TESTIMONY OF PATRICK A. MULLOY
BEFORE THE SUBCOMMITTEE ON INTERNATIONAL TRADE AND FINANCE
SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
HEARING ON U.S. ECONOMIC RELATIONS WITH CHINA: STRATEGIES AND OPTIONS ON EXCHANGE RATES AND MARKET ACCESS

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Introduction

Chairman Bayh, Ranking Member Martinez, and members of the Subcommittee, thank you for providing me with this opportunity to speak before you today on these important matters.

My name is Patrick Mulloy and I served as a member of the twelve person bipartisan, bicameral United States-China Economic and Security Review Commission from its creation in early 2001 through the end of 2006. I presently serve as the Washington Representative of the Alfred P. Sloan Foundation and also teach International Trade Law and Public International Law as an Adjunct Professor at the law schools of George Mason University and Catholic University.

I commend the Subcommittee for holding this important oversight hearing and I am honored by the invitation to testify. It is a source of enormous personal satisfaction for me to have served in a bipartisan manner on the staff of this committee from 1983 to early 1998 when I left to take a position as Assistant Secretary in the Department of Commerce's International Trade Administration where I headed the Market Access and Compliance unit. During the period of 1987-1988, when the provisions of the 1988 Omnibus Trade Law dealing with "Exchange Rates and International Economic Policy Considerations" were being formulated by this Committee, I served as the Committee's General Counsel and was directly involved in the negotiations which led to their formulation. Chairman Dodd and

Ranking Member Shelby are the only members of the Committee today who were involved in crafting the Banking Committee's contribution to the Omnibus Trade and Competitiveness Act of 1988. Among other things the Banking Committee contributions required the Treasury Department to identify countries that manipulate their currency to gain trade advantages. I was invited today to give the Committee my understanding of the background and early implementation of those provisions of law and also to discuss how they relate to China' current exchange rate practices.

I should note that the views I will present today are my own and not necessarily those of any of my present employers nor the U.S. China Economic and Security Review Commission.

Banking Committee Formulation of the Exchange Rate Provisions of the 1998 Trade Bill

Under Article I, Section 8 of the United States Constitution it is the Congress, not the Executive Branch, which is charged with the regulation of both foreign commerce and the value of our currency. In 1987 the leadership of the Congress, troubled by our nation's rising trade deficit, decided to craft an Omnibus Trade Bill and charged each relevant Committee in the House and Senate to formulate portions of such a bill that fell under such Committee's jurisdiction. Senator Proxmire, then Chairman of the Banking Committee, asked the International Finance Subcommittee, then led by Senators Sarbanes and Heinz, to develop the Banking Committee's portions of such a bill. Chairman Proxmire asked me as his General Counsel to work closely with the Subcommittee and to keep him informed of developments. I thus worked closely with Senators Sarbanes and Heinz and was personally involved with all facets of the Banking Committee's contribution to the Omnibus Bill.

The Banking Committee on May 19, 1987 marked up and ordered to be reported S. 1409, the United States Trade Enhancement Act of 1987, which dealt with a number of trade issues within the Committee's jurisdiction including exchange rates and international economic negotiation. The Committee Report stated:

> "The cumulative trade deficits of over $500 billion, built up by the U.S. since 1982, have made this country the world's largest debtor nation and underscore the need of our economy to compete internationally."

The various portions of this Omnibus Trade Bill reported by each Senate Committee were merged into one bill, each Title of which was managed by its authoring Committee and considered sequentially on the Senate floor during the summer of 1987. The House followed a similar procedure and in fact passed its bill H.R. 3 first. This was because the trade bill was considered a revenue measure on which the House had to act first. The Senate, at the conclusion of its work on its trade bill in August 1987, took up H.R. 3, substituted the text of the Senate bill and called for a conference with the House. Small groups of Senators from each Committee were appointed to conference the different portions of the Senate bill within the jurisdiction of each Committee. Senators Sarbanes, Dixon and Heinz of the Senate Banking Committee conferenced the provisions dealing with exchange rates and international economic negotiations.

