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HEARING BEFORE THE SENATE BANKING COMMITTEE'S SUBCOMMITTEE ON SECURITY AND INTERNATIONAL TRADE AND FINANCE

"U.S. ECONOMIC RELATIONS WITH CHINA: STRATEGIES AND OPTIONS ON EXCHANGE RATES AND MARKET ACCESS"

(May 23, 2007)

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On Behalf of the China Currency Coalition

Introduction

Good afternoon. Thank you for inviting me to participate in this hearing as counsel to the China Currency Coalition ("CCC"). The CCC consists of U.S. industry, agriculture, and labor organizations, and its purpose is to support the economy and security of the United States by working toward and achieving as promptly as possible a commercially realistic revaluation of China's undervalued yuan. The China Currency Coalition estimates that the yuan continues to be undervalued vis-à-vis the dollar by 40 percent or more.

Since 1994, when China abolished its dual-exchange-rate system, the yuan or renminbi has been pegged to the dollar and substantially undervalued. From the end of 1995 through mid-2005, the rate of exchange between the yuan and the dollar was approximately 8.28 to 1. On July 21, 2005, China announced that the yuan's peg to the dollar would be replaced with a basket of currencies, instituted a daily trading band of +/- 0.3 percent, and revalued the yuan by 2.1 percent to 8.11 yuan to the dollar. Currently, the yuan trades at approximately 7.66 yuan to the dollar, nominally a strengthening of the yuan of just 7.5 percent from its fixed rate of 8.28 yuan

to the dollar before the modest revaluation in July 2005. Last week, China advised that the daily trading band would be widened to +/- 0.5 percent.

I think it is fair to say that there has been no significant shift in the Chinese leadership's basic position on the yuan. The weightings of the currencies in China's basket have never been revealed, and it certainly appears that the yuan effectively remains pegged to the dollar. In real terms, after relative rates of inflation are taken into account, the yuan has appreciated against the dollar by only 0.2 percent since April 2005, notwithstanding that the dollar has lost strength against other currencies. Had a truly market-driven system been in effect since July 2005's revaluation – even with the narrow, daily trading band of +/- 0.3 percent – a 40-percent revaluation of the yuan would have been achieved by late March 2006. In the CCC's judgment, in light of recent history, no meaningful appreciation of the yuan against the dollar should be expected from the modified daily band of +/- 0.5 percent.

As far as the United States is concerned, the ineffectiveness of China's revised system should come as no surprise. China has been very clear with both the International Monetary Fund ("IMF") and the World Trade Organization ("WTO") that China's currency policy is meant to foster economic growth for China, foreign direct investment in China, employment for the 20-30 million new entrants in China's job market every year, and macroeconomic, social, and financial-sector stability in China. China's accumulation of foreign reserves, including roughly $1.3 trillion as of this year, also has enabled China to fund purchases of raw materials from around the globe and military hardware for its growing navy and army, as well as to begin to act as a lender of funds regionally to other Asian countries particularly.

In short, China's apparently deep-seated conviction is that the best way of accomplishing its goals, while avoiding as much as possible depreciation of China's investment in dollar-

denominated debt, is to enforce what amounts to a peg of the yuan to the dollar. It is reasonable to surmise that, from China's vantage, there seems to be no reason to alter this approach in the time ahead. The desired economic growth, foreign direct investment, and generation of employment are all being accomplished with the assistance of the undervalued yuan, and the yuan's incremental appreciation thus far has worked to prevent excessive losses for China's holdings of U.S. debt and curb social unrest. In the judgment of the CCC, however, the yuan's undervaluation is generating dangerous and increasingly damaging economic imbalances for the United States, for the global community, and for China itself.

The Undervalued Yuan's Impact on the U.S. and Global Economies

China's direct intervention in currency exchange as well as controls over capital movements, along with rigidities in its banking and financial sector, prevents market forces of supply and demand from determining an equilibrium exchange rate for the yuan. As a result, the dollar's value remains artificially high and the yuan's value artificially low. This skewing of the yuan's exchange rate is contributing to the loss by the United States of capital investment, research and development, and manufacturing capability in a variety of important industries and is causing skilled and unskilled jobs migrate to China at an unprecedented rate. China's accumulation of approximately $1.3 trillion in foreign reserves is one worrisome indicator of how imbalanced the U.S.-China trade relationship has become.

The yuan's undervaluation means that those U.S. companies that have not already gone out of business or relocated to China are able to export relatively little to China in the way of manufactured items. The yuan's weakness against the dollar serves as a formidable barrier to market access by increasing a would-be Chinese importer's cost of importing any goods from the United States into China in a compounded fashion: not only is the basic price of an item inflated

in terms of yuan, but the cost to enter the item into China also is inflated in terms of yuan, notably China's ad valorem tariffs on imports.

With the yuan's undervaluation facilitating exports to the United States and curtailing imports from the United States, the U.S. bilateral trade deficit with China in 2005 hit a historic high of $203.8 billion and in 2006 hit another historic high of $235.4 billion. The pace thus far this year points to another record trade deficit in 2007 for the United States with China. U.S. exports to third countries also are diminished by the yuan's undervaluation. To a significant degree, the loss of U.S. sales to third countries can be attributed to underselling by imports into those countries from China.

The effect on the U.S. manufacturing sector has been severe. U.S. employment in manufacturing has declined by over 3 million jobs since early 2001 due to technological change, trade deficits with other countries generally, and other factors. In a study released earlier this month by Robert Scott and the Economic Policy Institute ("Costly Trade With China"), it is estimated that the loss of fully 1.8 million jobs can be attributed to the trade deficit of the United States with China, and approximately 1.3 million of those jobs were in manufacturing.

This sharp drop in U.S. manufacturing employment due to China has occurred as U.S. manufacturing in many sectors has slumped and not recovered from the recession at the turn of the century. Industrial machinery, electronic products including computers, communications equipment, electrical equipment, electric lighting, and batteries, and motor vehicles and parts are some of the sectors that have not fully recovered from the recession.

