U.S. TREASURY DEPARTMENT OFFICE OF PUBLIC AFFAIRS

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STATEMENT OF
UNDER SECRETARY FOR INTERNATIONAL AFFAIRS TIMOTHY D. ADAMS
BEFORE THE SENATE FINANCE COMMITTEE
U.S.-CHINA ECONOMIC RELATIONSHIP REVISITED

Mr. Chairman and distinguished members of the Committee, I am pleased to be with you today to discuss Treasury's economic engagement with China, what we have achieved and the critical work to be done. The U.S. relationship with China may be the single most important economic relationship of the 21st century. Underlying Treasury's engagement is the fundamental belief that a broad, mature, candid, and constructive relationship with China will bring results that are good for the American people. When Secretary Snow traveled to China last fall, he articulated the three pillars of what China needs to do to contribute to sustained global growth and eliminate distortions and imbalances. These are: (1) adopt a more market-based, flexible exchange rate; (2) shift from investment- and export-oriented growth to a more consumption-based economy; and (3) reform and open up China's financial sector, including its capital markets. Implementing these reforms will promote an orderly reduction of global imbalances and lead to sustained and less volatile Chinese growth to the benefit of its own population and the global economy.

The Chinese have made some important achievements on these three pillars, but they still have much to do. Today I would like to describe those areas where greater efforts are needed. The best place to begin is by discussing more broadly U.S. economic relations with China.

<u>China's Importance</u>

Almost 20 years have passed since China began its transition to a market economy, and China has seen its standard of living surge. It has gone from maintaining an autarkic trade policy to subscribing to the WTO principles of open and fair trade, and from being a minor player in global trade to a major player in the global economy. China is now the world's 4th largest economy and the 3rd largest trading nation. The United States has benefited from China's growth: U.S. exports to China have grown at five times the rate of our exports to the rest of the world since China joined the WTO. Growth in exports to China has exceeded 20 percent over the last three years and China has risen to our fourth largest export market.

Variations in China's growth rate now have a significant impact on the global economy and a major impact on markets for steel, oil, copper and a variety of other products. Moreover, the U.S. and China together have accounted for almost half of global growth since 2000. A prosperous and secure China that meets its international obligations and is fully integrated and engaged in the global economy and global economic institutions is in our interest, and in China's interest. It presents enormous opportunities for U.S. workers and firms.

Economic Challenges

China's rapid growth and the character of that growth also pose challenges – for China and for the rest of the world. While China's growth has been rapid, it has depended too heavily on investment growth and increasingly on net exports.

Net Exports and the Current Account

Opening the Chinese economy to trade was a major factor in the development toward a market economy in China and the acceleration of Chinese growth. Chinese imports have grown rapidly along with Chinese exports, so that increases in the trade surplus have until recently made only a small contribution to Chinese growth. But the last two years have seen a dramatic increase in China's global trade surplus – from $25 billion in 2003 to $102 billion in 2005. Net exports accounted for 12 percent of real GDP growth in 2004. China's overall current account surplus has also risen sharply, from $17 billion in 2001 to $69 billion in 2004, and estimates for 2005 are near $150 billion, or almost 7 percent of China's GDP. China's current account surplus is now a major component of global imbalances, and its continuation risks undermining support for the open trade policies which have contributed so much to China's development. China is now simply too large to rely on export-led growth to pick up the slack when other sources of growth falter.

Investment

The dependence of Chinese growth on investment is even more striking. In each of the years since 2001, investment has accounted for more than 60 percent of GDP growth. Even with the new, revised GDP figures, China's investment is over 40 percent of GDP – significantly higher than other East Asian countries – and that share is still climbing. The result is an economy that has been skewed too heavily towards investment, much of it with little return.

Overall productivity growth has fallen since the early 1990s, and increased capital and labor input, rather than greater productivity, now accounts for the bulk of China's growth. The heavy dependence of growth on investment raises risks to the Chinese and global economy. China has a long history of credit-fueled cycles of investment-led booms and busts. To sustain rapid and stable growth in the future, China will need more selective and more productive investment. Given China's current size and integration into the global economy, the next Chinese downturn will have a global impact, and affect U.S. jobs and prosperity.

