

Statement before the Senate Banking Committee

“TREASURY DEPARTMENT’S REPORT ON INTERNATIONAL ECONOMIC AND EXCHANGE RATE POLICIES”

A Statement by

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Mr. Chairman, esteemed members of the Committee, it is my honor to testify today on the factors in China's that contribute to the undervaluation of the renminbi (RMB) and other economic policies that may act to disadvantage American businesses and their workers. .

Much has been written about the RMB and its value relative to the dollar and other major currencies. China has largely maintained a fixed exchange rate for the entire history of the People's Republic of China (PRC) since its foundation in 1949. For the first three decades of the PRC, the RMB was pegged at an absurdly overvalued rate of between 2.5 to 1.5 RMB to the US dollar. In the early 1980s, as China began to open to the outside world and the country became focused on export-driven growth, the RMB was devalued to improve export competitiveness such that, by 1994, the RMB was valued at 8.62 to the dollar. Following the Asian financial crisis of the late 1990s, China maintained a peg of 8.27 to the dollar from 1997 until 2005 when, in the midst of vocal international criticism (led in no small part by Congress), China announced an intent to gradually relax the peg.

The decision in 2005 to loosen its exchange rate policy to allow appreciation certainly came in the midst of extraordinary international outcry, but it also followed a lengthy period of heated external debate within China. Many of China's financial regulatory officials had long argued that the peg was undermining China's efforts to create a modern financial system; that it misallocated investments domestically; and that it contributed to what was then just becoming a chronic global current account surplus. These financial mandarins have faced a recalcitrant and powerful set of interests committed to maintaining export competitiveness as a key pillar in China's economic policy. When the financial crisis

took the world by storm in 2007, those Chinese officials determined to prop up exports put the brakes on additional appreciation so that global economic uncertainty would not undercut China's perceived export advantage conveyed by a competitively-valued currency. For all the wringing of hands within China about a loss of competitiveness that significant RMB appreciation would yield, China's enormously impressive economic performance suggests that fears of RMB appreciation are misplaced.

Despite the dramatic levels of economic and export growth, behind China's frustrating refusal to meaningfully appreciate the RMB lays an almost stunning insecurity about China's political and economic stability. The PRC's leadership is deeply concerned about its ability to maintain domestic economic stability, given the challenges (many of which are admittedly staggering) of income and development disparity, and other factors. Since many in China's leadership consider economic growth and stability to be a sine qua non of political stability, maintaining any competitive advantage to drive economic growth is a political necessity: without growth, the Communist Party is out of power, or so the thinking goes. While many of China's economic policymakers are seeking to reduce the country's reliance on exports for economic growth, there remains much skepticism that alternative pathways – particularly through increasing the share of consumption in GDP – are available in the near term to export growth. Accordingly, maintaining an export advantage is part and parcel of maintaining political control. Small wonder that Chinese officials are loath to answer the entreaties of Treasury and Congress to remove the RMB's peg to the dollar. They fear the domestic consequences: a loss of jobs and competitiveness that will stir public antipathy and, ultimately, cost them their political authority.

These concerns will no doubt be familiar to many in this body. To the extent concern in the United States public over Chinese economic policies can be said to reduce competitiveness, and lead to the loss of jobs and business opportunities, the administration and Congress have a solemn responsibility to the American public to confront those policies. So in many respects Chinese officials

are pursuing the same fundamental political goals we are. Their motivations, however, should not excuse policymaking behavior that undermines U.S. and global confidence in the fairness of the world's trade and financial architecture. More recently, this behavior has increasingly been bolstered by an increasing confidence among Chinese policymakers that their policies are right, and our concerns are misplaced.

Not all is bad news in the U.S.-China trade and economic relationship. In 1979, total trade between the United States and China was \$2.4 billion. 30 years later, by 2009, that trade had grown to \$365 billion. During this period China became the fastest growing export market in U.S. history; Chinese exports to the United States (which to an overwhelming degree did not compete directly with American production) enhanced the buying power of Americans, particularly those at lower income levels; and China became one of the most profitable and fastest-growing markets for the operations of American businesses. Not insignificantly, the commercial relationship between the United States and China has been an important area of common interest that has reduced bilateral tensions between two countries that are not, to say the least, natural political partners.

Yet, more broadly, Chinese economic policymaking, whether acts of commission like industrial policies that disadvantage U.S. competitiveness in its market; or acts of omission like China's completely ineffectual system of intellectual property rights protection and enforcement, is unquestionably undercutting Americans' faith in the fundamental fairness of trade between the United States and China. On one hand, the fact that China, by the introduction to the global labor market of twenty percent of the world's potential workers, has come into conflict with other countries, is far from surprising. That the rise of China from less than a percentage point of global GDP to around eight percent has created concerns among industrialized nations should further create challenges is hardly shocking either. However, in spite of all the misplaced outrage, the impact of China's rise in the global

trading order has still created valid challenges that need to be confronted. Indeed, China presents a fundamental challenge to the nature of the global trading order and the U.S. role in that order going forward.

