"China's Exchange Rate Regime and Its Effects on the U.S. Economy"

Grant D. Aldonas
Under Secretary of Commerce for International Trade Administration

Testimony before the House Committee on Financial Services
Subcommittee on Domestic and International Monetary Policy, Trade and Technology

October 1, 2003

Mr. Chairman, Members of the Committee, thank you very much for inviting me to participate in this hearing to discuss our trade relationship with China and the Department's role in implementing the President's Manufacturing Initiative. Both issues are timely and I appreciate your willingness to focus the Committee's attention on these two inter-related topics. While I will leave comments related to China's currency to Under Secretary Taylor, I will focus on the broader market rigidities that have impact for U.S. manufacturing.

The Economic Context

Let me start by setting the economic context for discussing both the health of our manufacturing sector and our trade relationship with China. I want, first, to underscore the continuing strengths of our manufacturing sector. We tend to forget that the United States remains far and away the largest producer and exporter of manufactured goods in the world. Standing alone, our manufacturing sector would rank as either the 4th or 5th largest economy in the world. Far from being hollowed out, our manufacturing sector is, in fact, larger than the entire economy of China.

In addition, I think it's important to stress that productivity in manufacturing today is higher than it was even during the late 1990s when everyone was speaking about a "new economy." Those increases in productivity, and the policies that we have adopted to reinforce them, have allowed the United States to reclaim the top spot in the World Economic Forum's rankings as the most competitive economy in the world.

The productivity numbers are important for another reason that reaches beyond the current economic prospects of our manufacturers. What they reinforce is the importance of a healthy manufacturing sector at the core of our economy. According to Paul Krugman, the noted economist and, I should add, at times a critic of this Administration, "Productivity isn't everything, but in the long run it is almost everything. A country's ability to raise its standard of living over time depends almost entirely on its ability to raise output per worker." What both the latest statistics and Krugman's comment point out is the contribution that manufacturing makes to innovation – innovation that is key to raising our productivity and the standard of living enjoyed by all Americans.

Having said that, there is no doubt that our manufacturers face some very significant economic challenges in today's business environment. Most importantly, they face continuing pressure on pricing power and profit margins due to the excess capacity on the market even as the recovery from the recent recession takes hold. The most recent figures suggest that the economy grew at a 3.3% rate in the second quarter of this year and the pace of economic activity appears to have accelerated since then. Timely fiscal stimulus and management of the money supply appear to have set the foundations for a solid recovery.

It now appears that manufacturing, after many months of very slow growth, is beginning to participate in that broader economic recovery. Durable goods orders have been up generally, although down in August. And, the Purchasing Manager's Index, a key indicator of future economic growth, is now consistently above the level that means stronger growth ahead.

Even on the unemployment front, there are signs of job growth consistent with a stronger economy. It's probably worth recalling that unemployment has remained above 6 percent for four months. Not that long ago, that would have been perceived as relatively low in terms of unemployment.

Having said that, I want to reiterate, as the President has, that the Administration is committed to working towards an economic climate where everyone that wants a job has one. And there is an important story to tell about the unemployment figures in manufacturing. The job losses began in 2000 when the manufacturing sector entered into a recession about 10 months earlier than the economy as a whole.

The recession in manufacturing began in 2000, ten months in advance of the general recession in the economy. The economy was just beginning to cope with the effect of a sharp drop in business investment as industry pulled back from a period of heavy investment in technology. Not surprisingly, most of the job losses in manufacturing came in precisely those industries – telecommunications equipment and computing – that benefited most from the boom in investment related to the "dot.com bubble" of the late 1990s.

What has surprised most economists has been the fact that manufacturing continued to shed jobs deep into the recovery of the economy. As recently as this past month, manufacturers dropped another 93,000 from the employment rolls. Employment in manufacturing has been declining for decades as productivity gains have significantly reduced the number of man-hours needed to produce a given product. Those gains have averaged 3% or more for the last 15 years. And, employment in manufacturing has fallen commensurately.