Treasury's Intensive Engagement with China

Treasury is in frequent and substantive consultations with the Chinese government on exchange rate and financial market reform issues. Secretary Snow and Finance Minister Jin convened the 17th Joint Economic Committee (JEC) meeting last October in Beijing, which covered a wide array of economic policy, financial sector, and capital markets issues. Over the past few years, we have broadened the JEC to include a range of senior Chinese and U.S. financial officials, including the National Development and Reform Commission (NDRC), and China's chief financial regulators. Treasury also conducted the first meeting of the Sino-U.S. Financial Sector Working Group, which brings together U.S. and Chinese financial regulators at a more technical level. We will host the next session in April.

In 2005, Secretary Snow dispatched a high-level envoy to conduct quiet and meaningful talks on the three pillars of our strategy, with special focus on exchange rate flexibility. Next month, Treasury's financial attaché, Dave Loevinger, will take up residence in Beijing. Getting more representatives on the ground, where they can advocate for U.S. interests, is part of Secretary Snow's initiative to place Treasury staff in the largest and fastest growing emerging markets, and is included in the President's FY 2007 budget request.

Two years ago, Secretary Snow launched a Technical Cooperation Program (TCP) to help the Chinese authorities overcome the technical obstacles they had identified to greater exchange rate flexibility. Treasury has hosted a number of exchanges, including training on developing and regulating financial futures markets.

Encouraging China to meet its responsibilities is a global task as it has global implications. To leverage our own efforts, we have enlisted support from China's major trading partners particularly through the G-7, APEC, and the IMF.

We believe the most effective way to promote change in China, including on the exchange rate, is by working in cooperation with our Chinese counterparts. There are several bills in Congress that would close our markets to Chinese goods if China does not move more on its exchange rate. We do not support those isolationist approaches. They would damage our economy and not achieve our shared goals.

In addition, we are reviewing the legislation Chairman Grassley and Senator Baucus introduced yesterday and look forward to providing our views on that legislation once our review is complete. With this strategy in place, it is useful to take stock now of how China has responded to the three pillars: greater exchange rate flexibility, balanced growth, and reform of China's financial sector.

Three Priority Issues

I. Exchange Rate Policy: Encouraging China to move more rapidly to a more market-based, flexible exchange rate regime is Treasury's number one priority. Exchange rate flexibility is in China's interest. Greater exchange rate flexibility will strengthen the ability of Chinese monetary policy to help assure sustained growth, avoiding the boom-bust cycles that have characterized Chinese growth to date. Greater ability to control domestic interest rates will also lead to more efficient financial intermediation, and help avoid credit-fueled investment booms and resulting buildups of non-performing loans. As China's transition to a market economy proceeds, command-and-control tools will lose their effectiveness, and interest rates and other price mechanisms will become more important. The price signals that come from a flexible exchange rate will be a critical part of readjusting China's economy to produce more balanced and sustainable growth. Finally, a more flexible Chinese exchange rate will help address global imbalances, particularly as it is likely to allow other Asian economies to adopt more flexible exchange rate regimes.

The Chinese leadership has publicly committed to greater exchange rate flexibility. Despite internal criticism on the pace of market reforms in China, Premier Wen reaffirmed this commitment in his press conference following the closing of the National People's Congress on March 14, saying China "will expand the foreign exchange market and allow more flexibility and fluctuation of the currency."

Our engagement with China on exchange rate policy is not now about "whether" but about "how quickly." China has made some progress in making its currency more flexible and market-determined, starting with the adoption of its new exchange rate mechanism last July. It has gradually allowed more movement and flexibility. It has authorized inter-bank trading of currency and more participants in the foreign exchange market. China has also introduced new financial products to hedge against currency risk, and strengthened its banks and its supervision of the financial system.

But to date China's progress has been far too cautious. Since China began changing its exchange rate last July, the RMB has appreciated by only 3.2 percent and the day-to-day fluctuation has been severely constrained. It has also failed to test the limits of the current narrow intra-day trading bands. That said, the RMB continues to be much more stable against the dollar than it is against a trade-weighted basket of the Yen, the euro, and the dollar (the renminbi's nominal effective exchange rate appreciated by around 9 percent in 2005). This tight control over the exchange rate prevents the market incentive needed to develop liquidity and hedging instruments. And China continues to accumulate foreign exchange reserves at an excessive pace. China's foreign exchange reserves are almost 600 percent of its short-term debt in 2004, while economists consider 100 percent coverage prudent. As a result neither China, nor the global economy, has reaped the benefits of a more flexible exchange rate. The Chinese government must allow market forces to play a much greater role in the determination of the RMB's value. The obstacles are no longer technical; China could easily move more rapidly towards greater flexibility. It should do so now.