In this connection, it should be stressed that the increased imports into the United States from China are not merely displacing imports from other low-wage Asian countries that have chosen to send parts and components to China for final assembly before exportation of finished

products to the United States. Under this line of thought, imports from China merely take the place of imports that would otherwise come to the United States from other countries, such that U.S. domestic output and employment are supposedly left unaffected by China's undervalued yuan.

This argument is not borne out by the facts, first and foremost that skilled U.S. manufacturing jobs are being lost at an alarming rate, as discussed above. Moreover, while China is being used to a significant degree by a number of Asian countries as a platform for exports to the United States and other destinations, the U.S. Census Bureau's data show that between 2001 and 2006 the value of imports into the United States from India, Malaysia, Taiwan, Singapore, South Korea, and Thailand significantly increased individually and by 40 percent collectively, jumping from an aggregate value of approximately $130 billion in 2001 to $181 billion in 2006. With imports into the United States increasing from each of these six countries as well as from China, the notion that China is simply displacing imports that would in any event enter the United States from elsewhere does not withstand scrutiny.

With China's foreign reserves and subsidization, the yuan's undervaluation also facilitates large purchases by China of needed raw materials in the United States and elsewhere. These raw materials are sent to China and then made by companies in China into value-added, downstream products for export by China to the United States and elsewhere. One notable example of this phenomenon is that of copper cathode and copper-based scrap, which are critical raw materials for a wide range of items important to the U.S. economy and national security, including parts incorporated in printed circuit boards for commercial and defense applications and cartridge brass for ammunition. In prior decades, far more of these raw materials than is the case now was fabricated into finished and semi-finished products in the United States.

Reduced income and revenues for U.S. workers and companies mean erosion of the U.S. tax base and greater difficulty for state and local governments particularly to fund basic, much-needed infrastructural projects.

With its ever-rising foreign reserves noted above, thanks to the undervalued yuan, the Chinese government is using foreign exchange to purchase U.S. government and quasi-government debt. This situation bears close monitoring, as Chairman Bernanke commented earlier this year, but as matters stand now China and Japan – as the two countries with the largest shares of U.S. debt – are not yet in a position to trigger dangerous financial disruptions by selling off their holdings of U.S. debt. A recent White Paper by the CCC on this subject is attached.

With its excessive foreign reserves and the printing and sterilization of enormous amounts of yuan that keep the yuan undervalued, China's government has been engaged in increasing the money supply in China's banking system, which in turn lends funds to Chinese businesses that are creating further excess capacity. Much of these bank loans is applied to underwrite debt or otherwise subsidize China's state-owned banks and other favored industries in China to the detriment of U.S. firms.

The yuan's undervaluation additionally acts artificially to stimulate foreign direct investment in China. In 1994, when the yuan was first devalued, China's total utilized foreign direct investment was $33.77 billion, according to the data of China's Ministry of Commerce. Since then, with small aberrations in 1999, 2000, and 2005, foreign direct investment in China has steadily increased and in each of the last several years has topped $60 billion. With this shifting of investment to China, there has also been a relocation of research and development from the United States to China. This trend is especially worrisome from the standpoint of the

ability of the United States to maintain the technological innovation that is so vital to the national economy and security.

The situation is made worse because other Asian countries, particularly Japan, Taiwan, and Malaysia, also maintain undervalued currencies in order to compete with Chinese companies in China and global markets.

From a global standpoint, a similar picture emerges. According to the official trade data of China's 39 largest trading partners (among them the United States), China has enjoyed a global trade surplus since at least 1999, rising from $140.6 billion in that year to $470.1 billion in 2006. After adjustment for Hong Kong's re-export trade, China's global trade surplus with its 39 largest trading partners was still $464.2 billion in 2006. It should be noted that China's official trade data consistently have overstated the value of China's imports and consistently have understated the value of China's exports, such that China has substantially under-reported not only its bilateral trade surpluses with the United States and other countries, but also its global trade surplus for years.

In summary, China's undervalued currency is creating various serious imbalances that threaten the global financial system as well as the U.S. economy and national security.

The Yuan's Undervaluation Is A Prohibited Export Subsidy That Should Be Countervailed If China Insists on Continuing to Undervalue the Yuan

In terms of what options and strategies are available to the United States to address China's undervaluation of the yuan, the China Currency Coalition believes that the most promising and appropriate step that can be taken is amendment of the U.S. countervailing duty law to treat undervalued-exchange-rate misalignment by China or by any other country as a countervailable prohibited export subsidy. Such exchange measures are a hybrid by nature,

having both monetary and trade aspects, and so fall under the jurisdiction of the IMF and under the jurisdiction of the WTO.

On the one hand, under the IMF's guidelines in Article IV(1)(iii) of its Articles of Agreement and a 1977 Surveillance Decision on this topic, currency "manipulation" is defined as manipulation of exchange rates or the international monetary system "in order to" prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members. The language in the IMF's Articles of Agreement, as reflected in 22 U.S.C. § 5304(b), has been interpreted by the Treasury Department as containing an element of intent that the foreign government must undervalue its currency "for purposes of preventing effective balance of payments adjustments or gaining unfair competitive advantage in international trade" before a finding of currency "manipulation" is justified.

On the other hand, there is no such element of intent in the WTO's agreements on prohibited export subsidies. In particular, as long as a prohibited export subsidy exists under Articles 1, 2, and 3 of the WTO's Agreement on Subsidies and Countervailing Measures ("the SCM Agreement"), and as long as a U.S. domestic industry can demonstrate that it is being materially injured or threatened by material injury by reason of subsidized imports, relief in the form of countervailing duties on subsidized imports entering the United States to offset the amount of subsidization is warranted.

