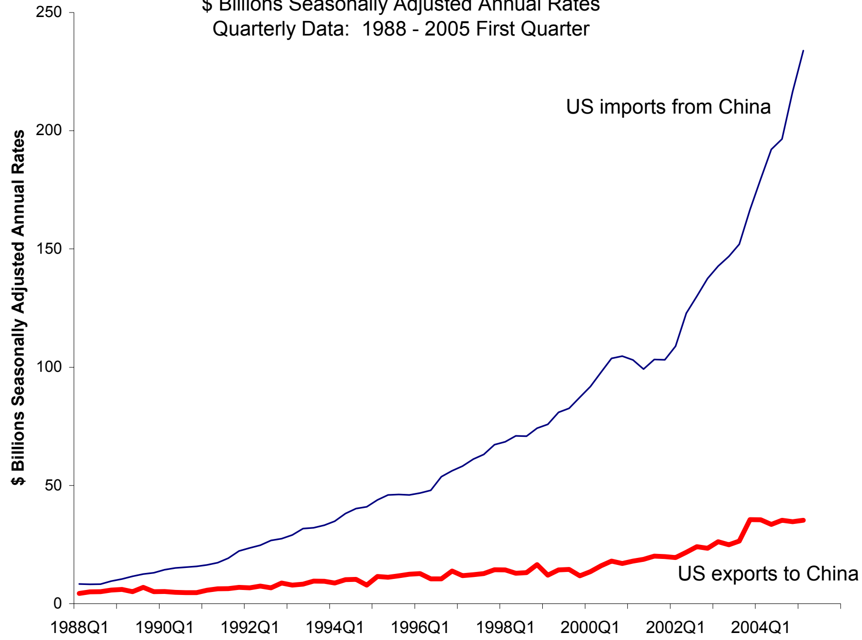
NAM member companies have a variety of views on China, but they all agree that the playing field has to be level and trade should follow market principles as closely as possible. During its three years of WTO membership, China has made progress in opening markets and adhering to international rules, but the benefits of the relationship still remain heavily one-sided in China's favor. Manufacturers continue to face an unlevel playing field that limits U.S. exports to China and gives Chinese products artificial advantage in the United States.

Many U.S. manufacturers can and will deal with the fact of China's low wages and lack of worker benefits through innovation and technology. But what is not fair and what we should not have to deal with is subsidized production or deliberate currency undervaluation and our government telling us there's nothing they can do to see that international rules are enforced.

We do not have five years or ten years to solve this problem. The issues I have outlined today are having a serious and negative effect on manufacturing in this country. We have an obligation to see that America's manufacturing base stays strong. We can do that within the rules of the international trading system. But we must not be timid in the insistence that those rules be enforced. Without enforcement when major trading partners egregiously violate these rules, many will lose faith in the efficacy of the system. We know that free trade properly administered benefits all of us. We must see to it that the consensus for free trade is maintained in this country. We look to the Administration and Congress to see to it that China plays by the rules and the system works.

Thank you, Mr. Chairman.