Some share of the recent reduction in manufacturing employment during the initial stages of the recovery and expansion is directly attributable to the efforts of manufacturers to cut costs and raise productivity. Under considerable competitive

pressure, American manufacturers are finding ways to do more with less. And, the labor market is responding by shifting jobs to other industries.

That said, the more important thing to focus on for purposes of our discussion today is the link between the competitive pressure that has driven American manufacturing to pursue those productivity gains and what is going on in the international environment, particularly with respect to our trade with China and its emergence from a fully state-controlled economy to become a major force in manufacturing.

On the international front, one of the most frequently cited statistics is our trade deficit, which has been growing overall and particularly with China. Although the trade deficit is often thought of as an indicator of our competitiveness, and over long periods of time it is such an indicator, today it is better understood as a measure of the relative growth in our economy compared to our trading partners. In past recessions, continuing growth abroad mitigated the effect of the U.S. recession on our manufacturers. In the most recent recession, that did not happen. Japan led and Europe followed us into the recession and neither has yet to climb out to any significant degree.

The data behind the trade deficit bear out the effects of differences in economic growth rates between economies. While the common perspective is that the entire deficit is due to an increase in imports, the truth is that our exports have fallen off far more sharply. That points to the fact that the economies of both Europe and Japan are stagnant. As former Treasury Secretary Lawrence Summers put it, “The world economy is flying on only one engine.” That engine happens to be the United States. In eleven of the last twelve years, US economic growth has outpaced that in Japan, Germany, and the European Union.

What’s more, slow growth among our leading trading partners is not new. Japan’s economy, which still represents close to 2/3 of the gross domestic product of Asia, has barely grown for a decade. Germany’s economy has not grown appreciably in three years. On top of that, the rest of Asia, with the notable exception of China, has presented a very mixed picture in terms of economic growth since the onset of the Asian financial crisis in 1997. While some economies have recovered, others have not. And, these are markets that were once among the fastest growing in the world – markets that had become significant consumers of the sorts of advanced technology capital goods that our manufacturers sell.

What that should tell us, both in terms of the economy as a whole, and the manufacturing sector in particular, is that perhaps the most significant single action we could take is to step up encouragement of our trading partners, particularly Japan and Germany which together make up 20 percent of the world economy, to jettison their anti-growth policies and to adopt policies that are designed to boost economic growth. We need to preach what we practice because the alternative to growth is always a zero-sum game of dividing up the existing pie and that leads directly to the sort of strains we are seeing now in our trade relationships.

Our Trade Relationship with China

Which leads me to China. In the more than 20 roundtables the Department held with manufacturers across the country over the past six months, there was no single country that garnered more attention than our trade with China and its emergence from state-imposed economic isolation to become a major center of manufacturing. The Chinese have made considerable progress over the last two decades in lifting more than 200 million people out of poverty by relying ever more heavily on the market to direct resources within its economy.

The stakes involved are high. China is our fourth largest trading partner. Bilateral merchandise trade reached $147.2 billion in 2002. Last year, China overtook Japan to become our third largest source of imports. In July of this year, China surpassed Mexico to become our second largest source of imports. Our imports from China are more than five times greater than our exports. The bilateral trade deficit hit $103 billion in 2002 and reached $65 billion in the first seven months of this year. In addition, China has provided help on a number of fronts – from the arms talks with North Korea to the War on Terrorism. China has helped on the economic front as well. Along with the United States, China accounts for most of the current growth in the world economy.

The upside is that China's economic policies have brought about a rising standard of living in China and considerably higher disposable income. All of that makes China an attractive market for much of what we produce in the United States.

It is worth noting that since 2001, China has been our fastest growing export market by far among our top ten trading partners. Our exports to China surged 19% in 2001, 15% last year, and more than 22% in January-July even though our exports to the world declined 7%, 5%, and rose less than 3% during the same respective time periods.

One of the basic reasons for negotiating for 13 years with the Chinese over their accession to the World Trade Organization was to ensure that we would knock down the many barriers to entering China's market. On paper, the accession agreement represents a considerable success. Today, the tariff rates that China imposes are lower on average than much of the rest of the developing, and in some instances, the developed world. In addition, the WTO agreement obliges China to protect the intellectual property of U.S. manufacturers and service suppliers. The agreement also eliminated many of the barriers to the free distribution of American goods throughout the Chinese economy, instead of being beholden to trading through a Chinese state enterprise as in the past.