The question, then, is whether exchange-rate misalignment – which borrows from the IMF's concepts apart from the element of intent, and which is defined as the undervaluation of a foreign currency as a result of protracted large-scale intervention by or at the direction of a governmental authority in the exchange market – is a countervailable prohibited export subsidy within the meaning of the WTO's provisions. As turned to next, the CCC believes that the

answer to this question is yes and that the U.S. in a WTO-consistent manner should amend the U.S. countervailing duty statute at 19 U.S.C. § 1677(5) accordingly.

In its Accession Agreement with the World Trade Organization, China unqualifiedly committed to cease all export subsidies by all levels of government by the time of accession, December 11, 2001. Despite this pledge, China has persisted in its undervaluation of the yuan. Although the precise issue has never previously arisen in dispute settlement or apparently otherwise, the China Currency Coalition submits that the yuan's undervaluation is a prohibited export subsidy in violation of Articles 1, 2, and 3 of the WTO's SCM Agreement and the parallel Articles 3, 9, and 10 of the WTO's Agreement on Agriculture that build on the SCM Agreement's provisions.

Under Articles 1, 2, and 3 of the SCM Agreement, a measure must satisfy three criteria in order to be considered a prohibited export subsidy. In essence, there must be a governmental financial contribution (Article 1.1(a)(1)), a benefit must thereby be conferred (Article 1.1(b)), and such a subsidy must be specific by virtue of being contingent in law or in fact upon export performance (Articles 1.2, 2.3, and 3.1(a)). The yuan's enforced undervaluation by the Chinese government meets each of these criteria.

In a typical export transaction, having been paid for goods sold to a customer in the United States, the exporter in China must transfer the U.S. dollars received to the Chinese government in return for yuan at the undervalued exchange rate in effect.

In this sequence of events, the Chinese government first provides a financial contribution to the exporter by means of a direct transfer of funds and through the service of converting U.S. dollars into yuan.

Second, a benefit is conferred by this governmental financial contribution that is equal to the difference between what the yuan would be worth if its value were set by the market and its artificially low value as the result of China's undervaluation of the yuan. With the yuan undervalued by approximately forty percent, therefore, for each U.S. dollar earned by the sale of goods to the United States the Chinese exporter will receive approximately 7.6 yuan rather than 4.6 yuan. As this illustration demonstrates, the exporter in China is "better off" as the result of being given more yuan than if there were no undervaluation.

Third, and lastly, this subsidy is contingent upon export performance. Only after the exporter has been paid in U.S. dollars for the goods that have been exported to the United States is the exporter required and able to convert those proceeds into yuan.

The setting forth in these straightforward terms of why the yuan's undervaluation should be seen as a countervailable prohibited export subsidy is not intended to overlook various underlying and, in some instances, arguably contrary points that add complexity to the analysis. At least a few should be mentioned at this stage, therefore, and there are perhaps others that might be advanced. Also importantly, due to incomplete transparency by China, not all facts and details are known about exactly how China's system functions. At the same time, however, in the China Currency Coalition's opinion the evidence that is available is more than adequate to support the conclusion that the yuan's enforced undervaluation is a countervailable prohibited export subsidy.

For instance, with respect to the criterion that there be a governmental financial contribution under Article 1.1(a)(1) of the SCM Agreement, such a finding can rest on one or more of several grounds. As suggested above, the Chinese government's exchange of yuan in return for U.S. dollars can properly be viewed as "a government practice {that} involves a direct

transfer of funds," in line with Article 1.1(a)(1)(i). The yuan's undervaluation might also be considered a governmental provision of services under Article 1.1(a)(1)(iii), inasmuch as the Chinese government both exchanges the yuan for U.S. dollars and then "sterilizes" the issued yuan in order to avoid inflation and loss of value by the yuan within China. These services by China are financial contributions integral to the yuan's undervaluation relative to the dollar. Further, to the extent that the Chinese government entrusts or directs private bodies to conduct the exchanges and "sterilizations" of yuan, that activity likewise can reasonably be seen as a governmental financial contribution under Article 1.1(a)(1)(iv).

Also on the criterion of a governmental financial contribution, there are some who urge that a government's undervaluation of its currency constitutes a general infrastructural measure that cannot properly be deemed a subsidy. As the U.S. Department of Commerce indicated in its final rule in 1998 implementing the countervailing duty sections of the Uruguay Round Agreements Act, however, governmental financial contributions to the general infrastructure include the provision of such services and items as highways and bridges, schools, health care facilities, sewage systems, port facilities, libraries, and police protection that are for the public good and broad social welfare of a country, region, state, or municipality and that are available to all citizens or to all members of the public. As a macroeconomic policy, exchange-rate misalignment is a governmental financial contribution that does not directly build up a community's basic, functional features of the kinds just recounted, and is accessible to just those persons who are in a position to deal with foreign currencies.

With respect to the prerequisite of a benefit, there is a widespread, although not unanimous, consensus that the yuan is undervalued, but opinions vary as to how to measure the undervaluation. To the extent there is no private exchange market in China that can serve as a

trustworthy benchmark to determine the amount of the yuan's undervaluation, the CCC believes that a methodology should be employed for this purpose that is objective and consistent with widely recognized macroeconomic theory and that incorporates governmentally published and other publicly available and reliable data. A benchmark arrived at in this unprecedented fashion to measure the amount of the yuan's undervaluation admittedly would be open to challenge at the WTO by China.

In cases involving Korean DRAMS and Canadian softwood lumber, however, the United States has been upheld in the past at the WTO on other important, first-time interpretations of the SCM Agreement. In the case of Korean DRAMS, the U.S. Department of Commerce was affirmed in finding indirect governmental financial contributions through the Korean government's entrustment to private Korean banks of preferential loans, equity investment, and debt forgiveness for a Korean producer of DRAMS. In the case of Canadian softwood lumber, the agency was upheld in its reliance upon benchmarks outside the subsidizing government's territory to measure the benefit from undervalued Canadian stumpage rights. In the CCC's judgment, measurement of exchange-rate misalignment of the yuan by a responsible methodology could similarly be defended and affirmed on very solid grounds in dispute settlement at the WTO.

