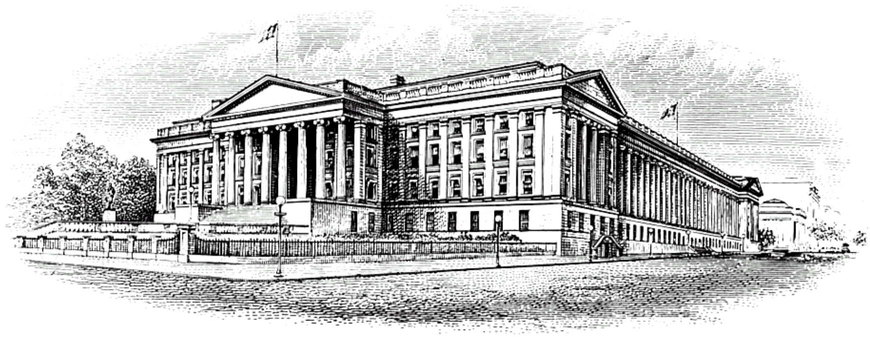

# DEPARTMENT OF THE TREASURY
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**"China's Exchange Rate Regime and its Effects on the U.S. Economy"**

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

**October 1, 2003**

Chairman King, Ranking Member Maloney, Members of the Subcommittee, thank you for giving me the opportunity to testify on China's exchange rate regime and its effects on the U.S. economy.

This is the fifth time that I have appeared before this Subcommittee as an Administration witness. Each time I have been asked to focus on an important facet of our international economic policy. I have testified on our policy toward emerging markets, on our policy for developing countries—including reforms at the Multilateral Development Banks and the new Millennium Challenge Account, and on our policy to remove barriers to the free flow of capital in our trade agreements—including those with Singapore and Chile. In each of these cases, an underlying goal of our policy has been to raise economic growth and increase economic stability around the world, and in doing so benefit the American people with more jobs, more security, and a better life. My testimony today on China's exchange rate regime will be no different in this respect.

## The Overall International Economic Strategy for Growth and Stability

The Administration's major economic endeavor now is to strengthen the economic recovery in the United States. The President's Jobs and Growth package, enacted into law this summer, was essential, as are his proposals for tort reform, regulatory reform, and health care reform. But there are barriers to economic growth and stability in other countries— in Europe, in Asia, in Latin America, in Africa—as well as in the international trade and financial systems that have important implications for growth in the United States.

This is where our overall international economic strategy fits in. Our policy toward China—and China's exchange rate regime in particular—is part of that overall strategy. The strategy has been to urge the removal of rigidities and barriers wherever they exist, and to encourage pro-growth, pro-stability policies that benefit the U.S. and the whole world. It is a *two-track approach*—domestic and international. The international component is applied bilaterally and multilaterally.

### *Progress on Growth and Stability*

I am pleased to report that this endeavor is working. Thanks to the fiscal and monetary policy responses, economic growth in the United States is picking up significantly now after the severe shocks of the terrorist attacks, the corporate accounting scandals, and the stock market drop of 2000. Global growth is also improving. There is more evidence of stronger economic growth in the world's second largest economy, Japan, and in Canada and the United Kingdom, as well as several emerging market countries.

There is also a notable improvement in economic stability around the world, despite the uncertainties about terrorist attacks and the ongoing war against terror. The number and severity of financial market crises are down, capital flows are up, and interest rate spreads are down compared with the late 1990s. This improvement in global economic stability is important for the United States. Greater economic stability is essential to creating a long lasting recovery, which is needed for sustainable job creation.

### *Agenda for Growth*

Despite this progress on the growth and stability front, we need to do more. During the summer months, Secretary Snow embarked on an international pro-growth tour starting in Europe, continuing on to Asia (including China as I will shortly discuss in more detail), and culminating in the annual meetings of the World Bank and the IMF in the Middle East where he forged an agreement on a new "G7 Agenda for Growth." This milestone agreement creates for the first time *supply side surveillance* – a process of benchmarking and reporting in which each G7 country takes actions to spur growth and create jobs. It focuses on supply-side policies that increase flexibility and remove structural barriers to growth, because such policies are most needed to raise growth among our G7 partners, especially those in the European Monetary Union. For its part the United States will work to lower health care costs, reduce frivolous lawsuits, and streamline regulations and needless paperwork. The other G7 countries are endeavoring to implement other supply side policies. For example, Germany is focusing on labor, health, and pension reforms.