<u>II. Rebalancing Growth Towards More Domestic Demand</u>: In addition to greater exchange rate flexibility, sustaining rapid and steady growth in the Chinese economy without the buildup of a large external imbalance will require a more balanced pattern of Chinese growth, with a much greater role for consumption, which is an estimated 47 percent of GDP under China's revised GDP statistics, compared to over 60 percent for India, 57 percent for Japan in the 1960s, and 67 percent for Korea in the 1970s, all periods of rapid growth in those economies.

The counterpart to China's high investment and its current account surplus is a savings rate of roughly 50 percent of GDP, which may be the highest in the world. One World Bank study estimated that China's savings rate was 10 percent of GDP higher than one would predict from China's economic and demographic characteristics. Chinese households save 25 percent of their income, on average, mostly in the form of low interest-earning bank deposits. Household saving reflects a weak social safety net and limited access to financing and insurance; households need high savings in the event of serious illness, disability, or to pay for children's education. The "iron rice bowl" of cradle to grave wages and benefits is gone and a modern social safety net has not yet been erected. Chinese state and private firms also save heavily – and invest the earnings they have rather than paying out dividends.

China's leaders recognize the importance of lowering the savings rate and boosting domestic demand, and achieving more balanced growth is central to current Chinese policy. To spur domestic demand, China has placed strong emphasis on consumption and rural development in its most recent Five-Year Plan. To boost disposable incomes of the rural poor, the government has recently decided to cut agricultural taxes and eliminate fees for rural primary education. It also plans to direct more capital and social spending to the rural sector.

There are a number of additional steps that China could take to lower savings and boost domestic demand. Policies to encourage China's state-owned enterprises to pay some of their earnings as dividends would reduce their savings and their inefficient investment, and could contribute to greater social welfare expenditure or reduced taxes. Strengthening and increasing enrollments in public pension and health insurance systems, particularly in rural areas, are also important steps.

Increasing the range of financial products available to households is also a critical component. Household saving could be reduced by insurance policies covering disability and catastrophic illness, by the ability to finance education and other major expenses, and by making higher return investment options available to households, including those overseas.

III. Financial Sector Reform: This brings me to the third pillar of our strategy – financial sector and capital markets reform. Inefficient financial intermediation remains the Achilles heel of the Chinese economy. China's financial institutions were built as an appendage to the planning system, their funds still go primarily to state-owned enterprises. The large amount of non-performing loans reflects the failures of the planning system.

There has been notable progress on banking reform. In the last 18 months, foreign strategic investors – including U.S. institutions such as Bank of America and Citigroup – have invested more than $17 billion in Chinese banks. In addition, international institutional investors invested around $11 billion in the Hong Kong IPOs of two of China's five largest banks. On the regulatory front, China has been tightening its risk classification system for bank loans, deregulating bank lending rates, and developing financial-sector infrastructure, such as the nationwide credit bureau launched in January and a deposit insurance system expected later this year.

China has also undertaken a number of steps to develop its capital markets. Reforms to reduce the overhang of non-tradable (predominantly government-owned) shares are moving forward. China expanded the Qualified Foreign Institutional Investor (QFII) program to allow more access for foreign investors to companies listed on local stock exchanges and has also launched a separate program to allow large, long-term strategic investors to purchase local shares above and beyond the QFII program. U.S. securities companies are also benefiting from Chinese equity offerings overseas. In 2005, Chinese companies raised more than $25 billion in equity in Hong Kong alone, and U.S. securities companies (such as Morgan Stanley, Merrill Lynch, Goldman Sachs, and JP Morgan) were the lead arrangers for 44 percent of those issuances. Assuming underwriting fees of between 3 percent and 5 percent, U.S. securities companies earned between $335 million and $560 million in revenue from leading these Chinese equity offerings.