As to whether the subsidy due to the yuan's undervaluation is contingent, in law or in fact, upon export performance, and so is "specific" under Articles 1.2, 2.3, and 3.1(a) of the SCM Agreement and countervailable, it is evident that this subsidy in fact is tied to actual or anticipated exportation or export earnings within the meaning of the SCM Agreement's Article 3.1(a) n.4. It is also possible that Chinese law and regulations might expressly provide that this

subsidy is contingent upon exportation, but China's lack of transparency is an impediment to ascertaining the actual circumstances in this regard.

Another aspect as to whether this subsidy is specific and export-contingent concerns its availability also to persons and entities in China that have obtained U.S. dollars by means other than through the export of goods or services to the United States. On at least two occasions, however, in dispute settlement at the WTO (United States – Upland Cotton and United States – Tax Treatment for Foreign Sales Corporations), the WTO's Appellate Body has recognized that the granting of a subsidy under conditions apart from exportation does not undercut the de facto export-contingent nature of the subsidy when the grant is tied to exportation. As long as it can be established, therefore, that there is a clear distinction between the eligible domestic recipients and the eligible exporters and different conditions for each group to receive the subsidy, the prerequisite of specificity for a countervailable prohibited export subsidy should be met.

From a broader standpoint, there is the question of whether responsibility and authority over exchange-rate problems lies with the IMF or the WTO or is shared by these two international organizations. Opinions vary. In early 2006, the WTO's Director-General was quoted as saying that to his knowledge currency manipulation does not belong to the WTO's legal order. This remark, however, does not seem to consider that prohibited export subsidies fall within the bailiwick of the WTO and that undervaluation of a currency like the yuan can be a countervailable prohibited export subsidy under the WTO's provisions without necessarily comprising currency "manipulation" within the IMF's definition of that term.

The Director-General's comment additionally appears not to take into account relevant portions of Article XV, notably Article XV:4, of the General Agreement on Tariffs and Trade, the gist of which is that member states shall not, by exchange action, "frustrate" the intent of the

GATT and shall not, by trade action, "frustrate" the intent of the IMF's Articles of Agreement. An addendum to Article XV:4 elaborates by examples as to what is intended by use of the word, "frustrate." More exactly, this addendum notes that infringements of the letter of any of the GATT's Articles by exchange action shall not be viewed as a violation of the GATT if, in practice, there is "no appreciable departure from the intent of the Article." Also pertinent, Article XV:9(a) of the GATT holds that nothing in the GATT shall preclude a member state's use of exchange controls or exchange restrictions in accordance with the IMF's Articles of Agreement.

The purpose of Article XV generally may be said to be the harmonious working in tandem of the IMF's Articles of Agreement with the GATT and the WTO's other agreements. What is deemed by one organization as consistent with its charter should not be found violative of the other organization's charter if at all possible and *vice versa.* Toward this end, Article XV:2 of the GATT stipulates in pertinent part that in all cases in which the WTO is called upon to consider problems concerning monetary reserves, balances of payments or foreign exchange arrangements, the WTO's Member States shall consult fully with the IMF and shall accept the IMF's determination of whether action by a member state in exchange matters is in accordance with the IMF's Articles of Agreement.

It is apparent that the drafters of the GATT and the IMF's Articles of Agreement recognized that trade action and exchange action can overlap and that coordination on such occasions is desirable. As Professor Lowenfeld observes at page 501 n.5 of his book, "International Economic Law," there was an acute awareness on the part of the United States and other countries after World War II that the 1930s had seen frequent resort to many monetary

devices, including use of exchange controls and competitive currency depreciation, that had undercut recovery in international trade.

Over the years, there has indeed been a need for international monetary-trade coordination, for example, with issues concerning restrictions on imports due to problems with balance of payments. On the other hand, there has been little or no discussion or occasion of relevance calling for coordination on issues of currency "manipulation" or undervaluation.

In November 1996, consistent with this historical background, the IMF and the WTO entered into an agreement (the Fund-WTO Cooperation Agreement, dated November 25, 1996) acknowledging the increasing linkages between the various aspects of economic policymaking and designed to facilitate linkages between the IMF and WTO. More precisely, paragraph 8 of this agreement provides that the IMF shall inform in writing the relevant WTO body (including dispute settlement panels) that is considering exchange measures within the Fund's jurisdiction whether such measures are consistent with the IMF's Articles of Agreement. Paragraph 9 of this agreement also directs that the WTO's Director-General and the IMF's Managing Director shall ensure cooperation between the staffs of their two institutions and shall agree on appropriate procedures toward that end, including access to databases and exchanges of views on jurisdictional and policy issues. Article 10 of the Agreement obligates the staffs of the WTO and the IMF to consult with each other on issues of possible inconsistency between measures under discussion with a common member under the WTO's and IMF's agreements.

What these provisions might mean for China's enforced undervaluation of the yuan remains to be seen. The answer to this question depends in good part on whether this situation is viewed purely as a trade matter or purely as a monetary matter or, as mentioned above, as a hybrid of the two. If, as the China Currency Coalition believes should be the case, the yuan's

undervaluation is considered to be a hybrid by virtue of being a measure that is both monetary and trade in nature with serious ramifications for international trade, it is to be hoped that the WTO and the IMF would effectively work in tandem under the terms of their 1996 agreement.

