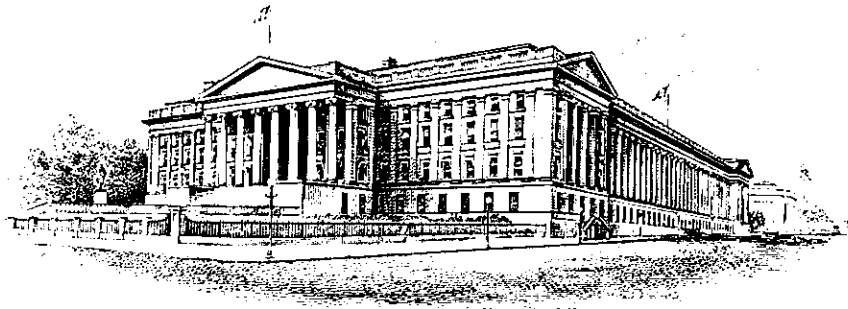




DEPARTMENT OF THE TREASURY

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**Testimony of Treasury Secretary John W. Snow
Before the
Senate Committee on Banking, Housing and Urban Affairs
on the Treasury Department's
"Report to Congress on International Economic and Exchange Rate Policies"**

May 26, 2005

Chairman Shelby, ranking member Sarbanes, members of the Committee, it is a great pleasure to appear before you to testify on the Treasury Department's latest report on "International Economic and Exchange Rate Policies."

The May 2005 Report encompasses a period of strong global economic performance, which reflects both great opportunity and challenge. The global expansion remains robust, more so than in many decades.

Addressing imbalances in the global economy is a shared responsibility among the major economic regions of the world. While imbalances occur as the patterns of trade and investment flows shift between economic regions, uneven rates of growth in the major economies and inefficient or distortionary policies restrict adjustments and put stress on the global financial systems. Economic policymakers must address these imbalances now; waiting increases the risk that adjustments will occur abruptly.

We know that the international economy performs best when large economies embrace free trade, the free flow of capital, and flexible currencies. Obstacles in any of these areas prevent smooth adjustments. At best, such obstacles result in less than maximum growth; at worst, they create distortions and increase risks.

The United States is doing its part to address imbalances by aggressively tackling our fiscal deficit and our long-term liabilities. Because of strong growth and appropriate fiscal policy, the

U.S. budget deficit in 2004 was well below projections, and with recent data, I expect improvement in our fiscal deficit position this year as well. [Some private forecasters predict that our fiscal deficit will be below 3% of GDP this year if we continue to hold the line on spending.] We are also working to put in place innovative policies to increase the savings rate. But our actions alone will not be sufficient.

I expect strong economic growth in the United States to continue. This is in the U.S. interest, and the world's. It is an essential component of our deficit reduction strategy as strong growth results in rising government receipts, as we have been seeing. But it is important to recognize that there is also no one-to-one correspondence between reductions in our fiscal and current account deficits. We do not, and will not, have a current account target. The best contribution the United States can make to our own people and the global economy is to keep our economic house in order and ensure continued strong growth.

Our actions alone will not be sufficient to unwind global imbalances. Simply put, large imbalances will continue if growth in our major trading partners continues to lag. European and Japanese GDP together exceeds that in the United States. Some European countries, such as Ireland and Spain, continue to perform well. But on the continent, notable weaknesses persist, and Japanese growth, while turning upward, remains modest. These economies must continue to adopt and implement vigorous and necessary structural reforms to establish robust rates of growth – both for the good of their own citizens and to contribute to reduction in the imbalances in the global economy.

The Treasury Department's Report to Congress on International Economic and Exchange Rate Policies outlines the currency practices of America's major trading partners. The report addresses the third -- and most immediately pressing -- element of the effort to address global imbalances: the imperative of exchange rate flexibility, especially in emerging Asian economies.

The report finds that no major trading partner of the United States met the technical requirements of the statute for designation during the period covered, which is the second half of 2004. However, it would be a mistake to interpret this conclusion as acquiescence with the foreign exchange policies of many of America's trading partners. In fact Treasury is actively engaged with several economies to promote the adoption of flexible, market-based exchange policies and to help facilitate broader adjustment. Most notable among these is China.

While the currency report that you have before you discusses several countries I would like to focus my remarks here on China. China's rigid currency regime has become highly distortionary. It poses risks to the health of the Chinese economy, such as sowing the seeds for excess liquidity creation, asset price inflation, large speculative capital flows, and over-investment. It also poses risks to its neighbors, since their ability to follow more independent and anti-inflationary monetary policies is constrained by competitiveness considerations relative to China. Sustained, non-inflationary growth in China is important for maintaining strong global growth and a more flexible and market-based renminbi exchange rate would help the Chinese achieve this goal.

A more flexible system will also support economic stability, which we understand is of paramount concern to Chinese leadership. China's ten-year-long pegged currency regime may have contributed to stability in the past, although it no longer does so, as China has grown to be a more significant participant in global trade and financial flows. Currently, China relies largely on administrative controls to manage its economy – controls that are cumbersome and increasingly ineffective. An independent monetary policy will allow China to more easily and effectively pursue price stability, stabilize growth, and respond to economic shocks. China has a history of significant swings in credit-fueled investment and inflationary pressures and these have often ended in “hard landings.” Such swings are disruptive to the Chinese economy and may prove more disruptive in the future – not only to China but also to the global economy.