Our engagement to foster pro-growth, pro-stability policies extends to the emerging markets and developing countries. For example, we recently created a new United States-Brazil “Group for Growth” through which the two countries will work together to identify pro-growth strategies at the micro as well as macro levels. And the Millennium Challenge Account is aimed at encouraging pro-growth policies in the developing countries. Our reforms also call on the World Bank to encourage economic growth by using IDA funds for the private sector as, for example, in the new IDA/IFC small business loan program for Africa. And we will continue to promote trade through the bilateral, regional, and global trade agreements. While the outcome at Cancun was a missed opportunity for global trade liberalization, our free trade initiatives, including the U.S. proposal to cut tariffs to zero in manufacturers will continue.

### *Policy Principles Regarding Alternative Exchange Rate Regimes*

Exchange rate policy also has bearing on growth and stability. The move by several large emerging market countries—such as Brazil, Korea, and Mexico—to flexible exchange rates combined with clear price stability goals and a system for adjusting the policy instruments is one of the reasons we are seeing fewer crises and greater stability.

We emphasize that the choice of an exchange rate regime is one where country ownership is particularly important. We also recognize that, especially in the case of small open economies, there are benefits from a “hard” exchange rate peg, whether dollarizing, as with El Salvador, joining a currency union, as with Greece, or using a credible currency board, as in Bulgaria or Hong Kong.

## The Economy of China

With this context, let me now address China’s economy and its exchange rate regime. Economic reforms in China have increased economic growth and have made China one of the largest economies in the world. China is now a major economy, and it is still growing rapidly. It is already an engine of global growth. With per capita income of only about $1,000 per year and with financial, legal and regulatory systems in need of reform, China still faces challenges in its effort to catch up with developed economies.

### *China’s Exchange Rate Regime*

For nearly ten years now, the Chinese have maintained a fixed exchange rate for their currency, the yuan, relative to the dollar. The rate has been pegged at about 8.28 yuan/dollar for the entire period. Thus, as the dollar has appreciated or depreciated in value relative to other currencies, such as the Euro, the yuan has appreciated or depreciated by the same amount relative to these other countries.

To maintain this fixed exchange rate, the central bank of China has had to intervene in the foreign exchange market. It sells yuan in exchange for dollar denominated assets when the demand for the yuan increases and it buys yuan with dollar denominated assets when the demand for the yuan decreases. Recently the central bank has intervened very heavily in the markets to prevent the yuan from appreciating. Since the end of 2001, dollar buying has been so great that the foreign reserves held by the Chinese government have risen by $153 billion to over $360 billion.

This accumulation of foreign exchange reserves would tend to expand China's money supply, although in recent months the Chinese central bank has moved to reign in monetary expansion. Among other measures to sterilize reserve accumulation, the central bank has – for the first time – begun issuing central bank paper to restrict growth of the monetary base. Nevertheless, the broader money supply continues to grow very rapidly: M2 climbed 22 percent over the 12 months ending in August 2003.

It is also important to recognize that China still has significant capital controls. China's capital controls allow for more inflows than outflows, thus bolstering foreign exchange reserves. China is gradually loosening some controls (on securities rather than debt), and outflows are likely to grow as new channels develop for Chinese to seek diversification and better returns than those offered by low domestic interest rates. Indeed, there is already significant leakage of capital. A relaxation of controls on outflows would reduce upward pressure on the yuan.

***Impact on the United States***

U.S. imports from China are equal to about 1 percent of U.S. GDP, or 11 percent of total U.S. imports. Although this share may seem small, China's imports to the U.S. have been increasing rather rapidly, between 20 and 25 percent in recent years and months. In general, these imports result from China using low-skilled labor to assemble and process imported parts and materials originating in other countries—mostly from other Asian countries that have traditionally exported directly to the U.S. Consequently, the share of U.S. imports from these other countries has declined just as China's share has increased. Asia's share of U.S. imports has declined slightly. Much of the increase in U.S. imports from China has come at the expense of imports that once came directly from other Asian countries.

At the same time, growth of U.S. merchandise exports to China has been accelerating recently and grew 22 percent in the first 7 months of this year. Growth has been especially rapid in recent years for U.S. exports to China of transportation equipment (including aircraft engines), machinery, steel-making materials, chemicals, and semiconductors.