Exhibit 1



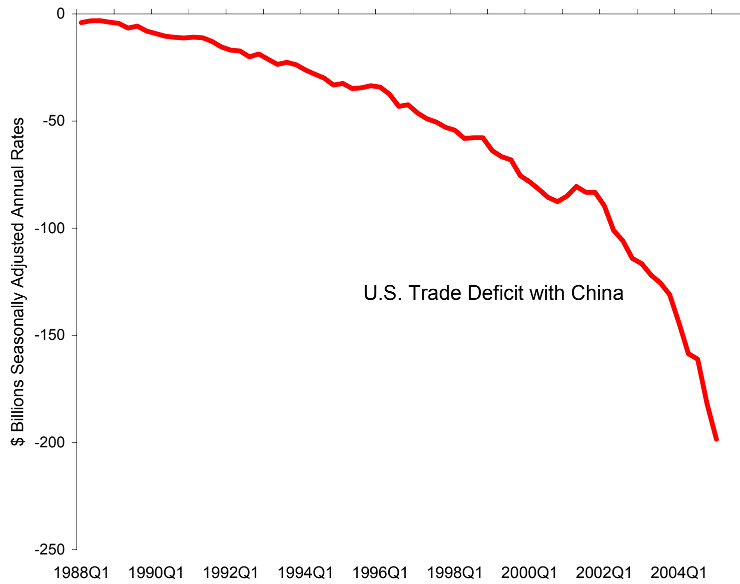
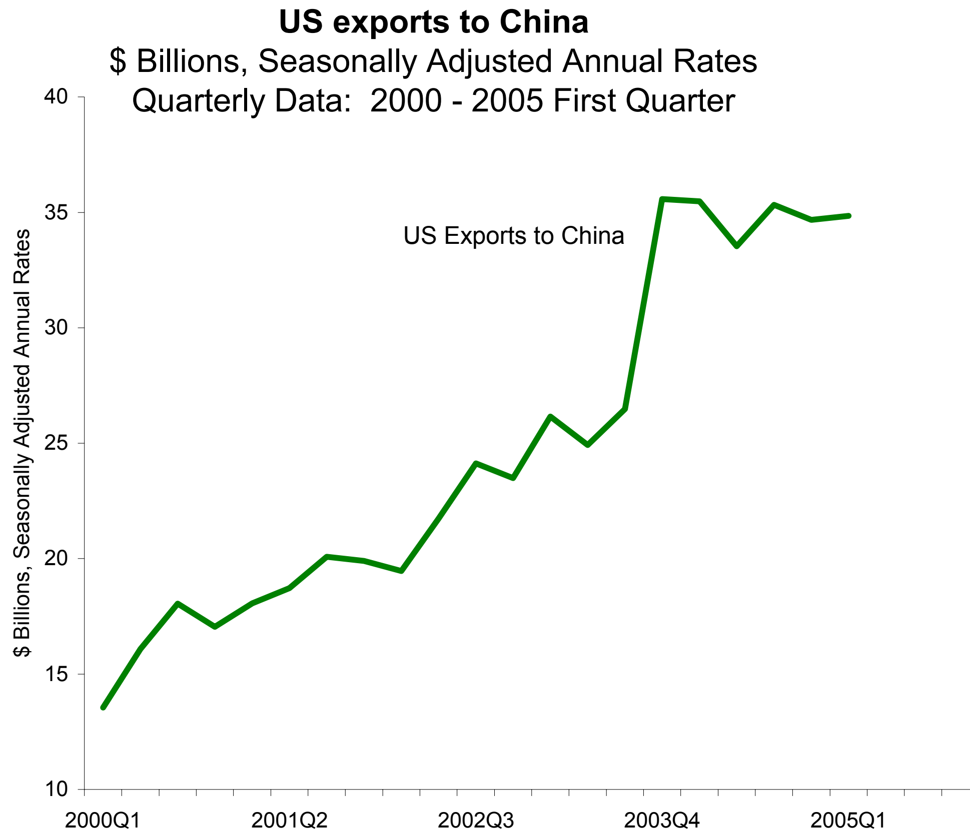


Exhibit 2



Source: Commerce Department

Exhibit 3

Alternative U.S. Trade Deficits with China in Five Years

At current rates of U.S.-China export and import growth (22% and 24% respectively) the U.S.-China trade deficit in five years would grow to $492 billion, triple the size of 2004 U.S.-China trade deficit.

2004 U.S.-China Trade Deficit: $162 Billion

Alternative U.S.-China Trade Deficit in 5 Years:

Using various export and import growth rates scenarios

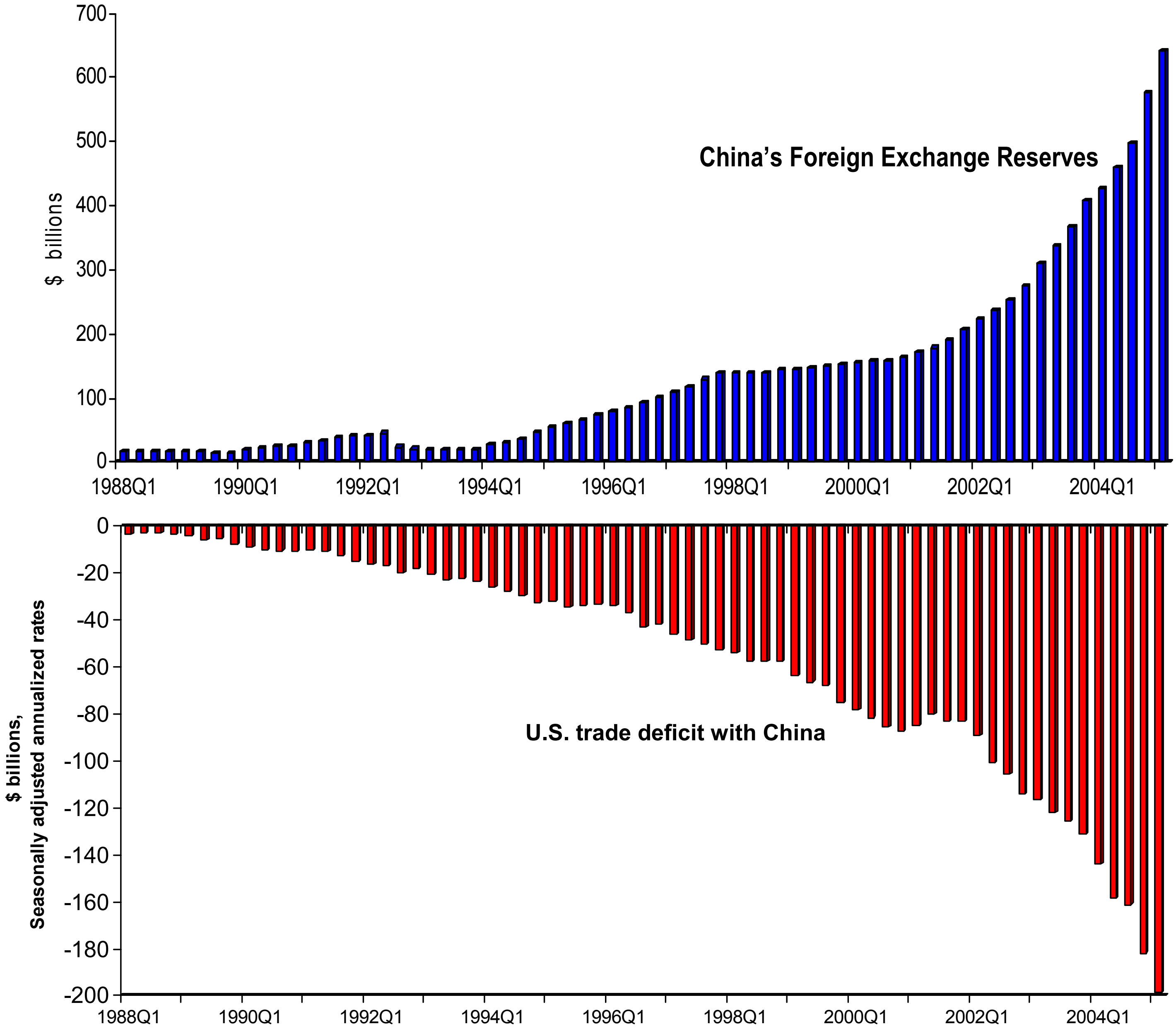
US EXPORTS TO CHINA / US IMPORTS FROM CHINA	**+22%**[1]	**+33%**	**+40%**
+24%[2]	**-$482 billion**	-$432 billion	-$390 billion
+15%	-$302 billion	-$251 billion	-$209 billion
+10%	-$223 billion	-$172 billion	-$130 billion
+7%	-$182 billion	-$131 billion	-$89 billion

Source: NAM calculations based on Commerce Department trade data
Simulations are generated from 2004 trade data
1/ 2002-2004 Average US export growth to China: 22%
2/ 2002-2004 Average US import growth from China: 24%

