BEFORE THE SUBCOMMITTEE ON ECONOMIC POLICY
U.S. SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

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HEARING REGARDING CHINA'S EXCHANGE RATE POLICY AND TRADE IMBALANCES

(April 22, 2010)

I am grateful to participate in today's hearing. My conviction, based upon my previous experience – most recently as Executive Vice President, Corporate Development and Chief Technical Officer of Allegheny Technologies Incorporated and as Chairman of the Specialty Steel Industry of North America – is that it is vitally important for job creation, the overall economy and national security that the United States strengthen and expand its manufacturing base. An integral part of this effort must be an international system of exchange rates that reflect market fundamentals and that adjust as those fundamentals fluctuate.

I. To What Extent Is China's Currency Misaligned?

For the past 16 years, China has engaged in the protectionist policy of currency depreciation by effectively pegging the renminbi ("RMB") to the U.S. dollar, and other countries have compounded this problem by undervaluing their currencies in an attempt to remain competitive with China.

There is a broad consensus that the RMB is substantially undervalued. The Peterson Institute estimates that the renminbi remains misaligned by about 25 percent on an overall, real-effective-exchange-rate basis and by about 40 percent relative to the U.S. dollar on a bilateral, real-exchange-rate basis. This 40-percent undervaluation vis-à-vis the U.S. dollar is as large today as it was 6 years ago before a modest revaluation and nominal appreciation of the RMB by

China between July 2005 and July 2008. China's intervention in the exchange markets is now approximately $30 - $40 billion per month, and China's foreign reserves are estimated to be at least $2.4 trillion and possibly as much as $3 trillion.[1] These numbers are staggering and contribute to a huge, artificial and competitive advantage for China in various ways.

II. What Effect Does the RMB's Undervalued Misalignment Have on the Trade Deficit and U.S. Employment?

A. Background

The U.S. manufacturing base has been eroding for a long time, while manufacturing capability in China has been increasing dramatically over the same time period. This shift has been well documented by others. The large and growing trade imbalance with China is one confirmation of this situation.

Loss of our domestic manufacturing base presents serious economic and national security problems as documented recently in the President's Framework for Revitalizing American Manufacturing. These problems include a significant loss of more highly compensated employment opportunities for our citizens. There are many factors affecting the competitiveness of U.S. manufacturers that are far more important than labor rates, which are often cited incorrectly as the reason for this loss of competitiveness.

One of the most important and most easily understood factors undermining U.S. competitiveness is the impact of exchange rates, and particularly the actions of the Chinese government to prevent the RMB from appreciating relative to the U.S. dollar. In order to understand the importance of exchange rates to competitiveness and, therefore, to the U.S. trade imbalance with China and loss of American jobs, it is helpful to understand how products are

[1] See Fair Currency Coalition, "Fact of the Week – China's Record Reserves" (Jan. 26, 2010), available at, www.faircurrency.org.

generally sold and then to apply that knowledge to both imports and exports in various market segments. Some examples are provided below.

B. How Products Are Sold

The following factors come into play when a decision is made by a supplier and a customer to enter into a purchasing agreement: (1) price and its impact on profit margin; (2) availability; (3) supply-chain management issues; (4) quality; (5) product capability; (6) short- and long-term customer-supplier relationships; and (7) strategic considerations. All other things being equal, price becomes the dominant issue where exchange rates have a direct and obvious impact. However, in order to understand a specific purchasing decision, it is often necessary to consider some or all of the other factors just mentioned.

C. Imports From China Into the United States

A 40% undervalued RMB has a dramatic impact on imports. When a product made in China is sold in the United States, the invoice is paid in dollars and then converted to RMB in China to pay the Chinese producer. If the Chinese product is sold for $100 in the United States, approximately 683 RMB are provided to the supplier in China under the current exchange rate between the RMB and the U.S. dollar. If the costs of manufacturing are 500 RMB in China, the Chinese producer's operating profit is 183 RMB.

If, on the other hand, the RMB were allowed to appreciate to market rates, 40% higher in value, only 409 RMB would be generated in China, resulting in an operating loss of 91 RMB. The net result would be an unwillingness by the Chinese producer to export that product to the United States at the original price of $100, and the Chinese producer's export price would rise, making U.S.-origin products more competitive.

Note that the Chinese producer's export price to the United States would not necessarily

rise by 40%. The specific price increase would depend upon the degree to which costs could be lowered in China and the minimum profit margin that would be acceptable to the Chinese producer. The Chinese producer's price increase would also depend on some of the other factors mentioned above, such as product availability from U.S. domestic suppliers and strategic considerations, including the ability of the Chinese supplier to decrease prices over time through cost reductions, the Chinese producer's ability to supply other products of interest to the U.S. purchaser, and the perceived long-term importance of the business to the Chinese supplier and U.S. customer.

