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THE TREASURY DEPARTMENT'S REPORT TO CONGRESS ON INTERNATIONAL ECONOMIC AND EXCHANGE RATE POLICIES

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED EIGHTH CONGRESS

FIRST SESSION

ON

THE TREASURY DEPARTMENT'S REPORT TO CONGRESS ON INTERNATIONAL ECONOMIC AND EXCHANGE RATE POLICY

OCTOBER 30, 2003

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THE TREASURY DEPARTMENT'S REPORT TO CONGRESS ON INTERNATIONAL ECONOMIC AND EXCHANGE RATE POLICIES

THURSDAY, OCTOBER 30, 2003

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:17 a.m., in room SD–106, Dirksen Senate Office Building, Senator Richard C. Shelby (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN RICHARD C. SHELBY

Chairman SHELBY. The hearing will come to order.

Mr. Secretary, we welcome you to the Committee. I am pleased that you are here to testify on the Treasury Department's Report to the Congress on International Economic and Exchange Rate Policies.

Secretary Snow, your report this morning is of great interest not only to us but also to the American people. The continued softness in labor markets and the loss of manufacturing jobs make the trade and exchange rate policies in China and Japan, in particular, a tangible issue to U.S. businesses and taxpayers.

Signs of an economic recovery in the United States are emerging, which is good news. Even today, we have heard that the GDP grew at a 7.2-percent annual rate. In the third quarter, the strongest since 1984, business spending rose 11.1 percent, we were told. On the labor front, new weekly claims were below 400,000 people for the fourth straight week. I hope this news is sustainable.

In today's global economy, it is important that we also look at trade and exchange rate policies of other countries. The news is more mixed in this area. The current account deficit was a record $480.9 billion last year and is currently running at 5 percent of gross domestic product. Employment in the manufacturing sector has fallen by 2.7 million jobs, 15.6 percent, since July 2000.

These trends are certainly cause for great concern to us in the Congress as well as you at the Treasury. I believe that we need to have a serious discussion, Mr. Secretary, about what can be done to reverse these trends. The G–7 nations issued a statement calling for more flexible currency policies, but it is unclear how China and Japan will proceed and on what timetable.

China's trade deficit with the United States hit a record $105 billion last year. The Chinese capital account is expected to become increasingly open to short-term flows. Greater exchange rate flexi-

bility would allow China to maintain a low-inflation, pro-growth monetary policy. I believe we need to continue the dialogue to ensure that China moves forward on a flexible rate path. However, we also need to encourage them to strengthen their entire financial and banking system. This will be critical to the success of a more open economy.

Mr. Secretary, I continue to be concerned, as you are, about the Japanese economy. Japan's banking sector is still struggling to recover from the effects of the stock and real estate bubbles of the late 1980's. Even with the recent actions on nonperforming loans, Japan's financial sector's troubles are far from over. Japan's focus on using exports to drive an economic recovery have not been totally successful. In continuing its active intervention in the currency markets, Japan holds the largest foreign exchange rate reserves in the world. We need to encourage, I believe, the Japanese to place more emphasis on domestic growth and demand.

Mr. Secretary, I know that there are no easy answers to the issues that I have raised here. At the same time, I believe we need to be careful about the message we send to the world community. Over the long-term, both the United States and the global economy will benefit most, I believe, from the continued pursuit of free trade and flexible exchange rate policies. The most desirable way to reduce our current account deficit would be through stronger growth abroad and more open trading markets and policies.

Mr. Secretary, I know that you and President Bush are working diligently on this issue. We look forward to hearing your testimony this morning and the discussion which will follow. Hopefully, we can all leave this hearing with a broadened awareness of the situation and the direction ahead to do something about it.

Senator Sarbanes.

STATEMENT OF SENATOR PAUL S. SARBANES

Senator SARBANES. Thank you very much, Mr. Chairman. I join with you in welcoming the Treasury Secretary this morning to present the Department's Report on International Economic and Exchange Rate Policies.