Exhibit 4

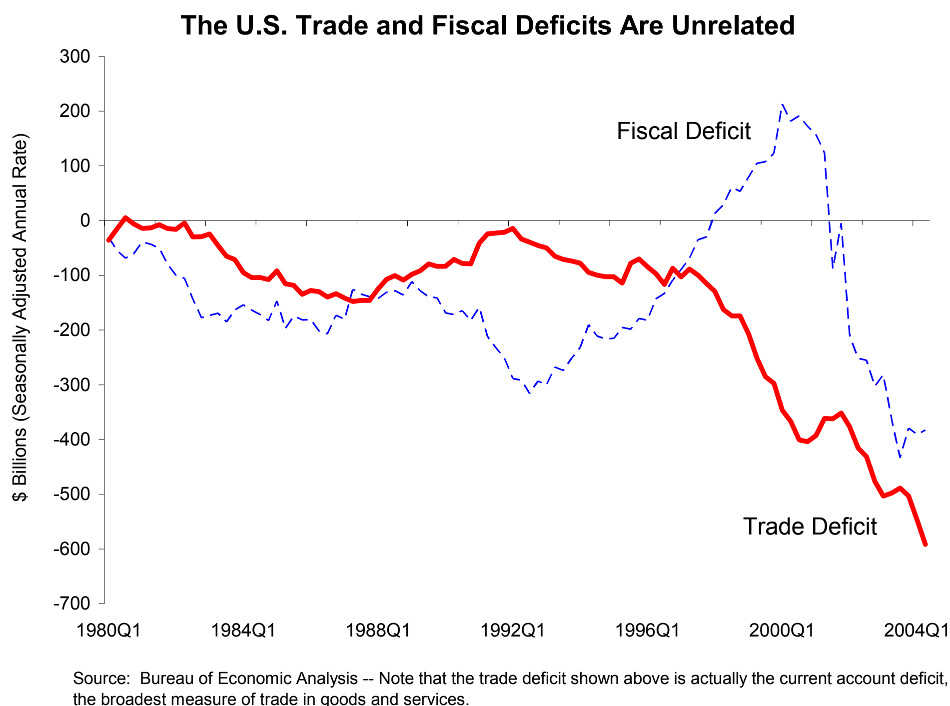
Comparison of Growth in China Foreign Exchange Reserves with U.S. Trade Deficit with China

Quarterly Data: 1988 – 2005 First Quarter



Sources: U.S. Census Bureau and International Monetary Fund

Exhibit 5



Source: Bureau of Economic Analysis -- Note that the trade deficit shown above is actually the current account deficit, the broadest measure of trade in goods and services.

It is frequently stated that the U.S. trade deficit is caused by the Federal budget deficit, the fiscal deficit. This actually is not the case, as is plainly evident the graph above. In fact, statistically, the coefficient of correlation for the trade and budget deficits is -.02, which is about as close to no relationship as possible.

Examination of the above graph shows, for example, that as the U.S. trade deficit *improved by $130 billion* between 1987 and 1992, the budget *deficit worsened $162 billion* during that time.

Moreover, the trade deficit *worsened by $306 billion* between 1992 and 2000, while during that same time, the fiscal balance *improved by $530 billion*.

APPENDIX I
Comments on Chinese Currency

U.S. Administration Officials

President Bush

- "There have been some indications that they're [Chinese government] thinking about ... an interim step toward floating the currency. We're constantly urging them, if they're going to take that step, to take it as soon as possible and eventually get to ... a currency which floats," "Obviously we're at a competitive disadvantage to the extent that their currency won't float."
  interview with CNBC, April 19, 2005

- "We've been talking to countries about currency policy to make sure that the currency policies of a government don't disadvantage America. Fair trade means currency policies are fair. .. We can compete with anybody. We just expect the rules to treat us fairly."
  Milwaukee, Wisconsin, Oct. 3, 2003

- "China should work to do something with her currency so that the trade between our respective countries is fair. That's all we want. We just want there to be a level playing field."
  WH Press Conference with EU leaders at U.S.-EU Summit, Washington D.C., June 20, 2005

Treasury Secretary John Snow

- "We feel there is a lot of mischief associated with that [China's fixed rate system] It's a way to get your currency out of alignment with underlying realities and thus confer unfair advantage on your own manufacturers and producers, to the detriment of American manufacturers and producers. The way to deal with that is to let the currency reflect those underlying market forces so nobody can be manipulating the currency."
  Edina, Minnesota, Oct. 26, 2004