Importantly, a 40% revaluation of the RMB could have a significant favorable impact on a Chinese producer's costs. A central consideration is the benefit the Chinese producer would realize when purchasing raw materials or energy in U.S. dollars with a more valuable RMB. For instance, over 50% of the value of stainless steel is in inputs such as nickel, chromium, molybdenum, and natural gas that are priced globally based on U.S. dollars. With reference to the previous illustration, if 50% or 250 RMB of the Chinese producer's total costs of 500 RMB were in U.S. dollar commodities, with a 40% revaluation of the RMB the Chinese producer's costs would decrease by 100 RMB to 400 RMB, and the loss of 91 RMB after revaluation of the RMB that was postulated above would become a small operating profit of 9 RMB. Nevertheless, such a large revaluation would still have a substantial, unfavorable effect on profitability even after taking such purchasing benefits into consideration.

To summarize, above all else a long-term, chronic undervaluation of the RMB has led and will always lead to the gradual loss of American manufacturing competitiveness, particularly when the undervaluation is so large. The larger the exchange-rate misalignment, and the longer in time that this misalignment is allowed to persist, the more price will become the determining

factor and allow the Chinese producer time to resolve all other issues at least to parity with the U.S. domestic producer. In addition, the longer this misalignment is allowed to persist, the higher the probability is that U.S. competitors will cease to exist when the misalignment is corrected.

D. Exports to China From the United States

The same logic that applies to imports into the United States from China, as discussed above, also applies to exports by the United States to China. In this case, the important issue is how many U.S. dollars a U.S. producer will receive when the U.S. product is sold in China in RMB and the RMB are then converted back into U.S. dollars. If the price in RMB doesn't change and the RMB-U.S.$ exchange rate is allowed to appreciate by 40%, a U.S. producer in the abstract should receive an effective price increase of over 60% in U.S. dollars.[2]

Such a huge revenue increase would be expected to significantly improve U.S. competitiveness and result in U.S. producers quoting on business in China that otherwise would produce inadequate margins. However, it is unlikely that such success would be completely realized. One reason relates to cost reductions that would occur for Chinese producers associated with dollar-denominated purchases of input materials and energy, as discussed above. In addition, it is critically important to the Chinese government that China be able to maintain a large GDP growth rate. If it is assumed that current prices produce acceptable profit margins to Chinese producers, many of whom have significant ownership by the Chinese government, it seems very likely the Chinese government would intervene in the future in some manner other than an undervalued RMB to prevent a significant disruption to the ability of Chinese producers

[2] If the unit price in China remained at 100 RMB for a U.S. producer's product, for instance, the U.S. producer would receive only U.S.$14.64 at the current exchange rate of 6.83 RMB/U.S.$1, but would receive U.S.$24.45 at the revalued exchange rate of 4.09RMB/U.S.$1, an increase of 67%.

to supply their own market. In other words, price has not been, nor will it be, the only factor considered in purchasing decisions made in China. We can all speculate on how China would accomplish this, but it seems highly likely that following a significant currency realignment, e.g., by 40%, action can and would be taken by the Chinese government to protect China's ability to continue to grow its own GDP and keep its citizens employed.

Because of its impact on jobs and national security, it is my opinion that the impact of Chinese currency manipulation on imports into the United States from China and the resulting inability of U.S. domestic manufacturers to supply their own U.S. market is a much larger problem than a lost opportunity to export products from the United States to China, although both are important.

E. Example 1: Specialty Metals

1. Titanium Condenser Tubing

This is a high-tech product used for seawater cooling in conventional and nuclear power plants. The important issues to understand here are (a) this product is critical to the functioning of these systems and (b) China has not had the capability to supply their own market with acceptable quality product. In situations like this, China has been unable to export product and depends on imports. Pricing relative to Chinese competition has not been a factor, and therefore the exchange rate has not been an issue. Orders are frequently quoted in U.S. dollars, and the currency risk (although there is none if the exchange rate is pegged) is assumed by the purchaser.

However, as China builds this ability over time (as it is attempting to do today), most likely using foreign technology, pricing will become a factor for both imports and exports of this product as discussed above, and exchange rates will become very important. So, as we look to the future, it is very important that we act now to help preserve the technology advantage that

currently exists with high-tech products like titanium condenser tubing produced by U.S. manufacturers.