Section 3005 of the 1988 Omnibus Trade and Competitiveness Act requires the Secretary of the Treasury to submit to the Congress on or before October 15 of each year a written report on international economic policy, including exchange rate policy, and then to update that with a written update 6 months after the annual report and testify before the Congress if requested.

I want to commend Chairman Shelby for requesting the Secretary to appear on this year's report. It was originally scheduled for October 16, and then put off until today. The legislation sought to provide Congress with a means to oversee the conduct of a critical area of economic policy. Given the current international economic position of the United States, and the attention that has been given to the value of the dollar relative to other currencies, this report and testimony could not be more timely.

Under Section 3004 of the Trade Act of 1988, the Treasury Secretary is required to analyze on an annual basis the exchange rate policies of foreign countries and consider whether countries manipulate the rate of exchange between their currency and the dollar

for purposes of preventing effective balance-of-payments adjustments or gaining unfair competitive advantage in international trade. If the Secretary considers that such manipulation is occurring with respect to countries that have material global account surpluses and significant bilateral trade surpluses with the United States, the Secretary is required to initiate negotiations with such countries on an expedited basis for the purpose of ensuring that such countries regularly and promptly adjust the rate of exchange between their currencies and the dollar to permit effective balance-of-payments adjustments and eliminate the unfair advantage.

The report submitted by the Treasury this morning raises concerns about the conduct of exchange rate policy by China, but does not make an actual determination of currency manipulation. In my view, there is compelling evidence that China and Japan, as well as Taiwan and South Korea, are engaging in currency manipulation to prevent effective balance-of-payments adjustments and to gain unfair competitive advantage in international trade within the terms of the 1988 Trade Act.

Mr. Chairman, I want to take just a moment or two to present some evidence to support this view.

First, China, Japan, Taiwan, and South Korea are all running material global current account surpluses and significant bilateral trade surpluses with the United States within the terms of the 1988 Trade Act. I want to present a few charts, and I think Committee Members have a set of those charts. The first chart shows the global current account surpluses and bilateral trade surpluses each of these countries is running with the United States. The size of China's bilateral trade surplus with the United States, $117 billion, relative to the size of trade between the two countries is particularly striking.

In addition, each of these countries has been engaging in sharply increasing accumulation of foreign currency reserves, principally dollars. The following charts will illustrate this clearly. The first of the following charts shows the growth in China's stock of foreign reserves, $111 billion over the past 12 months. This line is going up almost at a vertical climb. The second chart shows the growth in Japan's stock of foreign reserves, $103 billion over the past 12 months. And the next two charts show the sharp increase in the stock of foreign reserves by South Korea and Taiwan, respectively. Now, by way of useful contrast, the next chart provides important perspective on this issue because it shows the stock of foreign reserves held by the European Union, which, of course, participates in the regime of flexible exchange rates and is abiding by both WTO and IMF requirements. And, of course, what this shows is that its stock of foreign reserves has actually declined over the past 12 months.

The next chart shows the consequences of these reserve accumulation actions by these respective countries and by the EU for the value of the currencies relative to the dollar. The euro has experienced a substantial appreciation against the dollar over the past year, and that is indicated by the top upward-trending line. The currencies of Japan, South Korea, and Taiwan have experienced a significantly smaller appreciation, although there has been some appreciation, as Members will note as they look at the chart. The

value of the Chinese currency, since it is pegged to the dollar, is represented by the horizontal axis of the chart and has not appreciated at all against the dollar. You have this incredible trade deficit, this huge accumulation of reserves, and no adjustments in the value of the currency.

In my view, there is no ambiguity as to what is taking place. Each of these countries is intervening actively in the market to purchase dollars in order to depress the value of the currency. Each is manipulating its currency within the terms of the Trade Act to prevent effective balance-of-payments adjustments to gain an unfair, competitive advantage in international trade.

The United States this year is running trade and current account deficits of more than $550 billion. The four countries, I have discussed here, collectively account for nearly 40 percent of the U.S. trade deficit, and 60 percent of the U.S. manufacturing trade deficit, a sector in which the United States has lost 2.5 million jobs since 2001.