- "We [the U.S. gov't] were straight with them [the Chinese gov't]. We said, this system doesn't hold together. It doesn't work. It's not right for the world economy. It's not right for the world trading system and you need to move to a flexible sort of exchange rate that allows the market to set the value rather than having you arbitrarily establish the value."
  Senate Budget Committee, Feb.13, 2004

- “Reform of the currency exchange regime in China is one of the highest priorities for our international economic policy…China has maintained an exchange rate peg for over a decade. This impairs adjustment throughout the international system…As members of the G7 have recognized, the time has now come for China to introduce flexibility into its exchange rate. The Chinese are now ready to adopt a more flexible exchange rate, they have sufficiently prepared their financial system to live in a world of greater flexibility and need to take action now.”
  House Committee on Financial Services, April 19, 2005

- "Flexibility in its (China's) currency so it gets price signals right will help it and the global economy function better,"
  Centre for European Policy Studies, June 14, 2005.

Federal Reserve Chairman Alan Greenspan

- ``Fixing the renminbi to the dollar is beginning to work to the detriment of the Chinese economy. It's very much in their interest to move."
  Senate Budget Committee on April 21, 2005

- "Allowing revaluation in some form is very much to the advantage of the Chinese.”
  June 2005

- “If the exchange rate is significantly undervalued, and indeed a reflection of that would be their (China’s) accumulation of dollar assets, the accumulation of dollar assets will expand their money supply to the point that it will create problems in monetary policy and it will be to their interest to change. ‘
  House Finance Services Committee

Federal Reserve Governor Bernanke

- “..moving toward exchange rate flexibility is in the interest of China as well as the rest of the world.”
  Cato Institute Monetary Conference, Washington, D.C. , Oct. 14, 2004

International Institutions

IMF Managing Director Rodrigo Rato

- “It is in the interest of the Chinese people and the advantage of the Chnese economy to move towards a more flexible exchange rate system…For China, this is now a good moment [to make a move].”
  Shanghai, March 15, 2005

- "If policies do not adapt, do not change to react to these imbalances, we run the risk of an abrupt correction of the markets ... [when] confidence for different reasons could evaporate or could be reduced. There is a need for Asian countries to have more flexible exchange rates."

Kenneth Rogoff, (then) Chief Economist, International Monetary Fund

- "If the euro has to bear the lion's share of the adjustment in the dollar, that is going to create a lot more difficulties than if all the Asian currencies also allow themselves to appreciate significantly against the dollar. It is bad enough that the global economy has been flying on one engine but it is going to be a lot worse if it has to land on one wheel."
  Sept. 19, 2003

From an IMF Discussion Paper, January 2005

- "The net adverse effects on the Chinese economy of any appreciation in the yuan resulting from a move towards greater flexibility would be quite modest" and "a relatively early move toward greater exchange rate flexibility would be in China's interest."

Haruhiko Kuroda, Asian Development Bank President

- "China should reform its yuan currency sooner rather than later." With Chinese trade surpluses now surging, the needed appreciation "would be larger than people thought in the past."

Mr. Kuroda also cited China's fast-rising foreign exchange reserves as evidence of the need for China to change policy.
May 10, 2005

European Central Bank Chief Economist Otmar Issing

- "The euro's advance against the dollar has gone too far. The key to this problem lies with Asia and especially in the hands of China."
  Jan. 12, 2005

G7 Communiqué, Dubai, September 20, 2003

- "… more flexibility in exchange rates is desirable for major countries or economic areas to promote smooth and widespread adjustments in the international financial system, based on market mechanisms. Effective and persuasive IMF surveillance is crucial."