The Rise of the Beijing Consensus

This most recent global economic crisis has left many Chinese feeling triumphant. China's economy, after a brief pause, is once again roaring at double-digit growth. China's financial system was -underexposed to many of the "toxic" assets that were the bane of so many other countries', and its stimulus package was targeted and relatively efficient. Chinese media and internet chatting has been full of commentary that the United States was down and out as a result of the crisis and China is scaling new heights. There is a palpable sense among many Chinese that China's economic and political system has distinct advantages over that of the United States. Despite a long-time view that the U.S. model of development – based on the so-called "Washington Consensus"—had much to be admired, many Chinese now perceive that there is a distinct Chinese model of growth – based on "state-directed capitalism" -- that has little to be learned from the American experience favoring open markets and a preference for private activity. As Chinese Vice Premier Wang Qishan said, tongue clearly in cheek, to a forum of American business and government leaders as the extent of the financial crisis became clear: "We have learned that our teacher has some problems."

China's widespread perception that the U.S. economic model is inferior to that of the newer Chinese version has profound implications for both China and the United States. To begin with, it is based on a faulty supposition. China's twenty-five year run of breakneck growth is not the result of effective state-owned firms or savvy industrial policies. Rather, China's economy has largely grown by the government getting out of the way of entrepreneurial individuals and companies; by allowing the ambitions of Chinese private individuals to substitute for the will of the state. Rather than clever

planning by Chinese government agencies, as many Chinese now seem to suppose, twenty years of intensive market reform policies that removed the Chinese government from active intervention in market activity have been the primary source of Chinese growth. Chinese state-owned enterprises are largely a drag on growth, consuming 70 percent of Chinese resources and producing only 30 percent of Chinese output. China's industrial planners, those ministries that are heirs to the disastrous economic policies of China's Maoist past such as the Great Leap Forward and other tragic missteps, were largely sidelined during much of the two decades leading up to the beginning of this century as China's leadership sought to replace bureaucratic decision-making with market principles. Fifteen years of painful negotiations with the United States and other economies leading up to Chinese entry into the World Trade Organization in 2001 was intended by those steering the Chinese economy during this period to force reform on an otherwise recalcitrant bureaucracy. The wisdom of Chinese leaders in developing China's economies has not been to construct careful economic plans, but to eschew constructing those plans and drastically reduce state control over the economy. Unfortunately for those in China counting on unabated and efficient economic growth, the new generation of Chinese policymakers seems to have forgotten this important lesson.

The second problematic impact of a newfound Chinese economic triumphalism is on the ability of U.S. trade and economic officials to convince Chinese counterparts to revise or reverse policies that impact U.S. economic interests. In the past, examples from the U.S. economic experience were important teaching tools that our officials and businesspeople could deploy to demonstrate alternative policies that Chinese officials might choose as alternatives to problematic policies. In an era in which the U.S. model was a powerful case in point of how to get economic development right, Chinese officials were at least willing to provide some deference to these examples. Newly convinced of the superiority of the Chinese system, Chinese policy-makers are less easily converted to replace offensive policies and practices by examples from the "failed" U.S. model. As a result, when attempting to "fix" problems in

U.S.-China trade relations, U.S. trade officials are left with few alternatives and must seek Chinese concessions during high-level summitry like the Strategic and Economic Dialogue or the Joint Commission on Commerce and Trade; by seeking WTO dispute resolution; or through unilateral trade actions. Unfortunately, high-level summitry isn't an efficient process by which to resolve multiple complex trade issues. WTO dispute resolution is slow and unwieldy, and few problems in the relationship are clear violations of China's WTO commitments. Finally, unilateral trade actions can run afoul of our own multilateral trade commitments.

The final challenge placed by China's newfound sense of economic superiority has been to dramatically suppress the forces of reform in China. In 2001, with the goal of Chinese WTO accession realized, the forces of reform were relieved of their primacy in economic policymaking. The planning-oriented ministries and agencies that had been suppressed in the fifteen years of reform found overnight that they no longer were easily coerced by reform oriented ministries like Commerce and Foreign Affairs. The planning forces not only began to flex their muscles in ways that challenged U.S. economic interests, they did so with no small amount of resentment at the perceived heavy-handedness of the forces of reform during the period of their dormancy. Paradoxically, much of the decentralization of power and authority throughout the bureaucratic system that was a hallmark of WTO reform effectively empowered bureaus and offices throughout the Chinese ministerial to come up with creative plans that challenged the spirit of reform that embodied China's WTO push. When these plans challenged U.S. economic interests, however, U.S. officials have been forced to take up their concerns with different ministries, namely Commerce and Foreign Affairs, that may be most sympathetic to our concerns, but without the power and authority that they enjoyed in previous years.¹ Given the unique, stove-piped nature of the Chinese bureaucracy, the effectiveness of those agencies in over-turning

¹, Neither the Ministry of Commerce nor Foreign Affairs has a direct representative on the Politburo, unlike previous years. Experience managing international affairs among China's most senior leadership is therefore in short supply.

policies generated in other ministries is highly limited, absent external intervention from a higher-level authority. In short, the United States has difficulty finding an official audience in China that is both sympathetic and has political capital sufficient to do something about our concerns.