The United States has accumulated an external debt in excess of $2 trillion, about 25 percent of GDP. Chairman Greenspan has told this Committee that the rate at which the United States is running current account deficits and accumulating external debt is unsustainable. He said, "Countries that have gone down this path invariably have run into trouble, and so would we. Eventually, the current account deficit will have to be restrained." The IMF's latest World Economic Outlook reaches the same conclusion. As Warren Buffett recently warned, "Our trade deficit has greatly worsened, to the point that our country's 'net worth,' so to speak, is now being transferred abroad at an alarming rate. A perpetuation of this transfer will lead to major trouble."

If any progress is to be made addressing this problem, currency manipulation being engaged in by these countries must be curtailed. Each of these countries is a member of the WTO, and all but Taiwan are members of the IMF. A condition of membership in both of those organizations is not to engage in currency manipulation for competitive trade advantage.

Mr. Secretary, I have difficulty in the seriousness of the Administration on this issue if it fails to make the elementary determination, for which I believe there is compelling evidence, that these countries are engaged in currency manipulation and, therefore, fails to initiate formal negotiations as required by the Act. Furthermore, the Administration may also want to seek remedies within the WTO and the IMF.

Among the countries—and I close with these observations—China's intervention has been the most egregious. There is reason to believe that the other countries in the region, for competitive trade reasons, are hesitant to allow their currencies to appreciate unless China appreciates first.

In addition, as some observers have pointed out, it may be more realistic in the short-run for China to undertake a substantial upward revaluation of its currency rather than to simply allow its currency to float. Many observers think there is little expectation that China would be willing in the near-term to allow its currency to float freely, which is the goal being articulated by the Administration.

Their very weak banking system and the concern about a flight of capital if they were to move immediately to flexible exchange rates, is certainly a desirable objective. But if they were to go there immediately, may well inhibit their ability to move on this issue. I would urge the Administration to add to its approach prompt—well, to have the flexible rates as the ultimate objective, but to seek immediately in the short-run the revaluation of the Chinese currency as against dollar; in other words, the peg rate.

We do not want to deal with peg rates in the long-run, but we have to get moving. We are hemorrhaging on this trade deficit situation. Going to flexible rates right away with a very weak banking system and the potential significant outflow of capital obviously raises a problem for the Chinese.

But they could revalue the peg rate. That would, of course, enable these other countries that I have mentioned in the region to allow their currencies to appreciate as well and begin to deal with this issue.

And this is a matter I will revisit when we get to the question period.

Thank you very much, Mr. Chairman.

Chairman SHELBY. Thank you.

Senator Allard.

STATEMENT OF SENATOR WAYNE ALLARD

Senator ALLARD. Mr. Chairman, I would encourage you and other Members of the Committee to maybe just submit our statements for the record so we can go on and hear the testimony from Secretary Snow. I think both you and the Ranking Member have given pretty good introductory remarks, and so I am just going to ask that my statement be made a part of the record.

Chairman SHELBY. Without objection, so ordered.

Chairman SHELBY. Senator Dodd.

STATEMENT OF SENATOR CHRISTOPHER J. DODD

Senator DODD. Thank you very much, Mr. Chairman for holding this hearing, and thank you, Mr. Secretary, for being here this morning.

Mr. Chairman, I want to address and look at this from the net effect of what this policy may be creating. I want to look at this from a jobs standpoint. I represent a State whose economy historically has been tremendously dependent on foreign trade. Connecticut is one of the most dependent States on a per capita basis on foreign trade. We generate $13.2 billion in 200 foreign markets of trade coming out of the State of Connecticut. We take a back seat to no one in the importance of having a strong trade policy in the United States.

What concerns many of my constituents, Mr. Secretary, and others across the country is the net effect of not recognizing what is quite clear to many of us with currency manipulation is the job loss. I have lost 26,000 jobs in the last 24 months in my State in the manufacturing sector. That pales by comparison to the almost 2.5 million jobs that have been lost over the last 2 years across the country in this area. You are going to announce today that we saw GDP growth of over 7 percent in the third quarter of this year.