In sorting through this situation, it will perhaps also be helpful to keep in mind the earlier comment that currency undervaluation that is a countervailable prohibited export subsidy in the WTO's eyes is not necessarily currency "manipulation" in the IMF's judgment, because the latter is concerned with the issue of intent whereas the former is not. Consideration of the problem of undervalued currencies as exchange-rate misalignment under the WTO's trade rules is especially important, because the IMF has no dispute settlement mechanism and, as a practical matter, no means at its disposal other than moral suasion to address the issue.

In this way, even if the IMF were to continue to be reluctant to find currency "manipulation" by China for lack of a showing of the requisite intent under the IMF's Articles of Agreement, recognition of the yuan's undervaluation as a countervailable prohibited export subsidy could legitimately and reasonably assist U.S. companies and workers in a WTO–consistent manner to weather the storm and perhaps act both as a spur to China to revalue the yuan more quickly and realistically than it has to this juncture and as a deterrent to undervalued-exchange-rate misalignment by countries generally now and in the future.

Thank you for inviting me to appear before you today.

ATTACHMENT

CHINA CURRENCY COALITION
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White Paper

U.S. Indebtedness to China and Japan Should Spur, Not Delay or Deter, Efforts to Offset Trade Imbalances Aggravated By Exchange-Rate Misalignment of the Undervalued Yuan and Yen
(April 20, 2007)

Concerns have been expressed by some that the United States is so indebted to China and Japan that it would be unwise of the United States to enforce existing trade agreements by treating these and other countries' undervaluation of their currencies as a countervailable prohibited export subsidy. Underlying this view is the thought that such corrective measures might lead China and Japan to respond in a retaliatory fashion by liquidating their U.S. debt securities and diversifying large amounts of their dollar holdings into other investments elsewhere. The fear is that the result of this action would cause a dangerous run on the dollar, dramatically raise U.S. interest rates to the serious detriment of the U.S. economy, and perhaps create a global financial crisis.

These anxieties are not borne out by the facts and practicalities. It is true that U.S. indebtedness to foreign lenders is large, and the trend-lines are troubling and indicative that U.S. indebtedness likely will continue to increase unless remedial steps are taken. China and Japan, however, finance a relatively small portion of overall U.S. foreign-held debt and a much smaller portion of U.S. credit market debt. Moreover, the dollar has a broad, deep, and competitive market based upon confidence in the United States and its economy. As Secretary Paulson observed in a hearing before the Senate Banking Committee on January 31, 2007, the dollar provides the best risk-adjusted return

available for investors' money. China and Japan, as significant holders of U.S. debt, presumably concur in this assessment and do not want to act in a way that would cause the dollar to weaken and the value of their investments in U.S. dollars to decrease. Under these circumstances, it is reasonable to conclude that the United States is not beholden to China and Japan for financing U.S. debt. Even if China and Japan were to shift some portion of their investments from the dollar to other currencies, it could be expected that other lenders would take their place.

With more particular regard to the value of holdings in U.S. securities by China, Japan, and other foreign countries, attached are three tables derived from recent reports by the U.S. Treasury Department and the U.S. Federal Reserve: Table 1A contains data as of June 2005 and June 2006 on the composition of foreign holdings of U.S. debt securities by the largest 25 lending countries and overall; Table 1B shows U.S. credit market debt for all sectors and by instrument as of June 2005 and June 2006; and Table 2 provides data on the 25 countries that are the largest foreign holders of U.S. credit and their shares of total market debt as of June 2006. A number of points from these reports are worth highlighting.

First, as noted in Table 1A, China held approximately $298 billion and Japan held approximately $666 billion, for a total of $964 billion, of U.S. Treasury short- and long-term securities as of June 2005. The preliminary data from June 2006 show China's number growing to $372 billion and Japan's number falling to $614 billion, for a total of

$986 billion. China and Japan together have accounted over the last two years for about half of the roughly $2 trillion in foreign-held U.S. Treasuries.

But foreign-held U.S. Treasuries are less than half of total U.S. Treasury debt. As shown in Table 1B, from June 2005 to June 2006, the total of U.S. Treasury securities outstanding grew from $4.49 trillion to $4.76 trillion. China's and Japan's cumulative share of U.S. Treasuries thus increased from 20.3 percent as of June 2005 to 20.7 percent as of June 2006.

As summarized in Table 1A, in June 2005 China held $527 billion and Japan held $1,091 billion in U.S. credit market debt, which includes U.S. Treasuries, U.S. government agencies' debt, municipal debt, corporate and other privately-issued debt, and equities. As of June 2006, the comparable figures were $699 billion for China and $1,106 billion for Japan.

When compared, therefore, with total U.S. credit market debt outstanding, which Table 1B records grew from $39.2 trillion in June 2005 to $42.7 trillion in June 2006, China's share was 1.3 percent as of June 2005 and 1.6 percent as of June 2006. Japan's share of total U.S. credit market debt outstanding was 2.8 percent as of June 2005 and 2.6 percent as of June 2006. Thus, in the very large total U.S. credit market, Japan and China held about 4.1 percent of outstanding credit as of mid-2005 and about 4.2 percent of outstanding credit as of mid-2006, and only a fraction of this debt has been held by their governments.

As reported in Tables 1A, 1B, and 2, from June 2005 to June 2006, credit held by foreigners increased $915 billion, from $6.86 trillion to $7.78 trillion. China and Japan accounted for $187 billion, or 20 percent of this increase, while 109 other entities also increased their holdings of U.S. debt, and 35 entities divested part of their holdings.

On February 28th, appearing before the House Budget Committee, Federal Reserve Chairman Ben Bernanke was asked to comment on what might happen to the market for U.S. debt securities if a foreign buyer like China or Japan were to sell off a significant portion of its holdings. Chairman Bernanke responded:

> It's not in the interest of China or Japan to dump treasuries on the market. They would themselves -- would suffer capital losses from doing that. I do think if there were -- and I should be very clear, I have no information or expectation this is going to happen, but if there were significant sales by foreign central banks, for example, that there would be some short-run effect on the market in terms of the currency and interest rates, probably. I think the longer-term effect would be somewhat less because the market would adjust -- it is a liquid market and the holdings of, say, China of U.S. debt securities, including both public and non-public, is only about 5 percent of the total credit market outstanding. So

obviously we're watching that very carefully. I don't see that as a major threat to our financial system or our economy.