A more flexible system will allow for a more efficient allocation of resources and higher productivity. The current system is fueling over-investment and excessive reliance on export-led growth while under-emphasizing domestic consumption. Moreover, much of the investment and capital flows into these favored sectors and projects may not prove profitable under market-determined prices, which could lead to another investment hard landing, more non-performing loans and a weakened banking sector.

And a more flexible system would also quell speculative capital inflows that are costly to China's government and increasingly likely to prove disruptive. China's ability to sterilize capital inflows is increasingly limited and harmful to its banking sector.

Finally, recent history has taught us that it's better to move from a fixed to a flexible currency system during from a position of strength, and not when economic weakness compels reform.

Chinese officials have publicly acknowledged the need to move to a more flexible system, have repeatedly vowed to do so, and have undertaken the necessary and appropriate steps to prepare for such a move.

In September of 2003, I began an intensive engagement with China, aimed at hastening China's move to a more flexible exchange rate. I believe that this financial diplomacy has yielded important results. Since then, China has taken critical steps to establish the necessary financial environment and infrastructure to support exchange rate flexibility.

- It has introduced a foreign currency trading system permitting onshore spot trades in eight foreign currency pairs and allowing banks to act as market makers.
- It has adopted measures to increase the volume of foreign exchange trading, for example: eliminating the foreign exchange surrender requirement for many commercial firms; allowing domestic Chinese insurance firms and the national social security fund to invest in overseas capital markets; and increasing the amount of foreign currency business travelers can take out of the country.

- It has taken steps to develop foreign exchange market instruments and increase financial institutions' experience in dealing with fluctuating currencies. Foreign exchange forward contracts can now be offered in China; foreign exchange futures are being developed; and domestic Chinese banks can now trade dollars against other foreign currencies, not just renminbi.
- It has also acted to strengthen its financial sector and regulation, so that this sector is more resilient to any fluctuations in exchange rates.

As a result of our approach, of constant intense engagement, China is now ready to introduce flexibility and should do so now.

Unfortunately, the debate on China's currency regime is clouded by a number of misconceptions of U.S. policy. Allow me to address a couple of these. First, we are not calling for an immediate full float with fully liberalized capital markets. This would be a mistake at this time – China's banking sector is not prepared. What we are calling for is an intermediate step that reflects underlying market conditions and allows for a smooth transition – when appropriate – to a full float.

Second, we recognize that a more flexible system in China, in and of itself, will not solve global imbalances – as I have said, this is a shared responsibility. However, greater flexibility in China and other Asian economies is a necessary component.

Third, some argue that a more flexible system will prove deflationary and increase Chinese unemployment. In fact, a flexible system will provide China with a more sophisticated array of policy tools – namely an independent monetary policy – that will prove much more effective in achieving price stability and the ability to adjust to shocks.

Our engagement with China over the past two years, including fruitful accomplishments associated with Treasury's joint Technical Cooperation Program, leaves me with little doubt that China is now prepared to begin reform of its currency regime.

In fact, I believe that the risks associated with delay far outweigh any concerns with immediate reform. The current system poses a risk to China's economy, its trading partners, and global economic growth. Concerns of competitiveness with China also constrain neighboring economies in their adoption of more flexible exchange policies.

As the report that was sent to Congress last week states, if current trends continue without substantial alteration, China's policies will likely meet the technical requirements of the statute for designation. China is now ready and should move without delay in a manner and magnitude that is sufficiently reflective of underlying market conditions.

As the need for adjustment is global, multilateral organizations are addressing the need for flexibility. The Group of Seven finance ministers and central bank governors have adopted a policy, stated in its communiqués, that "...more flexibility in exchange rates is desirable for major countries or economic areas that lack such flexibility to promote smooth and widespread

adjustments in the international financial system, based on market mechanisms.” The Asian Development Bank and the Asia-Pacific Economic Cooperation (APEC) have also publicly stressed the importance of flexible currency regimes.

The chief officers of the International Monetary Fund and the Asian Development Bank have also stressed the need for currency flexibility. I have called on the International Monetary Fund (IMF), as part of its strengthening of multilateral and regional surveillance, to report on the potential contribution of emerging Asia to unwinding global imbalances, including an analysis of the regional impact of the Chinese foreign exchange system. As policy-makers, we have a responsibility to fully understand these important forces that are shaping the global economy. As the central international institution for global monetary cooperation, with a wealth of technical expertise, the IMF is best placed to undertake this work, and indeed has the responsibility for doing so.

It is critical that we address the issues of imbalances aggressively and in a cooperative spirit with the goal of raising global growth. Nothing would do more damage to the prospects of increasing living standards throughout the world than efforts to inhibit the flow of trade. However, it is incumbent on China to address concerns before mounting pressures worldwide to restrict trade harm the openness of the international trading system.