2. <u>Grain-Oriented Electrical Steel ("GOES")</u>

This steel also is a high-tech specialty metal product critical to the efficient distribution of electricity in any advanced or emerging economy. Electrical power is generated in power plants. In order to use this electricity, it must be distributed widely to all sectors of the economy. These distribution systems employ many large transformers, and GOES is critical to their efficient operation.

Ten years ago, the story of GOES in China was much the same as the titanium condenser tubing story. But over the intervening time period, China has added sufficient capacity using foreign technology for the most part so that Chinese producers can now supply their own market. The Chinese government recently implemented antidumping and countervailing duties claiming trade agreement violations by U.S. producers of GOES. The U.S. industry feels these decisions are unjustified and is considering its options.

During the last 5 years or so, imports of this product into the United States from China have not been significant, because China did not have an adequate domestic supply. Exports from U.S. producers to China, however, have occurred because of inadequate supply in China. As China increased capacity over this time period, exchange rate issues became more of a factor. With large import duties now imposed due to China's trade cases against the U.S. producers, exchange rate issues are of significant importance. If and when these duties are removed, exchange rates will remain important to future U.S. exports of GOES to China and will be **<u>critically</u>** important to the ability of U.S. producers of GOES to supply their own domestic market assuming increasing imports into the United States of Chinese product.

3. <u>Commodity Stainless Steel Sheet and Strip</u>

This product is considered a commodity product, because world-wide competition uses very similar technology. Highly productive processes have been developed that make labor costs less important relative to other cost components such as energy and raw materials. In addition, China has built significant capacity over the last 10 years using foreign technology. Major suppliers in China are government-owned, and in that sense, return-on-investment issues are most likely of lesser importance than is true for a normal, free-enterprise company.

Over the last decade, U.S. producers have been unable to sell significant quantities of this commodity product in China, whereas China has become one of the largest exporters of stainless steel sheet and strip to the United States. <u>See</u> Attachment 1. If the Chinese currency were revalued by 40%, one would expect imports of this product into the United States to be significantly reduced. However, it is unlikely in my opinion that U.S. exports of commodity products to China would increase as much for the reasons discussed above. China would be expected to intervene in some manner to prevent this from happening.

F. <u>Example 2: Consumer Products</u>

Gas grilles are an instructive example of how the RMB's enforced undervaluation affects trade between China and the United States in consumer products. Most gas grilles sold in big box stores were developed originally in the United States. But now, virtually all of these products are made in China and imported into the U.S. market.

These gas grilles are sold strictly on the basis of price. Were the exchange rate allowed to appreciate by 40%, it is highly likely that imports from China would be reduced over time as U.S. manufacturers restored capacity allowing significant production to return to the United States. Not only would such a transition benefit the U.S. producers of gas grilles, but a

significant benefit would accrue as well to the U.S. domestic manufacturers of gas grilles' component parts and raw materials, such as commodity stainless steel. At the same time, it is unlikely that U.S. exports to China would increase to nearly the same extent for the reasons discussed above along with the fact that significant Chinese capacity now being used for the U.S. market would need to be diverted to the Chinese market.

G. Economic Segments

The charts and tables in Attachment 2 set forth data with respect to major segments of products traded between China and the United States from 2000 through 2009. During those years China far and away exported more products to the United States in these segments than the United States exported to China. Further, China's exports to the United States have covered a wide diversity of products in terms of technology and sophistication and met a broad spectrum of basic needs for the U.S. economy. In addition, China's exports to the United States during this period generally expanded and grew over time, particularly in the segment of computer and electronic products. U.S. exports to China, in contrast, have been far less. These overall trends are underscored when specific products are analyzed. Considering the discussion above, it seems most likely that significant currency realignment would have the best chance of improving the trade balance between the U.S. and China by reducing imports over time in the following segments: Computer and Electronic Products; Apparel and Accessories; Electrical Equipment; Appliances and Components; Furniture and Fixtures; and Fabricated Metal Products.

II. WHAT HAPPENED WHEN CHINA ALLOWED THE RMB TO APPRECIATE FROM 2005-2008? WHY DID THE U.S. TRADE DEFICIT NOT NARROW DURING THIS TIME?

Between July 2005 and July 2008, the Chinese government allowed the RMB to appreciate nominally relative to the U.S. dollar by 17.6 percent, from 8.28 RMB/U.S.$1 to the current rate of 6.82 RMB/U.S.$1. During those three years, China's foreign reserves rose from

$711 billion to $1.8 trillion, and the U.S. trade deficit and number of jobs lost likewise increased substantially. There are two basic reasons why China gained ground and the United States lost ground despite this appreciation of the RMB during those three years.