The Conference Report Provisions

On April 20, 1988 the Conference Report on the Omnibus Trade and Competitiveness Act of 1988 was agreed upon and ordered to be presented. Title III of the Conference Bill dealt with International Financial Policy. Subtitle A dealt with "Exchange Rates and

International Economic Policy Coordination". In Section 3002 of the bill, which became law, Congress found that:

> "…a pattern of exchange rates has at times developed, which contribute to substantial and persistent imbalances in the flow of goods and services between nations imposing serious strains on the world trading system… **policy initiatives of some major trading nations that manipulate the value of their currencies in relation to the United States dollar to gain competitive advantage continue to create serious competitive problems for United States industries."**

Section 3003 of the Bill stated the "goal of the United States in international negotiations" was to achieve macroeconomic policies consistent with more appropriate balances in trade.

Multilateral Negotiation Provisions

Section 3004 (a) of the bill charged the President to engage in "multilateral negotiations" to achieve among other things:

> "more appropriate and sustainable levels of trade and current account balances, and exchange rates of the dollar and other currencies consistent with such balances."

Bilateral Negotiation Provisions

Section 3004 (b) of the bill entitled "Bilateral Negotiations" stated:

> 'The Secretary of the Treasury **shall** analyze on an annual basis the exchange rate policies of foreign countries, in consultation with the International Monetary Fund, and consider whether countries manipulate the rate of exchange between their currency and the United States dollar for purposes of preventing effective balance of payment adjustments or gaining unfair competitive advantages in international trade.'

That section went on to state that if the Secretary

> "considers that such manipulation is occurring with respect to countries that (1) have material global current account surpluses and (2) have significant bilateral trade surpluses with the United States, the Secretary of the Treasury **shall** take action to initiate negotiations with such foreign countries on an expedited basis, in the International Monetary Fund or bilaterally, for the purpose of ensuring that such countries **regularly and promptly** adjust the rate of exchange between their currencies and the United States dollar to permit effective balance of payment adjustments and to eliminate the unfair advantage…

<u>Treasury's Need to Be Honest Is Cited</u>

In the Conference Report the conferees also stated:

> **"It is the intent of the Conferees through the reporting requirement to increase the accountability of the Executive Branch regarding the impact of the exchange rate on foreign borrowing and the competitive position of U.S. industries as reflected in the nation's trade and current account balances…**

The Conferees then went on to state: "The success of the legislation hinges on the process of reporting and consultation by the Secretary of the Treasury with Congress". The Conferees knew the legislation could not achieve its purposes if the Treasury Department failed to accurately report on whether foreign governments were manipulating their currencies. That was a crucial first step to have the Congress and Executive Branch work together to develop strategies to counter the unfair practice.

<u>Reports on Foreign Treatment of United States Financial Institutions</u>

Two other sections of Title III of the Omnibus Trade Act of 1988 that have not received as much attention as the Exchange Rate sections are also relevant to the subject matter of the this hearing. They are Sections 3602 and 3603. Section 3602 requires the

Secretary of the Treasury to submit to Congress every four years beginning in December 1, 1990 a report which identifies countries which are denying U.S. financial firms national treatment, that is, equitable market access. Section 3603 requires the President or his designee (read Secretary of the Treasury) to conduct market access discussions with the governments of such identified countries that are major financial centers.

The first such report issued in December 1990 identified a number of countries whose financial firms had good access to the U.S. market but denied U.S. firms access to their own market. The Committee used that report as a basis for crafting a piece of legislation entitled "Fair Trade in Financial Services". This legislation would have required U.S. financial regulators and the Treasury to deny market access in the United States to financial firms from countries that denied market access to U.S. financial firms. That bill passed the Senate and the House and although it was never enacted into law it did play a major role in opening up the Japanese financial market to U.S. financial firms and demonstrated how the Congress and the Executive Branch could work together to achieve policy goals set by the Congress.

My understanding is that even though the provision of law requiring such national treatment reports regarding financial services is still on the books, the Treasury Department on its own decided to stop preparing them and submitting them to the Congress. I believe it would be very useful if the Banking Committee were to write to the Treasury asking it to carry out that legislative requirement. It would permit the Congress to better carry out its oversight of the important goal of achieving market access for U.S. financial firms in major foreign markets.