China has a large trade surplus with the United States. However, because China has a large deficit with the rest of the world, it does not have a large overall current account surplus. China's bilateral trade surplus was $103 billion in 2002 with the U.S. while China's deficit with the rest of the world was about $73 billion. Thus, China's current account surplus was under 3 percent of GDP in 2002 and likely to decline to less than 2 percent in 2003. Many imports from China are goods from other Asian economies that are processed or finished off in China before shipping to the United States. Other East Asian economies increasingly send goods to China for final processing before they are shipped to the United States. China accounted for 11 percent of U.S. imports in 2002, up from 3 percent in 1990. Meanwhile, the combined share of Japan, Korea and Taiwan declined to 17 percent from 27 percent over the same period.

The overall trade deficit of the United States is spread across many countries of the world in addition to China. For instance, the overall trade deficit reached $468 billion last year with 1) the Americas accounting for $105 billion, 2) Western Europe $89 billion, 3) Japan $70 billion, and 4) China $103 billion. The U.S. overall trade and current account deficit is due to the excess of investment over saving in the United States. If this gap were reduced through an increment in savings, the overall deficit could shrink as would the size of the bilateral deficits.

What impact would a change in the value of the yuan relative to the dollar have on the United States economy? An appreciation would make U.S. exports to China less expensive and it would make U.S. imports from China more expensive. The price of Chinese goods in the United States would not change by as much as the change in the exchange rate, because only a portion of most exports from China are produced in China, and because the retail price in the United States includes marketing, transport, and other logistical costs. And with a higher yuan, substitutes for Chinese products would likely come from countries other than China.

***The United States Policy Position***

With its rapid growth and substantial foreign exchange reserves, China is now in a position to show leadership on the important global issue of exchange rate flexibility. China represents one of the largest economies in the world, and a flexible exchange rate regime would be a good policy for China. It would allow China to open the nation to capital flows and reduce macroeconomic imbalances.

We have also been urging the Chinese to build on their strong record of economic reform by moving forward in two other areas: reductions in barriers to trade and capital flows. In the area of trade, it is important for China to fully implement, and even surpass, the commitments it made to the World Trade Organization. Tariffs on manufactured goods are scheduled to come down from an average of about 17 percent to an average of about 9 percent. This will still be well above the average of the United States and other large economies, which stand at about 4 percent. It is important that China continue to reduce its tariff barriers. It should also open its markets to agricultural products such as soybeans, as well as effectively enforcing intellectual property laws.

China’s restrictions on capital flows are one of the major rigidities interfering with market forces. The authorities understand this and are beginning to reduce barriers to capital flows and develop more open and sophisticated capital markets. In fact, China has taken a number of steps in this area recently, including developing measures that will allow for some cross-border portfolio investment. At the same time, the Chinese authorities are working to strengthen the banking system and liberalize capital flows in order to prepare for a more flexible exchange rate.

Secretary Snow encouraged each of these steps in his trip to Beijing last month. He met Premier Wen, Vice Premier Huang, Central Bank Governor Zhou and Finance Minister Jin. In all his meetings discussions were detailed and candid. He also stated publicly, "the establishment of flexible exchange rates, of a flexible exchange rate regime, would benefit both our nations as well as our regional and global trading partners." The Chinese reported that they intend to move to a market-based flexible exchange rate as they open the capital account.

Secretary Snow's visit to Beijing was associated with announcements by China's central bank, including liberalized regulations for foreign firms managing their foreign exchange and significantly liberalized provisions to allow Chinese travelers to take foreign currency out of the country and to do so more frequently. We will continue to urge the Chinese to make rapid progress in these areas.

We are working on a possible technical cooperation agreement in the financial area. We intend to continue the high level conversations on this subject begun by Secretary Snow.

In addition, following Secretary Snow's visit, the Chinese and the G7 agreed to engage in talks about economic issues. This represents another example of how China, the U.S. and other affected parties can come together to work on an issue of vital interest to them all. The first meeting between senior officials from the G-7 and China's finance ministry and central bank took place last week in Dubai, where the Chinese economy, the G7 economies, and other economic issues, were discussed. Further meetings will be scheduled on a regular basis with China, the United States and the other G7 countries. After the Dubai meeting, China's central bank representative said that China is moving as fast as it can in its reform.

**Conclusion**

I am pleased to report that our efforts to engage in financial diplomacy are bearing fruit. Active engagement with China and other countries is paving the way toward freer markets. The Administration's effort to raise growth in the United States and abroad, and thereby create jobs at home is already showing signs of success.