<u>Chinese Officials</u>

Yu Yongding, member of Central Bank of China's monetary policy advisory board

- "Now is the time to revalue the yuan. We need more flexibility. That means revaluation."
- "Our exports are too high right now, making the economy more susceptible to external shocks."
  Davos, Jan. 28, 2005

People's Bank of China Governor Zhou Xiaochuan

- "Rigid exchange rates amid imbalances in revenues and expenditures present huge risks."
  Dec. 7, 2004

- "There is definitely pressure, but that is beneficial to our reforms and our work." (Zhou acknowledged that the intense international interest in the renminbi regime has helped concentrate the minds of Chinese policymakers, and could end up helping to speed up the pace of exchange rate reform.)
  Hainan, Apr. 23, 2005

- "A long preparation for a yuan change is not needed."
  June 7, 2005

Guo Shuqing, director of the State Administration of Foreign Exchange

- "Indiscriminate support of exports and foreign capital influx has created short-term economic problems, including excessive speculation in the property market and the economic decoupling of the fast-growing coastal areas with the rest of China "We should gradually reduce the preferential treatment to exports and seriously review our foreign investment policy."

Researcher at China's State Council's Development Center

- The Chinese yuan is "clearly undervalued."

Xu Gang

- China should revalue the yuan as it is undervalued to some extent. An appreciation will have limited negative impact on the economy.
  reported in the China Securities Journal, May 13, 2005

International Finance Ministries

French Finance Minister Thierry Breton

- The Chinese yuan is "very undervalued" against the euro; "20-30% below its true value."
  May 2, 2005

Bank of England Governor Mervyn King

- The US trade and budget deficits and the purchase of large US dollar reserves by Asian countries were combining to cause "global imbalances."
  G7 Feb. 2005

Canadian Finance Minister Ralph Goodale

- "The point has been strongly made in the past and all of the countries around the table [at the G8 meeting] remain of the same opinion. The sooner that flexibility is shown in Asia, the better."
  June 2005

Bank of Canada Senior Deputy Governor Paul Jenkins

- "A critical issue is the need for some effective depreciation of the U.S. dollar against the currencies of emerging Asia…the key element here is China's fixed exchange rate."

Bank of Canada Governor David Dodge

- "Failure to let the yuan float freely against the U.S. dollar could also cause serious damage to the world economy."
  Montreal, May 31, 2005

Japanese Vice Finance Minister for International Affairs Hiroshi Watanabe

- "It is in China's interest to make a meaningful decision quickly,"
  June 2005

German Finance Minister Hans Eichel

- "The efforts of Asian countries for more flexibility in exchange rates are still not sufficient."

German Deputy Economics Minister Bernd Pfaffenbach

- "Just about every exporter to China would gain." – referring to a revaluation of the yuan.
  June 6, 2005

APPENDIX II

NAM STAFF ANALYSIS OF ARGUMENTS THAT A YUAN REVALUATION WILL NOT AFFECT U.S. TRADE

First: A revaluation of the yuan will have no effect on U.S. trade deficit, production or jobs.

Not so. First of all, it has long been established in economics that changes in relative prices, whether from tariffs or from changes in exchange rates, have a strong determining influence on trade. Why else then do we bother expending a great deal of time and effort to negotiate away tariffs of 6 or 7 percent? The experience of the U.S. trade balance bears this out. As recently as 1997, the U.S. trade deficit was only $183 billion, or 2.2 percent of our GDP – and had been growing moderately, However, as the dollar appreciated 25 percent against other currencies in the following years, the U.S. trade deficit exploded – more than tripling. U.S. trade experienced a similar pattern in the first half of the 1980's – the previous time the dollar had become very overvalued.

Second, while it is not unusual to hear individuals say that trade deficits are the result of too little savings and too much investment in the United States, this is not actually a cause of the trade deficit. Savings minus investment, production minus consumption, and exports minus imports are three different descriptions of the same economic concept. They are identities. One does not cause another. The cause is external – such as a price maladjustment with other economies because exchange rates are not allowed to equilibrate differences in price levels.

Additionally, some say that the U.S. trade deficit is caused by the Federal Government budget deficit, so if the deficit with China were to be reduced, the deficit would simply be moved elsewhere until the budget deficit was reduced. A glance at Exhibit 5 shows this argument doesn't hold water. There is absolutely no relationship between the Federal Budget deficit and the trade deficit. For the economists reading this analysis, the coefficient of correlation is -.02, which is about as close as you can get to no relationship whatsoever.