The Treasury at First Actively Identifies Currency Manipulators

The exchange rate provisions of the Omnibus Trade Law were enacted into law in the final months of the Reagan Administration in 1988. The new Administration of President George Herbert Walker Bush made good use of the new tools given to it by Congress to go after countries that manipulated their currencies. That Administration had no difficulty identifying and reporting to Congress that at various times Korea, Taiwan and China were currency manipulators. It negotiated with each to put an end to the cited practices it then found objectionable. The then Under Secretary of the Treasury for International Affairs David Mulford, who is now Ambassador to India, told the Committee he found the law most helpful and commended the Committee for formulating it.

The Committee should understand that such identifications of currency manipulators and successful negotiations to curb the cited practices took place during the period before the United States joined the World Trade Organization in 1994. Prior to joining in 1994 we still maintained unimpaired Section 301 of the Trade Act of 1974 as amended by the 1988 Omnibus Trade Act. Under Section 301 the USTR maintained the ability to identify unfair trade practices of foreign governments that damaged U.S. commerce and to impose duties or other import restrictions in retaliation. We had the ability under Section 301 to use access to our market as a lever to open foreign markets or to negotiate to end unfair trade practices utilized by foreign governments.

Use of Section 301 Curbed by Our Entry into the WTO

The United States gave up the ability to use Section 301 unilaterally to target unfair trade practices when it joined the World Trade Organization. Although Section 301 is still on the books it now only provides a vehicle whereby private industry or certain Committees

of Congress can petition USTR to negotiate with foreign governments about unfair trade practices or to take cases to the WTO. It also provides the Executive Branch with the statutory authority to implement WTO authorized retaliatory action that would be permitted only after winning a case in the WTO's dispute settlement process.

Because Section 301 remained on the books after we entered the WTO there were concerns voiced by some countries that it might be used contrary to our WTO obligations. The European Union thus brought a case in the WTO claiming that the U.S. by **simply** maintaining the statute on its books was violating its WTO obligations. The WTO Panel which handled the dispute did not find that having Section 301 on our books was itself a WTO violation because it noted the U.S. Government agreed it would use the provision of law only to implement actions permitted after a WTO dispute settlement process was completed. (See International Economic Relations: Cases and Materials by Jackson, Davey and Sykes at page 331).

Once China joined the WTO in 2001 the U.S. Government lost its ability to take unilateral action under Section 301 against China for unfair trade practices such as currency manipulation. This does not mean we can not use other provisions of our law to target specific unfair trade practices utilized by the Chinese to increase their exports to our market such as dumping or export subsidies. The Chinese under priced currency is clearly acting as an export subsidy to Chinese exporters and should be countered by countervailing duty tariffs.

The Treasury Failed To Utilize the Exchange Rate Provision of the 1988 Trade Bill from 1994 to the Present

The Treasury Department has failed to utilize the exchange rate provisions of the 1988 Trade Bill since 1994. Despite very evident practices of exchange rate manipulation by a number of Asian nations, including China, the Treasury has read the relevant provisions of the 1988 Trade Bill in a tortured manner in order to avoid carrying out the important task given it by Congress regarding the policing of currency manipulation. For some reason which is difficult to fathom the Treasury has been reluctant to use the tool this Committee crafted to have the Congress and Executive Branch work together to head off currency manipulation that harms our industries and workers. Perhaps its officials are closer to certain interests which would consider naming currency manipulators a "protectionist" practice. The Treasury's failure to be honest with Congress has consequences even to its own efforts to curb China's illegal currency practices. In September of 2005 when Tim Adams, the Treasury Under Secretary for International Affairs, publicly criticized the IMF for failing to police blatant violations of the IMF provisions forbidding currency manipulation, which will be discussed below, Mr. Rodrigo de Rato, the IMF Managing Director defended the IMF by retorting that the Treasury had not named China a currency manipulator in its own reports to the Congress.

In recent years under Chairmen Sarbanes, Shelby and Dodd this Committee has taken a very active role in calling the Treasury to account for its failure to carry out its statutory duties on exchange rates. It has pressed that agency to acknowledge the reality of how China and other Asian nations are using under priced currencies to undermine our domestic manufacturers and encourage them to outsource their operations to Asia to survive. Because of the Treasury's reluctance to carry out its statutory duties the Committee might consider changes to the current law that would give the Congress a greater role in policing currency

manipulation as an illegal and unfair trade practice. It is the Congress, after all, that has the authority under the Constitution to take the lead in foreign commerce matters.