The situation facing our manufacturers from a competitive perspective was far worse prior to China's entry into the WTO. Our manufacturers lacked access to the Chinese market, but their manufacturers had relatively free access to ours. In the first year following China's accession to the WTO, I think both Congress and the President showed an extraordinary amount of patience as China worked to pass the literally thousands of new laws needed to bring the country into compliance with WTO rules.

Now, as we move deeper into the second year of China's participation in the WTO, we need to see actual enforcement of those laws and basic compliance with WTO rules in other areas. I know that the President, Secretary Evans, Ambassador Zoellick, and most recently Secretary Snow have all made that point vigorously with their counterparts in China. And, I can attest that, at a working level, the rest of us have taken up the cause just as vigorously.

But, there is still a very, very long way to go. We have considerable challenges in terms of WTO compliance, particularly in areas like the protection of intellectual property that represents the key U.S. competitive edge in many manufacturing industries. In fact, no country raised more attention as a source of concern than China during the roundtable discussions. Our manufacturers complained about rampant piracy of intellectual property; forced transfer of technology from firms launching joint ventures in China; a broad range of trade barriers; and capital markets that are largely insulated from free-market pressures. We also heard rising concerns about the timeliness and direction of China's implementation of its WTO commitments in areas such as transparency, IPR protection, trading rights and distribution services, agriculture, and financial services.

Fundamentally, China's change from a non-market economy to one that operates fully on market principles is incomplete. Although the Chinese often make the case that they are a market economy because they want the benefits that designation would yield under our antidumping laws, the simple fact is that many of the main drivers of the Chinese economy remain in state hands. Whereas U.S. companies face continuing pressure from our capital markets to turn a profit, that pressure simply does not exist in many cases in China.

In one sense, this problem is not new. American firms have seen the same pattern in other Asian markets for years. Even the 1997 financial crisis has not weaned industries or governments from those unhealthy practices – witness Korea's continuing support for the Hynix semiconductor operations, a company that was otherwise headed for liquidation.

I recognize that many commentators see a demand for a "level playing field" as a demand for protection, but that is not always, or even usually the case. Most manufacturers I have spoken with over the last six months didn't want protection; they wanted the unfair trade practices that rigged the game against them eliminated. A good example is the forest products industry, which has an enormous fight with Canada over subsidies. In the context of our roundtable on forest products manufacturing their principal request was for the President to negotiate the elimination of the barriers they faced abroad and the subsidies they faced in terms of competition from imports.

The same held true for most manufacturers with whom we discussed China. There was a strong recognition that we were better off in a world in which the rules were observed and the competition was fair, than a world segmented by trade barriers which would mean less trade and slower economic growth for all.

At the same time, I also must stress that there are significant parts of our manufacturing sector that are under extraordinary pressure to adjust to new levels of competition from imports, particularly from China. Industries like textiles and apparel in the south and tool and die in the Northeast and Midwest offer examples of the sorts of pressures our manufacturers face. Both the challenges and the pain felt in many communities are very real.

In the case of textiles and apparel, the challenges are particularly intense because the industry is emerging from a 40-year period when it was protected by quotas on imports of competing material and clothing. As a consequence, the industry remains highly fragmented and is being forced to go through, all at one time, the adjustment and consolidation that most U.S. industries went through in the 1970s and 1980s.

In the last round of world trade negotiations, President Clinton agreed to phase out the quota system that had protected the textile industry. Most of the truly sensitive items from the perspective of U.S. industry were given the longest phase-outs. But, the quotas will come to an end on January 1, 2005, and that will mean still stronger competition from imports.

What is not generally understood is that most of the sharp increase in Chinese imports has come at the expense of our other trading partners. As new products have come free of quota arrangements, retailers no longer face the need to source products from multiple countries. Instead, much of what was previously shipped to the United States from other Asian countries now comes to us from China. But, that has not meant less pressure on U.S. manufacturers in terms of price competition.