Prices DO matter, and the NAM has heard from many companies that they can be competitive with Chinese products were there to be a 10-20% increase in Chinese prices. Granted, that will not happen across the board. Areas like many consumer electronics which have been produced little in the United States for over a decade and for which China serves largely an assembly function, will likely see little effect. But in sectors like machine tools, hand tools, mold making, plastics, machine tools, furniture, fabricated metal products, and other sectors where we are hearing a lot from our member companies, there will be real benefit when prices reflect market based currencies.

Those who say that there is no way to compete against Chinese wages have to remember that wages are a relatively small factor in the overall price of U.S. manufactured goods. Census Bureau data show that for all U.S. manufacturing, direct wages and benefits average only 11 percent of the cost of the final product. When Chinese prices are half or less of U.S. prices, factors other than wages are at work – such as an undervalued exchange rate.

Second: Production will only move to other low cost producers.

Not so. Another argument is that Chinese imports substituted for imports from other countries, not U.S. production, and if Chinese prices rose then other countries would once again begin supplying these products and U.S. producers would see no gain. This argument has considerable merit for electronic products – which used to be imported from Japan and other Asian countries and are now largely imported from China. However, it has no merit for the broad range of products made by NAM members who tell us that they are being displaced by Chinese products in industries such as fabricated metals, plastics, tools, and others. These products were previously made in the United States, not other Asian nations – and it is likely that some or much of their production would return to the United States if the price relationship with China were to change as a result of China's currency moving up in value, or at least that further loss of production would be slowed or halted.

Since 2001, for example, total import penetration of the U.S. manufactured goods' market grew 2.2 percent. China's import penetration grew 1.6 percent during this period, three quarters of the total increase. At the same time, import penetration from the rest of Asia fell only slightly – 0.2 percent. Thus it is obvious that increased Chinese import penetration has not been offset by decreased import penetration on the part of other Asian countries.

Additionally, it is important to note that to the extent there would be production shifts from China to other Asian nations, U.S. exports and the U.S. trade balance would be likely to benefit. The U.S. share of China's imports is considerably smaller than the U.S. share of the import markets of other Asian or Latin American markets. For example, for every dollar of goods Malaysia sells to the United States, it buys two-thirds more from us than does China. If a Central American nation sells something to the United States, it is likely to spend more than 40 cents of every dollar in the United States, whereas China at best would spend 8 cents in the United States. The locational origin of what we buy can have a significant effect on how much we sell.

Another factor not considered in this argument is that other Asian nations have also been suppressing their currencies so as not to have their products too expensive relative to Chinese products. With a Chinese revaluation, these other nations would no longer be constrained by China's undervaluation and would be able to pursue market-determination for their currencies as well. As Secretary Snow said in his remarks upon releasing the Treasury report in May, "China's rigid currency regime has become highly distortionary... concerns of competitiveness also constrain neighboring economies in their adoption of more flexible exchange policies." Bearing out this point, Kwon Tae Kyun of the Korean Ministry of Finance recently said that "It is better to do it [yuan revaluation] as early as possible. Currency and oil costs have always been the two major risks the Korean economy faced. The yuan's revaluation would clear one of them."

Third: There is very little Chinese value-added in Chinese exports, so a revaluation would have little or no effect.

Not so. This is probably true for Chinese exports of electronics products, most of which are made in foreign-owned plants operating in export processing zones and assembling components largely made in other Asian countries. But it is not true for the rapidly growing range of Chinese products that are competing with U.S. manufacturing production in the broad range of sectors that are feeling the pinch of Chinese competition – including auto parts, metal products, industrial supplies, plastics products, and the like. These, for the most part, are not made in China's export processing zones and are principally of Chinese origin and value-added. These products have benefited the most from China's undervalued exchange rate and would be the ones most likely to be less able to compete with U.S. production once the exchange rate reflected economic fundamentals.

China's trade data differentiate between exports (and the related import inputs) from processing zones, both by state-owned enterprises and foreign-invested enterprises. What these data show is that 55 percent of China's 2004 exports were either "process with assembly" or "processed with imported materials." The import content of these exports was 67 percent – meaning that the domestic content was only 33 percent.