Reports of the Bipartisan China Commission Cite China

The bipartisan U.S.-China Economic and Security Review Commission, on which I served three two year terms, has had no problem identifying China as a currency manipulator. In its very first Report to the Congress in July 2002 the Commission stated:

> "The exchange rate of the Chinese yuan to the dollar is also an important factor contributing to the U.S. deficit … China accomplishes this by large official purchases of dollars in order to maintain an exchange rate lower than would otherwise occur by market forces alone. By holding down the exchange rate China gains an unfair trade advantage that increases the U.S. trade deficit beyond what the market would dictate."

That statement by the Commission was made almost five years ago. Instead of taking action in a timely manner to stop the practice the Treasury has permitted this problem to metastasize creating a much more difficult issue with China, giving China increasing leverage over our economy, and doing great harm to the U.S. manufacturing base, including our defense manufacturing base.

The bipartisan China Commission in three subsequent reports to the Congress issued in June 2004, November 2005 and November 2006 has described how China's exchange rate policies violate both its WTO and IMF obligations and is doing great damage to America's manufacturing and industrial base.

China's Exchange Rate Policies Violate Both its WTO and IMF Obligations

The Chinese Vice Premier Madam Wu Yi, who is leading the Chinese delegation at this week's Strategic Economic Dialogue with Treasury Secretary Paulson, said last week that "the U.S. should not politicize trade issues." Secretary Paulson in turn is quoted in the May 22nd Washington Post as telling his Chinese counterparts "that Congress legislates on trade and there is a protectionist sentiment in this country." These statements imply that we are politicizing trade issues or acting protectionist if we ask China to live up to its legal obligations. I have often heard other Chinese officials claim that they have a "sovereign" right to control their own exchange rates policies. This would be true if they had not joined the International Monetary Fund and the World Trade Organization. By joining these organizations, from which they derive enormous benefits, China has agreed to follow the rules set forth in the treaties that establish and govern these organizations. If China were not a member of the WTO the United States would not have to give China most-favored-nation (MFN) trade treatment. Without MFN treatment Chinese goods would face over a 40 percent average tariff entering the United States. Because we give China MFN trade treatment as a member of the WTO their average tariff for goods exported to the United States is less than three percent. Every day as China violates its WTO and IMF obligations to us, we continue to permit it virtually unimpeded access to our markets. Demanding that China live up to its legal obligations is not acting in a protectionist manner. In fact those who countenance illegal foreign trade practices that inflict massive damage on our domestic corporations and their workers will bring about the very protectionist reaction they claim to fear. Let me explain what treaty obligations governing exchange rates China is violating.

a) China's IMF Obligations

The International Monetary Fund (IMF) was established in 1945 to help nations cooperate to avoid some of the economic and trade problems that marked the 1920's and 1930's. Article I of the IMF Charter, which is a treaty, states that one of its purposes is to

> "promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciations."

Article IV of the IMF Charter, entitled "Obligations Regarding Exchange Arrangements", obligates each member nation:

> **"to avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustments or to gain an unfair competitive advantage over other members"**

The IMF has adopted surveillance provisions to guide member nations on how various IMF Articles will be interpreted. With regard to surveillance of Article IV it defined currency manipulation as:

> **"protracted large scale intervention in one direction in the exchange market."**

China is blatantly violating this IMF obligation by having its Central Bank on a regular basis intervene in currency markets to purchase hundreds of billions of dollars in order to prop up the dollar's value against the yuan, the Chinese currency. The more U.S dollars China earns in trade, the more purchases of U.S. dollars China's Central Bank makes. In the first quarter of 2007 it bought about $45 billion dollars monthly which exceeds last years purchases significantly. This is because China's bilateral trade surplus with us and its global surplus are both increasing dramatically. Its surplus with us this year will be above $250 billion and its global surplus will be near $300 billion. In the last decade the United States has run trade deficits with China totaling nearly $1.2 trillion. China has also

accumulated foreign currency reserves of over $1.2 trillion dollars, many of which are in U.S. dollar reserves. They invest these dollars in U.S. Treasury bills and other dollar obligations such as those issued by Fannie Mae and Freddie Mac. These re-cycled dollars help keep U.S. interest rates lower than they would otherwise be, but also give the Chinese Government increasing leverage over the health of the American economy. We also must pay the interest on these bonds to the Chinese Government so we send China additional dollars to what they earn on their ever increasing trade surpluses with us. This adds to our current account deficit. It is a situation that poses a real danger to our national interests if left to worsen. China's exchange rate practices also violate China's WTO/GATT Commitments.