Despite this progress, much needs to be done to improve China's financial markets. China's stock markets are still too often viewed as a way to keep inefficient state enterprises afloat rather than as a way to channel capital to the most competitive firms and sectors and a way to transfer control to more productive owners. Deeper bond markets would reduce corporate reliance on state-controlled lenders and more active derivatives trading would allow firms to better manage risk. On the banking side, the state dominates: government entities own all but one Chinese bank, and the central government's "Big 4" banks account for more than half of financial sector assets. This pervasive state involvement has led to inefficient allocation of resources and a large build-up of non-performing assets.

To help modernize China's financial system and capital markets, Treasury has identified a number of priorities. First, we believe it would be in China's best interest to allow more competition and market forces into the sector, in particular, by eliminating ownership caps on foreign stakes and expanding the scope of products they can offer.

Second, China's regulators and firms need to improve capacity for risk management. This involves better accounting and financial reporting, and institutions such as an effective nationwide credit bureau accessible to all financial services providers (including foreign banks and other non-bank financial companies). An essential component of this effort will be to establish a consolidated supervision framework for financial institutions in China.

Third, China needs to improve opportunities for private companies to obtain finance so that capital can be channeled to its most productive and efficient uses and support more balanced growth. In the corporate bond market, we have encouraged the authorities to eliminate duplicative government approvals and move to a more disclosure-based system. Such a system will require professional institutional investors and independent, credible credit rating agencies. On the equity market side, we are arguing for an end to the moratoriums on new listings and sales of domestic securities companies to foreign investors. Finally, China needs to continue to privatize its extensive portfolio of state-owned enterprises.

We are also pressing China to make substantial new commitments in financial services as an essential element of any Doha agreement. China can open its financial system to competition by improving its WTO offer to allow 100 percent foreign ownership of subsidiaries, whether by new investment or acquisition, and allowing them to perform a full range of securities and asset management services. China's plan to open completely the banking sector to foreign participation by the end of 2006 is a key WTO commitment and something that Treasury will watch closely to ensure that regulatory impediments do not undermine China's meeting its commitment.

Another important area of engagement with China is protecting China's financial system from abuse. Overall, the U.S. has been favorably impressed by the political commitment to anti-money laundering and countering the financing of terrorism (AML/CFT) issues demonstrated by Chinese authorities. The U.S. is working in cooperation with the Chinese financial authorities to update their current legal provisions and improve regulations in their financial sector to combat money laundering and terrorist financing. These continued efforts will help reduce fraud and tax evasion, and help improve Chinese banks' access to other markets. We have been working closely – bilaterally and multilaterally – with the Chinese authorities on these issues in order to ensure that China joins the global community in adopting and implementing the international standards to combat money laundering and terrorist financing. China must strengthen its draft AML law, as it falls short in some key areas, such as its definitions of money laundering offences and rules for financial institutions to identify the beneficial owners of accounts.

Finally, let me address the concern of some members of this committee regarding China's holdings of Treasury securities. Chinese holdings are 3.2 percent of the $8.2 trillion in total public debt outstanding, or 6.6 percent of the $4.0 trillion in total privately held public debt outstanding. China has purchased around $34 billion in Treasury securities in 2005. This is in the context of the extraordinarily deep and liquid Treasury market where daily turnover exceeds $500 billion. China holds only about $470 billion, or 2 percent, of a total of $23 trillion in U.S. credit market debt securities.

Conclusion

China continues to undergo a historic economic transformation. Developing a constructive and mutually-beneficial economic relationship with China now is vitally important since the decisions we take in the next few years will guide the U.S.-China relationship over the next generation – and the shape and pace of global growth for years to come. As a significant member and beneficiary of the international economy, China should make a greater contribution to sustaining strong global growth by reducing its large current account surplus and working to maintain global support for open trade and investment. To put it simply, China must play be the rules of the system. Failure to do so entails consequences both for China and for the global economy. It is important that we manage our relations in a way that preserves global growth and maintains an open trade and investment policy, which is a "win-win" proposition for both economies. The U.S. Treasury is committed to promoting a path of mutual prosperity and global leadership in our economic relations with China.

Thank you for this opportunity to appear before the Committee. I am happy to take your questions.

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