First, the time between July 2005 and July 2008 was one in which China's economy was growing rapidly, and China's ability to supply the U.S. market was increasing dramatically, both in terms of manufacturing costs and product capability. Moreover, as seen in the examples above, as Chinese producers have become more self-sufficient there has been less reason for China to import from the United States. Each of these influences contributed to a more pronounced trade deficit by the United States with China.

Attachment 3 gives a graphic picture of total trade between China and the United States from 2000 through 2009 and shows the extent of the increasing trade deficit by the United States with China over that time. As depicted in Attachment 3, the U.S. trade deficit worsened considerably during the period of 2005 through 2008, and the largest trade deficit incurred by the United States with China occurred in 2008.

Second, the RMB's appreciation between July 2005 and July 2008 was in nominal terms, but then as now the RMB's undervaluation relative to the U.S. dollar was around 40% on a bilateral, real-exchange-rate basis. What was needed then, in other words, was a meaningful revaluation of the RMB in that amount in accordance with inflation-adjusted, trade-weighted exchange rates. The same is true today.[3]

[3] Morgan Stanley has said that it expects China will permit the renminbi to appreciate to 6.54 RMB/U.S.$1 by the end of 2010 and to 6.17 RMB/U.S.$1 by the end of 2011. Morgan Stanley, "China Economics – Renminbi Exit from USD Peg: Whether, Why, When, How," at 1 (Apr. 5, 2010). Yet that nominal appreciation from the current rate of 6.83 RMB/U.S.$1 would be only 9.7 percent, about the same pace over the next 21 months as the pace China set between July 2005 and July 2008. That pace of nominal appreciation will be no more effectual than the RMB's nominal appreciation was between July 2005 and July 2008.

III. IF CHINA WERE TO ALLOW FOR A CURRENCY REVALUATION, WHAT IS AN APPROPRIATE APPRECIATION? WHAT TOOLS SHOULD CONGRESS CONSIDER TO REMEDY THIS IMBALANCE? WHAT ARE THE MULTI-LATERAL POLICY OPTIONS?

What is needed is for China to revalue the RMB relative to the U.S. dollar by 40% on a bilateral, real-exchange-rate basis. But what should we do if this does not happen in a timely manner? Unfortunately, while the International Monetary Fund for the last five or six years especially has been sounding the alarm about China's undervaluation of the renminbi, the IMF's authority is so limited under its Articles of Agreement that China has been able to block publication of the IMF's 2007, 2008, and 2009 reports on China's currency policy. It is apparent that a strengthening of the multilateral rules on protracted currency depreciation is imperative.

In the absence of unilateral action by China to appropriately revalue its currency, a first step that can be taken by Congress and the Executive Branch against this protectionist practice is to authorize the imposition of countervailing or antidumping duties against imports from any country with a fundamentally undervalued currency. This approach would be a reasonable implementation in U.S. domestic law of the World Trade Organization's provisions, would assist materially injured U.S. industries and workers, would act as a deterrent, and would underscore that protracted currency depreciation will not be tolerated.

IV. CONCLUSIONS

Currency manipulation by the Chinese government has significantly affected the bilateral trade deficit of the United States with China, primarily through its effect on the levels of imports into the United States from China. From 2002 to 2009, the United States ran a cumulative trade deficit of nearly $5.4 trillion for All Merchandise, including a deficit of almost $1.6 trillion with

China. China's share of the U.S. trade deficit in All Merchandise rose from 22 percent in 2002 to 45.3 percent in 2009.[4]

This deficit has resulted in a significant loss in the United States of important manufacturing capability and its higher-paying jobs that would have been used to supply the U.S. market at realistic prices. Prices of Chinese imports are artificially low due to the effective subsidization associated with the undervalued Chinese currency vis-à-vis the U.S. dollar. As the Economic Policy Institute reported in a study last month, the RMB's substantial undervaluation has been a major reason for the United States' imbalanced trade with China, the loss of 1.6 million manufacturing jobs in the United States between 2001 and 2008, and depressed and lower wages for many more millions of U.S. workers.[5]

As devastating to the United States as these trends are, the longer-term prognosis if China persists in its behavior is even more troubling. In addition to further trade deficits and lost jobs, the renminbi's undervalued misalignment is an important factor in making investment in China more attractive and feasible than investment in the United States. It is not necessary or even desirable to stop investment overseas by multinational companies, but it is critical that the protectionist policy of China's enforced undervaluation of the RMB should not be tolerated. If not countered, that policy will increasingly drain the United States of knowledge and expertise, continue to contribute to the demise of its basic manufacturing capability, as well as jobs and revenue, by weakening companies in areas such as the U.S. specialty metals industry, which are constantly developing new technology that has essential applications to the U.S. economy and national defense.