b) <u>China's WTO/GATT Commitments</u>

The WTO rules governing exchange rates derive from the pre-existing Article XV of the General Agreement on Tariffs and Trade which was incorporated as part of the legal commitments assumed by WTO members when the latter organization was created in 1994. Article XV of the GATT entitled "Exchange Arrangements" states in part:

> "Contracting parties shall not by exchange actions frustrate the intent of the provisions of this Agreement, nor by trade actions, the intent of the provisions of the Articles of Agreement of the International Monetary Fund"

The intent of the GATT Agreement as stated in the organization's preamble states the desire of its parties to enter into:

> "reciprocal and mutually advantageous arrangements related to the substantial reduction of tariffs and other barriers to trade and to the elimination of discriminatory treatment to international commerce."

Moreover there is a direct linkage between GATT Article XV and IMF Article IV since the GATT Article XV states that the GATT when dealing with problems regarding

foreign exchange arrangements shall consult fully with the IMF. It is thus very important to ensure that, if the United States should decide to bring a WTO case against China for its currency manipulation, it should also be working within the IMF to convince its members that China's exchange rate actions violate that institution's Article IV obligations and are creating very serious imbalances in today's global economy that threaten its stability. The G-7 Finance Ministers at their meeting on February 10, 2007 called for a rise in the Yuan's trade weighted exchange value.

China's Exchange Rate Practices Are Part of Its Larger Economic Strategy

In my additional views filed under the U.S.-China's Economic and Security Review Commission's 2006 Report I stated that:

> "China has instituted economic incentives, including subsidies and an under priced exchange rate to induce foreign companies including U.S. multinational corporations to increase their "shareholder value" by transferring production facilities and technology to China. There they can achieve higher profits by producing goods for sale back to the United States and to other markets. Such incentives are part of China's "export led growth strategy".

This Chinese export led growth strategy contributes to the enormous imbalances in our economic and trade relationship with China, and to the erosion of America's manufacturing and technology base. America's corporations may achieve short-term increases in shareholder value by cooperating with such a strategy but overall the situation poses a long term threat to America's economic primacy and even our national security as we lose skills and capacities essential to our defense industrial base.

Our Corporate and National Interests Have Diverged

The above discussion should not imply that the single minded focus on shareholder value demonstrated by U.S. based multinational corporations is somehow an indication of malevolent behavior. Rather it demonstrates recognition of the fact that there can be fundamental conflicts between the goals of U.S. companies (which are operating in a system that requires and rewards them to make profits for the corporation's shareholders) and our broader national interests. Sixty per cent of China's exports are made by foreign invested companies in China. That nation's current economic strategy is based on its understanding of how to motivate the behavior of the world's multinational corporations to help it build its economy. China has been following such a strategy since 1978 with ever increasing success. In recognition of this fact, America's elected officials must reclaim control of the policy agenda of our economic relationship with China from the corporate sector. Our public officials, who are accountable to all our citizens and not just corporate shareholders, must develop policies to give U.S. companies incentives to serve America's national interest by keeping and creating in this country good paying high tech jobs that sustain high living standards and our defense industrial base.

Conclusion

We as a nation need a coordinated comprehensive national policy and strategy to compete in the global economy. Such a strategy must be multifaceted, including among other things, developing measures to incentivize corporations to keep higher value added jobs in this country, increased emphasis on science education, modernizing our nation's infrastructure, vigorously enforcing our trade laws and agreements, increasing funding incentives for breakthrough technologies, getting our fiscal affairs in order, reforming health

care to reduce its costs to our businesses, and ensuring we do not countenance exchange rate practices that undermine our domestic manufacturers.

Thank you again for giving me the opportunity to present my views on these important matters. I hope they are of some assistance to this great Committee on whose staff I happily served for many years. I will be pleased to answer any questions you have on these issues.