While the argument most frequently raised about China by commentators seems to be the difference in wage rates, most of my conversations with manufacturers, particularly in textiles, suggested other reasons for increased Chinese competition. What is not often understood is that, today, the textile industry is actually very high tech. There is very little labor involved in many products that come out of the industry and wages are a relatively small portion of the total cost of production except in the case of products that require considerable hand stitching.

The truth of that statement was brought home to me in a conversation with a North Carolina manufacturer of textile products used in the luggage industry. Most bags today are made with some form of rip-stop material, none of which is hand sewn. Nor is the frame of most roll-on bags manufactured by hand. Yet, the North Carolina manufacturer showed me 5 suitcases, one nesting inside the other, that sold for a total price – delivered from China – of under $30. In other words, the total cost of the five bags was below the North Carolina manufacturer's cost of materials alone.

The point to that story is simply that it is not wages alone that allowed the Chinese manufacturer to sell the 5 pieces of luggage for a delivered price of less that $30. The cost of most of the materials is determined in world markets, so if the Chinese economy were open to international trade and competition, then the Chinese

manufacturer's materials costs would be comparable to that of the U.S. costs. This means that to get the delivered price down to below $30 there must be a very large amount of government subsidy, express or implied, to the manufacturer – a subsidy that can take the form of an outright cash grant to the exporter, but more often will take the indirect form of tariff protection against competition, the forgiveness or rebate of taxes, or the continuing extension of credit to uncreditworthy enterprises.

In my view, although the textile industry is commonly criticized for seeking protection based on the past 40 years of quotas, the complaint that has led the industry to seek safeguards against Chinese imports stems from a different motive. There is no real argument that the Chinese market operates fully on a market basis, and the reasons for the industry's request for help stems from that simple difference between the pressures they face in our market on a day-to-day basis and the pressures that their Chinese competition doesn't.

What that also points out is the fact that, in addition to pressing the Chinese at every opportunity on their compliance with their WTO commitments, we also have to be extraordinarily vigilant regarding the injurious effects of other forms of government support for Chinese industry that are not covered by current WTO rules. Those sorts of practices require a different type of tool – one that requires digging out the facts regarding the underlying competitive differences that our industry faces in terms of import competition from China.

As I noted above, the textile industry is not alone in facing Chinese subsidies and protection. Other industries like tool and die face similar competitive conditions. That is why one of the most forward-leaning recommendations we intend to make regarding our trade is the establishment of an office in the Commerce Department the sole function of which will be to investigate these sorts of practices. When we find these anti-competitive practices, we will vigorously seek their elimination by the Chinese and by other trading partners.

The one thing I can assure you, Mr. Chairman, and Members of the Committee, is that the Department of Commerce is dedicated to making sure China does play by the rules. We will vigorously pursue China's compliance with its WTO commitments and we will enforce our domestic unfair trade laws rigorously and fairly, as both President Bush and Secretary Evans have made clear.

The Department of Commerce's Role in Trade With China

The Department of Commerce, in close coordination with USTR and other agencies, has adopted an aggressive and multi-pronged approach to ensure that China honors its WTO commitments and that U.S. companies benefit from these opportunities. We will target unfair trade practices wherever they occur. We are exploring the use of new tools to expand our trade promotion activities in China. We are expanding efforts to engage Chinese officials to make sure they "get the rules right" as they continue their enormous task of restructuring their economic system.

The Commerce Department has actively provided WTO-related technical assistance to China since September 2000, well before China's accession to the WTO. Initial programs focused on increasing the awareness of general WTO principles among Chinese government officials. As China developed an increasingly sophisticated understanding of the WTO system, our programs have been tailored to more specific areas, such as standards development and intellectual property right (IPR) protection. For example, in 2003 Commerce sponsored or coordinated programs on fertilizer standards, antitrust, government procurement, medical device regulatory training, and information and communication technologies standards and conformity assessment.