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[4] See Fair Currency Coalition, "Fact of the Week – RMB Peg Fuels China Trade Surpluses, Undercuts U.S. Recovery" (Feb. 23, 2010), available at, www.faircurrency.org.

[5] Robert E. Scott, "Unfair China Trade Costs Local Jobs" (Economic Policy Institute, Mar. 23, 2010).

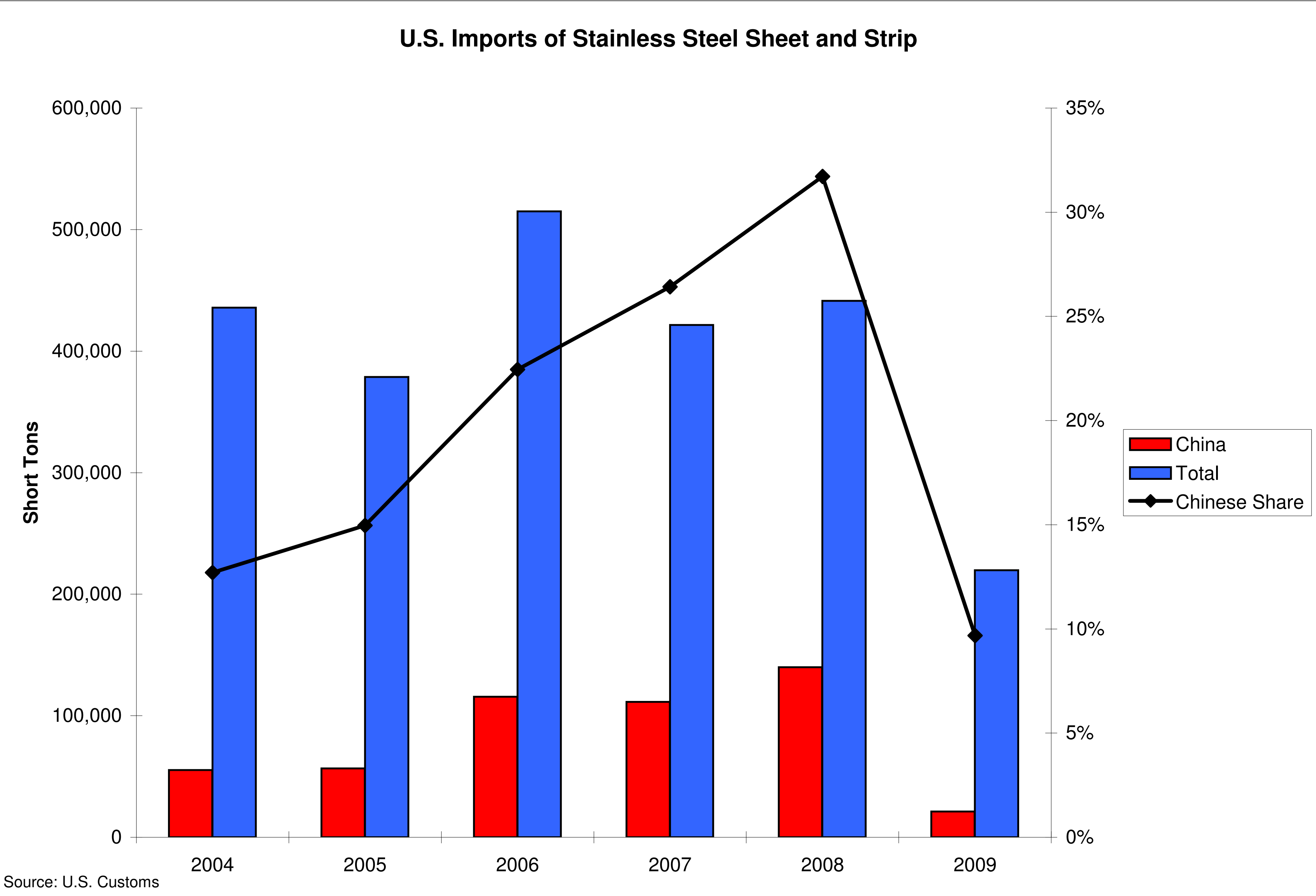
The major benefit associated with China allowing the RMB to appreciate by 40% to market levels, or otherwise mitigating this problem, will be to allow U.S. manufacturers to recapture the U.S. market that has been lost or will be lost to Chinese imports. Less benefit to exports of U.S. products into China is anticipated, because the Chinese government's emphasis on large increases in GDP each year will almost certainly be reflected in other measures that favor Chinese domestic production and sales, thereby compensating in part for any meaningful revaluation of the RMB.