The remaining 45 percent of China's exports were neither processed in assembly zones nor produced with imported components, and can be viewed as 100 percent domestic content (other than the costs of imported energy, etc. that is true with all countries). Thus, combining the 55 percent having 33 percent local content and the 45 percent having 100 percent local content shows that the overall local content of China's exports may be estimated at 63 percent. That proportion of China's export value would be affected by upward movement of its currency.

Fourth: Most imports from China are produced in U.S.–owned plants and a revaluation would directly harm U.S. firms.

While popular, this argument is absolutely false. U.S. Census Bureau data show that only 27 percent of U.S. imports from China are "related party trade" – i.e., are imported by one part of a company from another part of the same company. "Related party trade" covers all imports within the same corporate family, including those by foreign owned companies. Thus, 27 percent of U.S. imports from China are imports of U.S. companies from their Chinese subsidiaries, imports into the United States by Japanese affiliates from their Chinese branches, etc. Since most investment in China is not from the United States, but from Taiwan, Korea, Hong Kong, and Japan, a minority of related party trade is likely to be due to U.S. companies – but the Census Bureau data related party trade data do not distinguish trade by the country of parentage.

In addition, the Commerce Department's investment data show that the overwhelming amount of U.S. investment in China is for the purpose of supplying the domestic Chinese market. Very little of this production is shipped to the United States.

Fifth: U.S. interest rates will rise if China stops buying massive amounts of Treasuries to keep its currency artificially cheap.

Not so. An argument frequently heard is that if China moves away from its currency peg, it will stop buying Treasury bonds and interest rates will increase, housing prices will fall, and all manner of economic strife will be visited on the U.S. economy and citizenry. To see that this is not so, it is only necessary to quote two of many officials who have been asked that question.

Federal Reserve Chairman Alan Greenspan at the Economic Club of New York said, "The effect of a reduction in the scale of intervention, or even net sales, on U.S. financial markets would likely be small...Accordingly, any incentive for monetary authorities to sell dollars, in order to preserve market value, would be muted,"

U.S. Treasury Assistant Secretary for International Affairs, Randal Quarels said that the U.S. Treasury securities market "is the broadest, deepest, most liquid active capital market in the world, and will remain so. It's very unlikely that that sort of rebalancing would have significant effects on the U.S. Treasury market, the U.S.'s ability to finance itself."

To amplify Chairman Greenspan and Assistant Secretary Quarels remarks, the Treasury market trades roughly $600 billion a day, so if China were to stop purchasing an additional $20 billion a month – not all of which is in dollars, there would be little effect. Moreover, when Japan intervened heavily from December 2003 to March 2004 – increasing its reserves $156 billion in that period – more than $50 billion a month – and then suddenly stopped in April 2004, there wasn't a blip in the market. No one even noticed.

Sixth: A revaluation will hurt China

To the contrary, the Chinese economy will be helped by a revaluation and movement toward a flexible currency. One need only look at recommendations from the International Monetary Fund, the U.S. Treasury Department, Alan Greenspan and a number of Chinese sources among many others, who say that greater flexibility in China's exchange rate system is very much in China's self-interest. The current 10-year old peg is encouraging huge speculative inflows of capital betting on a revaluation, which in turn grows the Chinese money supply and encourages further uncreditworthy bank lending which only adds to the build-up of nonperforming loans and weakens the Chinese banking system. A key component of China's eventual move to a market-determined currency will be a functioning, solvent banking system and dampening speculative inflows through a significant revaluation would be a positive step towards that goal.

Those saying that it is China's own interest to make moves to a flexible currency are too numerous to cite here, but include Treasury Secretary Snow, Federal Reserve Chairman Greenspan, the Canadian Central Bank, the European Central Bank, the World Bank, the International Monetary Fund and a host of other economists. As Secretary Snow said, "China's rigid currency regime has become highly distortionary. It poses risks to the health of the Chinese economy, such as sowing the seeds for excess liquidity creation, asset price inflation, large speculative capital flows, and over-investment. "