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

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

To What Extent is China's Currency Misaligned:

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

What is the Effect of this on the U.S. Trade Deficit and on U.S. Employment:

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

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

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

What Sectors of the Economy would Increase Employment in the Wake of an RMB Revaluation:

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

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

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

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

What is the Appropriate Appreciation for the RMB at this Point:

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

What are the Options:

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

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

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

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

The problem, however, is far bigger than China's currency, and let's be clear that China is not the only one in this game. Many of the East Asian countries are managing their currencies to facilitate their export competitiveness into the U.S. market. But currency is just the tip of the iceberg. We've all been engaging in a huge charade. We in the United States have been acting on the basis of the presumption that in a world of globalization, with a majority of countries being IMF and WTO members, that all countries are playing the same globalization game. And that it is a game of win-win free trade. This has never been true and is increasingly less true. In fact, the world is divided – some important countries (the U.S., the UK, a few others) are more or less free traders, but many other countries are neo-mercantilists pursuing export-led growth strategies guided by elaborate industrial policies. We've seen this movie before. We've seen Japan pioneer the export-led growth strategy, followed by the Asian Tigers, and now we're seeing the last tiger, or perhaps the first dragon, perfecting the model. A model, it should be noted, that is not unique to Asia. Indeed, we see Germany pursuing accumulation of chronic trade current account surpluses and insisting that it can never buy more of the products of its partners in the EU.

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

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

Rather than making this a bilateral issue, it is clearly preferable that some multilaterally negotiated arrangement be achieved, perhaps in the G20 or in the WTO or even in the IMF. Another option is negotiating with China in a multilateral context, such as the G20 or the WTO. But if that can't be achieved in some reasonable period of time, countries, including the United States, will be obliged to defend their interests in whatever way they deem appropriate, unilaterally or as a coalition of concerned countries. A difficulty is that the global institutions and many of their key underlying concepts such as most favored nation and national treatment are not cognizant of the present structural realities and not adequate to deal with the problems of a world that is half neo-mercantilist/strategic trade and half free trade. How laughable is it that countries put enormous effort into the WTO to lower tariffs while ignoring exchange rates which can easily move by a magnitude greater than the value of the tariffs the WTO system has reduced, or that the IMF can discuss currency values and exchange rates without reference to trade and investment? Yet they do. We should recognize and use this opportunity to begin establishing 21st century institutions for the 21st century. The first step is to recognize the realities.

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

Negotiations similar to those of the Plaza Agreement of 1985 should be launched immediately to coordinate a substantial (40 to 50 percent) revaluation of a number of managed Asian currencies versus the dollar and the euro over the next two to three years. This would also have to entail an agreement to halt strategic currency management activities. A second longer term objective of the deal would be a reversal of savings and consumption patterns in the United States and Asia. Once the current recession is behind us, Washington would promise to balance the federal budget over the business cycle and to reform poorly targeted consumption incentives like the tax deductibility of interest on home equity loans, while key Asian and oil producing countries and Germany would undertake to increase domestic consumption. China could upgrade its social safety net, and a true liberalization of Japan's housing and consumer credit markets might do wonders. The oil countries also need to improve social safety nets and greatly upgrade their infra-structure.

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

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

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

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

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

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Time to cool China, US tempers

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

By LEON HADAR
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MEMBERS of a bipartisan coalition of US lawmakers are accusing the Chinese of a plot to manipulate the value of its currency in order to boost its exports and make American imports harder to sell in China.

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

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

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

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

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

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

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

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

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

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

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

But since the Chinese do not allow their currency to float freely, the same economists also disagree over the degree to which the Chinese undervalue their currency. Economists also differ in estimating the extent to which the appreciation of the Chinese currency will lead to the narrowing of the US trade deficit with China. After all, reducing that deficit seems to be the main rationale for the proposed legislation on Capitol Hill.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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