Virtually all segments of the U.S. economy should benefit, but major sectors representing high levels of imports into the United States from China would be advantaged the most. As indicated by the charts and tables in Attachment 2, these segments include computer and electronic products, primary metal manufacturing, textile mill products, apparel and accessories, plastics and rubber products, electrical equipment, appliances, and components, furniture and fixtures, and other fabricated metal products.

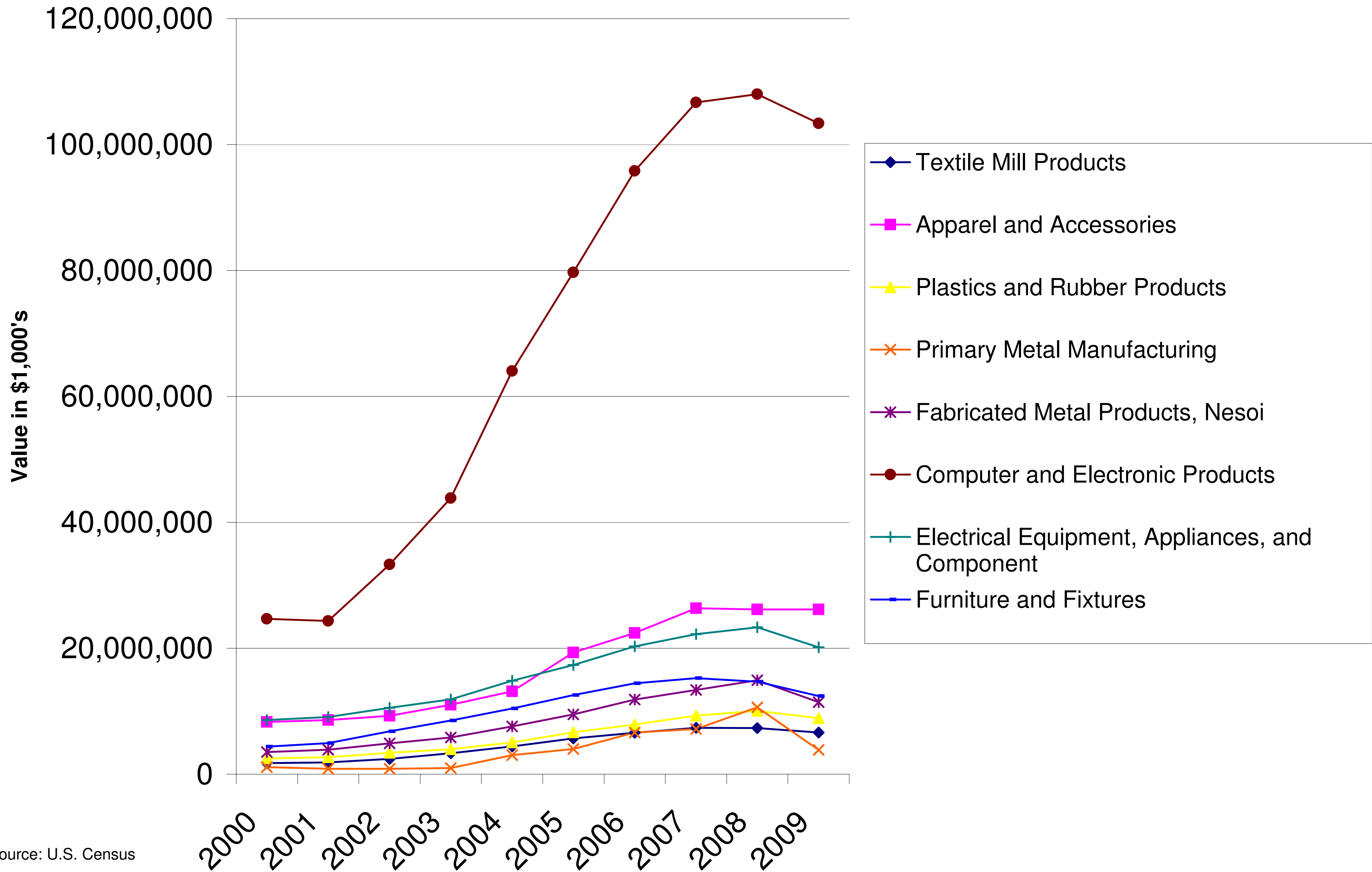
The importance of this issue, and its potential impact, is directly proportional, or perhaps even geometrically proportional, to the magnitude of the currency misalignment and its remediation. Current estimates of 40% misalignment are enormous in this context. Likewise, token efforts to reduce this misalignment will be generally ineffective.