Chairman Bernanke's evaluation echoes that of Secretary Paulson and is substantiated by the data just reviewed. Japan and China, individually and collectively, are important purchasers of U.S. debt, but as matters stand now are not in a position to trigger the sort of financial disruptions noted earlier by selling off their holdings. In the first place, as seen, those holdings are not that great in comparison with the total U.S. credit market debt outstanding, and the market would be able to adjust due to its liquidity.

In addition, as suggested by Chairman Bernanke, a reduction by China and Japan of the amount of their holdings of U.S. debt would entail capital losses for them. This factor was underscored recently in a report by the Associated Press that Stephen Green, Chief Economist at Standard Chartered Bank in Shanghai, calculated that China's central bank made a net profit of $29 billion on its reserve holdings. Japan also likely has realized sizable profits on its U.S. debt holdings. In the final analysis, Japan and China have too much at stake to jeopardize their trading relationships with the United States.

At the same time, if Congress does not take action to remedy the impact of exchange-rate misalignment on U.S. producers, the stability and strength of the U.S. economy will be eroded further and probably more quickly than has been the case to date. The trade and financial imbalances generated by protracted undervaluation of currencies will almost certainly be so extensive and devastating as to be extremely damaging to the national

economy and security not only of the United States, but also of the countries that indulge in the undervaluation and of the global community.

In summary, the risk is rather slight at this juncture of financial turmoil resulting for the United States or any other country from a statutory declaration that undervalued exchange-rate misalignment is a countervailable prohibited export subsidy. Doing so now actually should help to avoid severe economic fluctuations and debilitation. The real risk will be run down the road if amendment of the U.S. countervailing duty law is delayed. Calling a halt to tolerance of the protectionist policy of undervalued exchange-rate misalignment is very much necessary.

TABLE 1A -- FOREIGN HOLDINGS OF U.S. DEBT SECURITIES BY TOP 25 LENDING COUNTRIES, JUNE 2005 AND JUNE 2006

		Foreign holdings of debt securities by country as of preliminary June 2006 (top 25) ($Millions)						Foreign holdings of debt securities by country as of June 2005 ($Millions)					
No.	Country	Total	Equity Holdings	Short-Term & Long-Term Debt	U.S. Treasury Short- & Long-Term	Gov't Agency Short- and Long-Term	Corporate Short- and Long-Term	Total	Equity Holdings	Short-Term & Long-Term Debt	U.S. Treasury Short- & Long-Term	Gov't Agency Short- and Long-Term	Corporate Short- and Long-Term
1	JAPAN	1,106,396	194,542	911,855	613,915	188,519	109,421	1,091,430	177,674	913,757	666,440	142,469	104,847
2	CHINA, MAINLAND	698,929	3,818	695,111	372,234	263,878	58,999	527,275	2,542	524,733	297,811	190,347	36,575
3	UNITED KINGDOM	639,587	299,700	339,887	51,779	29,679	258,429	559,838	260,364	299,474	50,443	25,257	223,774
4	LUXEMBOURG	549,016	193,061	355,955	58,833	42,002	255,120	460,212	150,639	309,573	38,760	43,481	227,331
5	CAYMAN ISLANDS	485,044	178,083	306,961	24,513	45,255	237,193	429,983	152,204	277,779	37,208	50,361	190,211
6	CANADA	381,891	273,815	108,077	21,973	4,334	81,770	307,872	220,504	87,368	19,598	5,256	62,514
7	BELGIUM	330,776	21,415	309,361	13,710	43,763	251,888	334,886	18,062	316,824	15,619	51,244	249,962
8	NETHERLANDS	280,415	158,359	122,056	19,326	19,706	83,024	262,246	160,875	101,370	19,586	19,461	62,324
9	SWITZERLAND	261,939	144,511	117,427	39,171	10,250	68,006	238,236	129,159	109,077	36,373	10,693	62,011
10	MIDDLE EAST OIL-EXPORTERS	242,800	110,588	132,211	94,683	19,383	18,146	160,916	82,472	78,444	54,639	14,082	9,722
11	IRELAND	231,978	68,550	163,428	13,690	28,088	121,650	191,392	57,730	133,662	22,237	16,610	94,814
12	COUNTRY UNKNOWN	213,663	170	213,493	17	20	213,456	196,135	1,979	194,155	163	447	193,545
13	GERMANY	211,169	72,804	138,365	41,758	16,069	80,538	200,034	82,783	117,251	46,081	15,277	55,893
14	BERMUDA	205,610	60,033	145,577	28,749	30,885	85,943	201,895	59,054	142,841	27,991	30,476	84,374
15	FRANCE	164,216	95,324	68,892	25,888	6,287	36,717	122,138	71,331	50,807	24,776	2,455	23,576
16	SINGAPORE	162,766	100,662	62,104	35,174	6,854	20,077	144,165	88,715	55,450	34,258	6,380	14,812
17	TAIWAN	135,210	7,317	127,893	63,394	53,022	11,477	126,008	6,688	119,320	67,770	41,106	10,444
18	KOREA, SOUTH	124,213	1,323	122,890	65,578	45,924	11,388	118,257	1,132	117,125	62,933	45,075	9,117
19	RUSSIA	110,850	237	110,612	4,533	106,058	22	76,382	227	76,155	1,297	74,835	23
20	HONG KONG	110,113	22,098	88,015	48,604	26,538	12,873	95,925	23,347	72,577	44,336	20,340	7,901
21	AUSTRALIA	109,171	64,497	44,674	5,681	21,224	17,769	92,191	56,541	35,650	4,869	21,806	8,975
22	MEXICO	98,085	14,961	83,124	46,121	27,054	9,948	79,923	13,111	66,812	29,172	28,504	9,136
23	SWEDEN	81,065	47,780	33,284	13,296	4,872	15,116	84,198	49,397	34,802	16,874	4,601	13,326
24	BRITISH VIRGIN ISLANDS	77,707	46,120	31,587	11,978	3,723	15,886	75,094	46,692	28,402	10,938	2,890	14,573
25	NORWAY	74,707	42,633	32,075	3,118	5,394	23,562	68,211	37,317	30,894	8,484	5,922	16,488
TOTALS	TOP 25 + ALL OTHERS	7,779,249	2,431,201	5,348,048	1,980,140	1,131,467	2,236,442	6,864,260	2,143,885	4,720,375	1,882,379	940,631	1,897,364