Despite China's commitments to crack down on rampant piracy, counterfeit CDs, DVDs, and pharmaceuticals continue to flood the U.S. market. In addition, piracy and counterfeiting in China has a significant impact on U.S. intellectual property rights holders in China itself. In fact, the International Intellectual Property Alliance estimates that business software, music, movie and entertainment software piracy rates in China exceed 90%, with damages of $1.85 billion in 2002. We have raised specific IPR concerns during our meetings with senior Chinese government officials and have repeatedly demanded that the Chinese government uphold its bilateral and multilateral IPR commitments.

Through the annual Special 301 process, we scrutinize China's IPR conditions in close coordination with our colleagues in other agencies. To make sure that China has the tools to implement its commitments, we have organized a series of seminars with Chinese officials. Programs in development for later this year include a WTO pharmaceutical regulatory seminar and anti-counterfeit training, and IPR criminal & border enforcement seminars. We have worked on these programs on an intra and inter agency basis, using the resources of US Patent and Trademark Office, Department of Justice and other agencies. We think China can and should do better in these areas. We continue to press for progress.

However, keeping our focus on China's WTO implementation and the country's other trade practices is only part of the solution. We must continue to enhance the ability of U.S. businesses to compete in China. We are increasing our efforts to ensure that U.S.-developed technical standards are accepted in China just as they are throughout the world. We are launching "Doing Business in China" seminars in cities across the country to address concerns about the Chinese market from small and medium-sized businesses. We are exploring ways to develop more trade leads in China and to provide even more targeted information on opportunities in China for companies in the U.S.

Combined with these domestic efforts, we regularly engage Chinese government officials to ensure trade agreement compliance and market access for our products and services. Secretary Evans will visit China in October to advance U.S. interests and advocate for a level playing field in our economic relations with China. We will have another opportunity to raise outstanding issues during the 15th U.S.-China Joint

Commission on Commerce and Trade (JCCT) to be held in Washington in early December.

The President's Manufacturing Initiative

With that, I would like to turn to the topic of the President's Manufacturing Initiative. In March of this year, during Manufacturing Week, Secretary Evans had the opportunity to speak before the National Association of Manufacturers in Chicago. At that time, he announced the President's Manufacturing Initiative.

As a part of that initiative, Secretary Evans directed me to lead a comprehensive review of the issues influencing long-term competitiveness of U.S. manufacturing. The central goal of the review is to develop a strategy to ensure that government is fostering an environment that promotes a dynamic manufacturing industry. The review will conclude with the release of a report later this fall.

The Commerce Department's senior management, including Secretary Evans and Deputy Secretary Bodman, all pitched in. We held roundtable discussions with manufacturers in the aerospace, auto, semiconductor, and pharmaceutical sectors, among others, in more than 20 cities across the United States – from Manchester, New Hampshire to Columbus, Ohio, to Detroit to Los Angeles – to develop the report and recommendations.

What we heard from manufacturers in terms of the challenges they face was significant. While the international competition is what has garnered most of the attention in the press, by far the greater weight of the manufacturers' comments focused on domestic issues – what I call "keeping our side of the street clean." What I mean by that is simply paying attention to the needs of our manufacturers as we develop legislation or implement regulations. It is the steady accumulation of multiple burdens, rather than a single cause, that has had the most severe impact on the competitive environment in which our manufacturers operate.

The list of issues our manufacturers identified should not surprise anyone who has taken a serious interest in manufacturing. While our manufacturers have tightened their belts and raised their productivity in an effort to remain competitive and, in fact, to succeed in the day-to-day competition in the marketplace, they have seen that advantage and the hard-won productivity gains eroded by everything from higher energy costs to higher medical and pension costs to higher insurance costs due to a run-away tort system.

Just a few examples might suggest why manufacturers have seen their costs rise. We heard from manufacturers in New Jersey that 30 cents of every dollar of revenue went to pay health benefits for employees. Manufacturers gladly pay for their employee's health benefits because they see their own interest served by a healthy and motivated workforce, but if we are serious about manufacturing, we have to be serious about grappling with the underlying drivers that have created 145 percent increases in health care insurance costs that obviously are not sustainable indefinitely.