It is critically important that we act now. Pushing the problem ahead will only produce a bigger problem in the future as U.S. GDP weakens and U.S. manufacturing and technology capability is lost. In the absence of unilateral action by China to appropriately revalue its currency, a first step that can be taken by Congress and the Executive Branch is to authorize the imposition of countervailing or antidumping duties against imports from any country with a fundamentally undervalued currency.

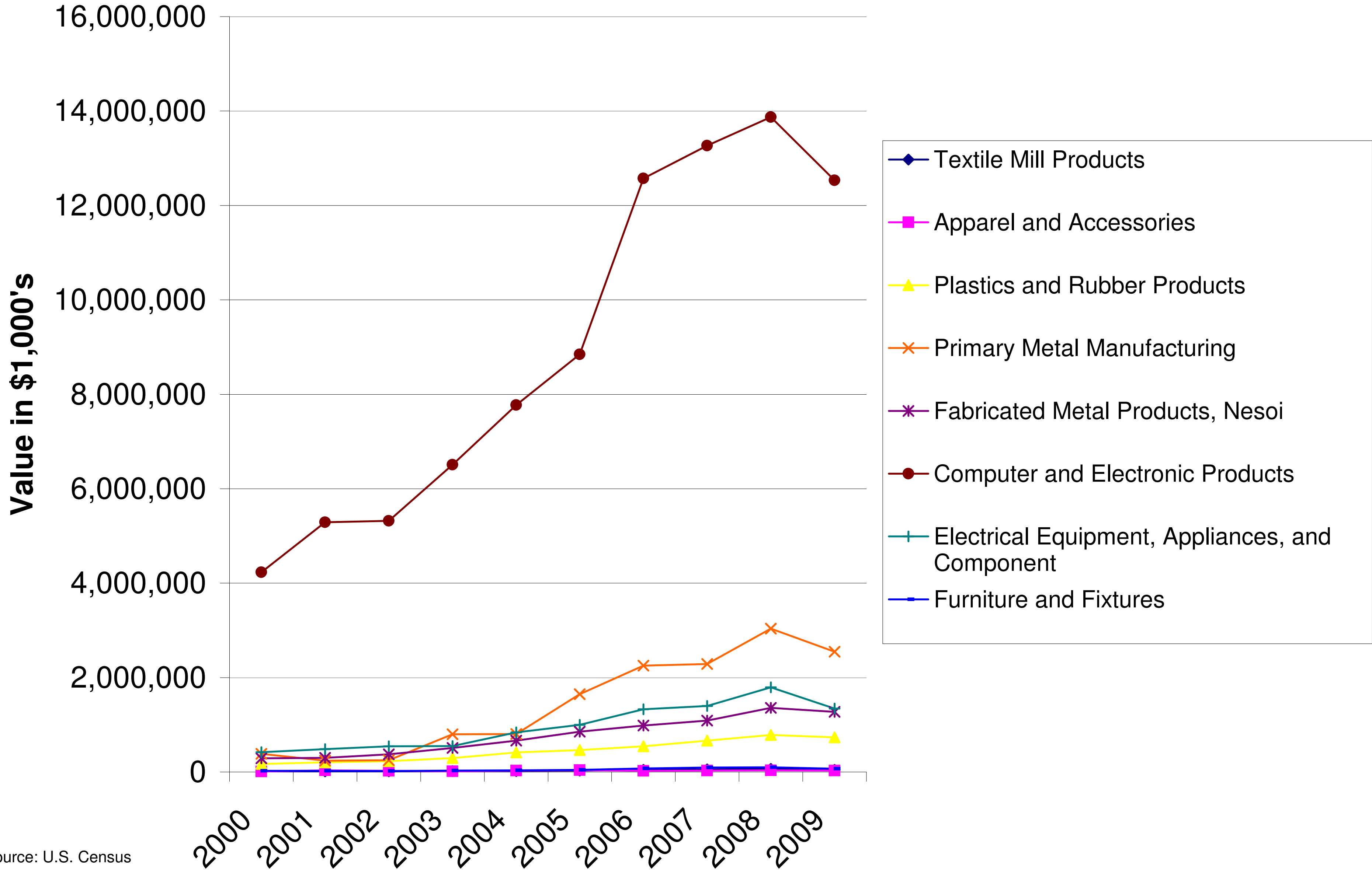
Attachment 1

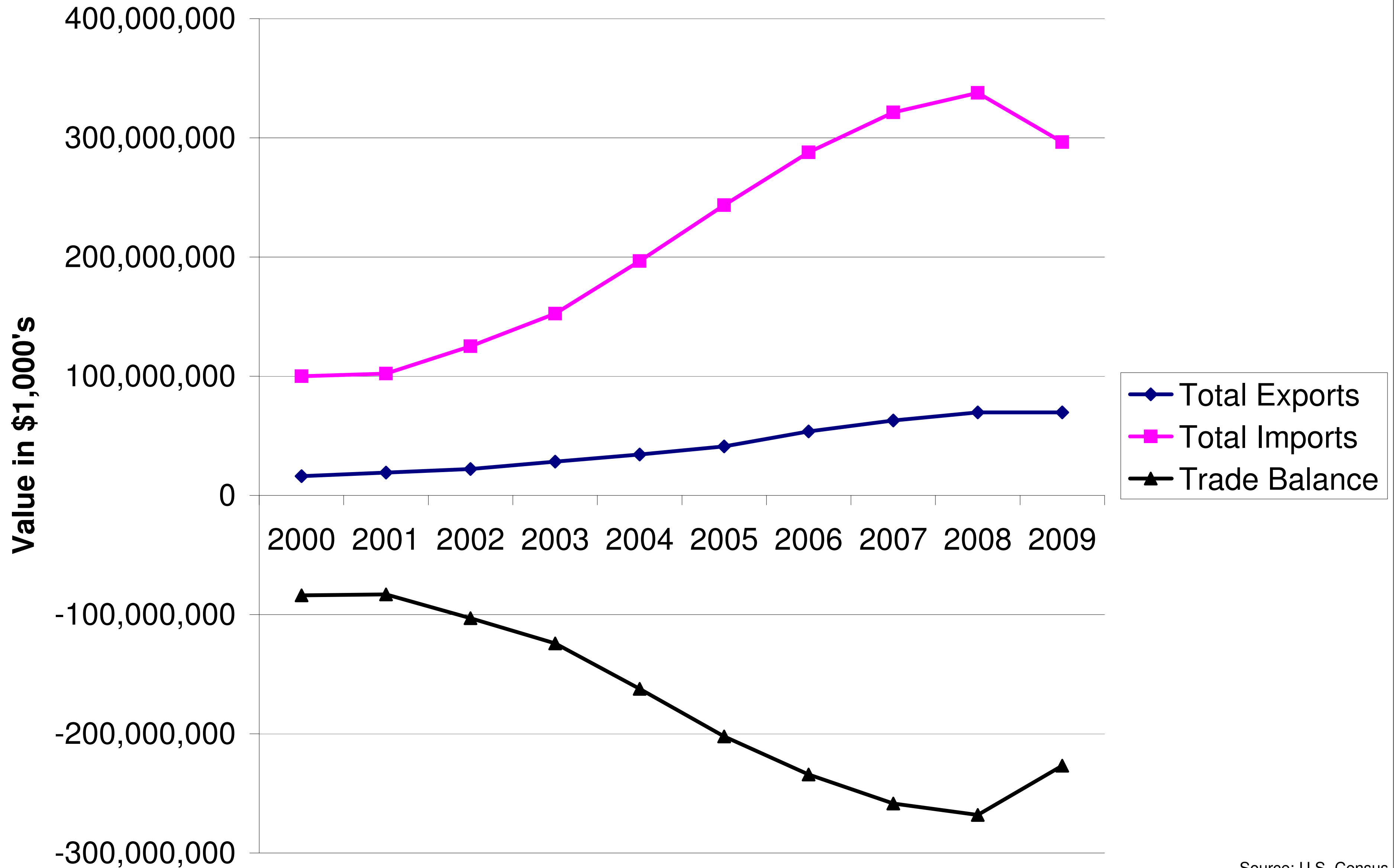


Attachment 2



Attachment 2




U.S. Trade in Goods with China
400,000,000
300,000,000
200,000,000
100,000,000
0
-100,000,000
-200,000,000
-300,000,000
Value in $1,000's
2000 2001 2002 2003 2004 2005 2006 2007 2008 2009
Total Exports
Total Imports
Trade Balance
Source: U.S. Census