Source: U.S. Department of Treasury Report On Foreign Holdings of U.S. Securities (Mar. 30, 2007).

TABLE 1B

For use at 12:00 p.m., eastern time
Thursday
December 7, 2006

FEDERAL RESERVE statistical release

Z.1

Flow of Funds Accounts of the United States

Flows and Outstandings
Third Quarter 2006

Board of Governors of the Federal Reserve System, Washington DC 20551

L.4 Credit Market Debt, All Sectors, by Instrument

Billions of dollars; amounts outstanding end of period, not seasonally adjusted

		2001	2002	2003	2004	2005 Q1	2005 Q2	2005 Q3	2005 Q4	2006 Q1	2006 Q2	2006 Q3	
1	**Total**	**29257.9**	**31726.6**	**34614.0**	**37703.7**	**38372.8**	**39181.3**	**39941.3**	**41041.4**	**41891.5**	**42712.0**	**43467.4**	1
2	Open market paper	1571.1	1507.6	1432.5	1567.2	1606.2	1668.5	1744.1	1833.9	1901.3	1960.9	2090.4	2
3	Treasury securities	3352.7	3609.8	4008.2	4370.7	4535.6	4493.1	4566.0	4678.0	4834.4	4759.6	4803.2	3
4	Agency- and GSE-backed securities	4989.1	5536.3	6108.1	6225.6	6177.9	6177.3	6165.0	6275.8	6387.2	6526.7	6557.7	4
5	Municipal securities	1603.5	1762.9	1900.5	2031.0	2085.7	2134.2	2176.1	2225.6	2254.9	2305.7	2337.5	5
6	Corporate and foreign bonds	5487.4	6121.5	6890.6	7675.0	7857.6	8082.9	8162.1	8358.4	8518.7	8721.3	8872.6	6
7	Bank loans n.e.c.	1424.3	1344.2	1283.9	1332.4	1353.5	1398.9	1423.9	1491.4	1547.3	1583.0	1623.7	7
8	Other loans and advances	1444.5	1464.7	1499.2	1590.2	1604.8	1666.5	1664.8	1707.2	1702.9	1760.4	1763.0	8
9	Mortgages	7485.6	8366.6	9373.9	10677.8	10935.7	11319.7	11751.1	12145.8	12450.8	12765.5	13033.1	9
10	Consumer credit	1899.6	2013.0	2117.0	2233.9	2215.8	2240.1	2288.1	2325.3	2293.9	2328.8	2386.2	10
	Memo:												
	Selected claims not included above:												
11	Corporate equities	15310.6	11900.5	15618.5	17389.3	17002.3	17185.9	17914.7	18277.0	19140.8	18668.9	19306.3	11
12	Mutual fund shares	4135.4	3638.4	4654.2	5436.3	5471.6	5595.7	5874.4	6048.9	6464.1	6420.0	6625.8	12