In Michigan, I met with auto parts suppliers that faced continuing pressure from the auto companies to lower their prices by 20 percent or face the prospect that the auto companies would turn to overseas sources of supply. Much of the concern those parts suppliers reflected the terms on which they compete with those overseas suppliers, particularly in China. But the auto parts suppliers knew that the ultimate source of the problem lay in an auto industry that is grappling with the same sorts of legacy costs that burdened the steel industry. If we are serious about manufacturing, then these industries will have to get those financial obligations under control.

In Columbus, Ohio, Des Moines, Iowa, and in my hometown of Minneapolis, Minnesota, I met with manufacturers in the plastics and adhesives businesses that are heavy users of natural gas. The companies in the plastics businesses in particular risk seeing whole new markets fall to their foreign competitors who see lower natural gas prices. If we are serious about manufacturing, we have to adopt a national energy plan that will help us access new sources of supply and improved transmission to reduce the cost of energy to our manufacturers as well as to consumers.

Another example we heard from virtually every manufacturing trade association we met with was the need to eliminate the complexity and the disincentives our tax system creates for investing in manufacturing in the United States. Any number of issues fall in that category. Take the bias in the current tax code against equity financing, which raises the cost of capital, thereby reducing the investment. This bias also translates into a preference for debt, which yields highly leveraged companies and a highly leveraged country, all the while encouraging the worst sorts of gaming as clever tax lawyers try to find ways to take what is an equity interest and call it debt in order to qualify for an interest deduction. Taken together, even without cutting rates, reforms of the tax code could make a profound difference to the relative attraction of investing in manufacturing in the United States.

But, perhaps the most egregious example comes out of the tort system in this country. If we are serious about manufacturing, we have to get serious about reforming the tort system.

One issue, in particular, stood out among the manufacturers' concerns about the tort system. That was the ongoing asbestos litigation. There, the continuing litigation has yet to help many individuals who were harmed by prolonged exposure to asbestos, while, at the same time, the litigation hangs over virtually all U.S. manufacturing, raising their insurance costs and dampening their returns.

Manufacturers pointed to declining vocational school programs, declining enrollments in engineering and the funding of scientific research, all of which are essential to the productivity gains that keep our manufacturing sector competitive and keep a skilled workforce employed.

Finally, as I noted above, in addition to keeping our own side of the street clean, U.S. manufacturers demanded a level playing field. For most, that translated into a demand that we negotiate down tariff rates that are higher than ours and break open new markets. Or it translated into a demand for the enforcement of rules barring the theft of intellectual property. It translated into a demand for the enforcement of our unfair trade laws or laws against customs fraud.

What I did not see was an interest in outright protection. Rather, most manufacturers saw trade as a simple question of equity. If we keep our markets open to our trading partners goods, they should do the same for us. But, where our trading partners did not live up to the terms of our agreements or otherwise heed the rules, our manufacturers expected that those trading partners should pay a price.

While we are still in the process of finalizing the report and recommendations across many fronts, Secretary Evans has outlined several new initiatives in response to the concerns we heard from manufacturers, particularly the need for a stronger focus within the U.S. government on manufacturing and the most immediate cases of unfair trade affecting our manufacturers. The first initiative, announced by the President on Labor Day, is a new Assistant Secretary of Commerce to serve as the point person in the Administration and within the U.S. government for manufacturers and as an effective advocate for the manufacturing sector's competitiveness. There are many programs within the federal government that bear on manufacturing, but heretofore there was no one person or one office responsible for bringing their efforts into a coherent strategy. The second would call for the creation of Assistant Secretary for Trade Promotion to boost our exports, particularly to those markets that our negotiators have recently opened to our trade like China. And, the third is the establishment of an Unfair Trade Practices Team to track, detect, and confront unfair competition before it injures an industry here at home.

We expect the report and the remainder of the recommendations to be out soon. In addition to moving on the implementation of those recommendations, we intend to do two things to follow up. The first is to go back to the manufacturers we visited earlier this year to get their reaction on what we have suggested and to help us refine our approach as we move forward. The second is to discuss the next set of issues we intend to tackle as part of our on-going commitment to support our manufacturing sector.

That concludes my testimony. I would be pleased to answer any questions that you, Mr. Chairman, or any other Members of the Committee may have.