L.5 Total Liabilities and Its Relation to Total Financial Assets

Billions of dollars; amounts outstanding end of period, not seasonally adjusted

		2001	2002	2003	2004	2005 Q1	2005 Q2	2005 Q3	2005 Q4	2006 Q1	2006 Q2	2006 Q3	
1	**Total credit market debt (from table L.4)**	**29257.9**	**31726.6**	**34614.0**	**37703.7**	**38372.8**	**39181.3**	**39941.3**	**41041.4**	**41891.5**	**42712.0**	**43467.4**	1
2	Official foreign exchange	46.8	55.8	62.3	62.2	56.3	54.3	52.0	45.9	46.0	48.3	46.5	2
3	SDR certificates	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2	3
4	Treasury currency	24.5	25.5	26.0	26.7	26.9	27.2	27.4	27.5	27.6	27.8	28.1	4
5	Foreign deposits	810.1	831.1	867.8	957.7	1062.7	1010.0	1032.9	1044.5	1101.8	1161.7	1185.8	5
6	Net interbank liabilities	191.4	206.0	193.3	212.2	196.6	207.6	204.3	220.3	198.1	154.5	151.3	6
7	Checkable deposits and currency	1360.2	1351.9	1432.0	1521.8	1499.7	1514.6	1481.9	1525.0	1508.6	1538.5	1493.4	7
8	Small time and savings deposits	3370.5	3695.9	4001.7	4284.6	4376.0	4408.5	4523.7	4599.4	4688.7	4733.0	4791.4	8
9	Large time deposits	1121.0	1171.0	1232.8	1504.9	1575.4	1637.1	1738.0	1776.0	1876.1	1949.0	2053.7	9
10	Money market fund shares	2240.6	2223.9	2016.4	1879.8	1841.0	1831.5	1876.7	2006.9	2014.1	2067.4	2166.5	10
11	Security RPs	1233.7	1340.3	1567.5	1650.7	1782.8	1911.3	1983.9	2005.6	2127.7	2221.8	2371.4	11
12	Mutual fund shares	4135.4	3638.4	4654.2	5436.3	5471.6	5595.7	5874.4	6048.9	6464.1	6420.0	6625.8	12
13	Security credit	825.9	738.8	871.3	1037.9	1051.5	1064.5	1068.0	1030.2	1105.2	1147.9	1180.7	13
14	Life insurance reserves	880.0	920.9	1013.2	1060.4	1059.4	1067.2	1077.7	1082.6	1091.6	1092.6	1103.1	14
15	Pension fund reserves	8766.4	8068.0	9672.7	10636.8	10461.7	10666.5	10954.2	11176.7	11393.8	11271.4	11633.8	15
16	Trade payables	2372.3	2460.2	2485.2	2674.6	2721.6	2783.4	2867.6	2914.2	2950.5	3030.0	3087.5	16
17	Taxes payable	219.2	241.4	240.5	268.1	285.0	287.7	295.8	295.7	311.6	311.8	321.1	17
18	Miscellaneous	11281.6	11976.1	12431.7	13877.4	13895.1	14106.8	13878.6	13982.4	13807.0	13807.1	14043.7	18
19	**Total liabilities**	**68139.7**	**70674.1**	**77384.5**	**84798.0**	**85738.2**	**87357.6**	**88880.3**	**90825.3**	**92606.1**	**93697.0**	**95753.3**	19
	+ Financial assets not included in liabilities:												
20	Gold and SDRs	21.8	23.2	23.7	24.6	22.6	22.3	19.3	19.3	19.4	19.7	19.7	20
21	Corporate equities	15310.6	11900.5	15618.5	17389.3	17002.3	17185.9	17914.7	18277.0	19140.8	18668.9	19306.3	21
22	Household equity in noncorp. bus.	4805.7	4970.0	5399.6	5957.7	6133.1	6357.7	6555.0	6739.9	6942.3	7055.0	7140.9	22
	- Liabilities not identified as assets:												
23	Treasury currency	-8.6	-9.1	-9.5	-9.7	-9.6	-9.4	-9.0	-9.1	-10.3	-10.2	-10.0	23
24	Foreign deposits	630.9	652.5	705.9	767.9	864.1	803.3	808.9	813.2	873.9	941.0	972.1	24
25	Net interbank transactions	11.1	15.5	12.6	27.3	35.7	23.3	27.5	38.5	44.0	44.4	45.5	25
26	Security RPs	390.6	426.6	402.6	258.8	361.1	427.7	413.5	389.8	461.9	551.3	636.6	26
27	Taxes payable	93.3	126.3	69.3	96.2	91.9	97.0	80.8	95.4	93.1	74.3	56.7	27
28	Miscellaneous	-3450.2	-3269.9	-3026.9	-2878.7	-3117.5	-3104.3	-3451.4	-3378.6	-3599.6	-3853.0	-3827.7	28
	- Floats not included in assets:												
29	Checkable deposits: Federal govt.	-12.3	-11.7	-17.9	11.2	4.9	1.7	2.8	1.8	1.5	1.5	2.7	29
30	Other	21.6	20.9	20.8	20.6	16.4	19.6	12.4	20.6	16.4	19.7	12.4	30
31	Trade credit	-140.5	25.3	64.9	58.9	-3.5	-34.9	-19.6	39.7	-11.3	-29.3	-24.8	31
32	**Totals identified to sectors as assets**	**90742.0**	**89591.5**	**100204.4**	**109817.1**	**110652.5**	**112699.3**	**115503.3**	**117850.0**	**120838.9**	**121700.8**	**124356.7**	32

TABLE 2 -- 25 LARGEST FOREIGN HOLDERS OF U.S. CREDIT MARKET DEBT (MILLION $), PRELIMINARY JUNE 2006 DATA

No.	Country	% Holdings of U.S. Credit Market Debt Outstanding	Increase In U.S. Debt Holdings June 2005 - June 2006	% Increase In U.S. Debt June 2005 - June 2006	% Holdings Of U.S. Treasury Securities
1	JAPAN	2.6%	14,966	1%	13%
2	CHINA, MAINLAND[1]	1.6%	171,653	33%	8%
3	UNITED KINGDOM	1.5%	79,749	14%	1%
4	LUXEMBOURG	1.3%	88,804	19%	1%
5	CAYMAN ISLANDS	1.1%	55,060	13%	1%
6	CANADA	0.9%	74,019	24%	0%
7	BELGIUM	0.8%	-4,110	-1%	0%
8	NETHERLANDS	0.7%	18,169	7%	0%
9	SWITZERLAND	0.6%	23,703	10%	1%
10	MIDDLE EAST OIL-EXPORTERS[3]	0.6%	81,883	51%	2%
11	IRELAND	0.5%	40,586	21%	0%
12	COUNTRY UNKNOWN	0.5%	17,528	9%	0%
13	GERMANY	0.5%	11,136	6%	1%
14	BERMUDA	0.5%	3,715	2%	1%
15	FRANCE	0.4%	42,077	34%	1%
16	SINGAPORE	0.4%	18,601	13%	1%
17	TAIWAN	0.3%	9,201	7%	1%
18	KOREA, SOUTH	0.3%	5,956	5%	1%
19	RUSSIA	0.3%	34,468	45%	0%
20	HONG KONG	0.3%	14,188	15%	1%
21	AUSTRALIA	0.3%	16,980	18%	0%
22	MEXICO	0.2%	18,162	23%	1%
23	SWEDEN	0.2%	-3,134	-4%	0%
24	BRITISH VIRGIN ISLANDS	0.2%	2,614	3%	0%
25	NORWAY	0.2%	6,497	10%	0%
TOTALS	TOP 25 + ALL OTHERS	18%	914,989	13%	42%

Source: U.S. Department of Treasury Report On Foreign Holdings of U.S. Securities (Mar. 30, 2007); and U.S. Federal Reserve Statistical Release, Flow of Funds Accounts of the United States (Dec. 7, 2006).