That is great news, except you failed to note that we lost 41,000 jobs in that very same period of time.

So while it is going to be important to discuss the subject matter of currency manipulation in this hearing, to disregard the effect this is having on jobs in this country I think is a significant mistake. I am hopeful that we can focus on that.

In February 2003, the President's economic advisers estimated that the economy alone would grow by 4.1 million new jobs by the end of 2004. In addition, the Administration claims that recently enacted tax cuts signed by the President would create 1.4 million new jobs by the end of 2004. However, a recent *New York Times* op-ed piece October 24 related an interview you gave last week to the *London Times.* The interview cites that you expected roughly 2 million jobs to be created by the end of 2004.

The question I have to ask you here is what has happened to 3.5 million jobs here. Something is going on here other than just the status quo. And so for this Senator's interest, while I am curious to hear what you have to say about currency manipulation, particularly as it appears, at least in testimony that Alan Greenspan gave before this Committee in July, where he seems to indicate that this is a serious problem. The Fed apparently is taking a different viewpoint than Treasury is on this. I would be curious how you justify this apparent contradiction that exists here. I will ask that the article be included in the record, but Alan Greenspan, Chairman of the Federal Reserve, yesterday warned that Chinese authorities could not continue to peg their currency without posing a danger to China's economy and obviously one to ours. That is the Chairman of the Federal Reserve in July.

So, I am very interested to know what the Treasury's response is to really millions of Americans and their families who are losing their jobs despite the claims the economy is growing. And so my emphasis will focus on that.

Mr. Chairman, I thank you.

Chairman SHELBY. Senator Bunning.

STATEMENT OF SENATOR JIM BUNNING

Senator BUNNING. Thank you, Mr. Chairman, for holding this very important hearing, and I would like to thank Secretary Snow for testifying today. Don't worry, Mr. Secretary, I won't ask you any questions about TVA today.

I believe our economy, though still growing rapidly, is still lagging behind in the creation of new jobs. We have great news today with the GDP growth at 7.2 percent for the third quarter, and I was heartened by the new job increase last month. But I am still very concerned about new job creation, especially in the manufacturing sector.

One of my biggest concerns is the countries keeping their currency artificially low. We all know that the People's Republic of China has continued to keep the yuan at an artificially low level versus the dollar. It is about a 27.5-percent premium by pegging it to the dollar that we are penalized in trading with the Chinese. It has hurt our manufacturing base by making their products, while inferior, so much cheaper. This makes it very difficult for U.S. manufacturers to compete.

When I played baseball, we called that kind of behavior "cheating." And when I see someone cheating against my team, I always tried to help my team, and I sent a message. Usually it was in the form of a high inside fast ball.

The Chinese are cheating. That is why I am an original cosponsor of the Chinese currency bill with Senator Schumer. It sends the right message. And like a fast ball hard and inside, I think it will get their attention. Given the reports yesterday that the Chinese will start increasing their purchasing of U.S. goods, it may already have done so.

I look forward to hearing your report and your testimony, Mr. Secretary, and I look forward to engaging you more in the question and answer period.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Schumer.

STATEMENT OF SENATOR CHARLES E. SCHUMER

Senator SCHUMER. Thank you, Mr. Chairman. And I want to thank you, Mr. Secretary, for being here. Again, many of us who feel strongly about this issue—nothing personal. We know you are working the best you can on this. But I have to tell you, I read the report this morning with deep disappointment. Simply put, the report lets China off the hook, and it will do serious damage to the United States economy. This report is a whitewash. It treats China with kid gloves when it should be taking off the gloves and confronting Beijing about the fact that it is manipulating the yuan. Pegging the currency to any set level flies in the face of free trade.

The time for diplomatic niceties is past. The Administration needs to grow some backbone and take a firm line with the Chinese on the currency issue, or American jobs will continue to go overseas faster than children leaving the classroom on the last day of school. The Chinese want all the advantages of being part of the world of nations. Well, how about some of the responsibilities? No one says they have to let their currency float tomorrow, but they should be making some progress instead of telling you not to bother to even bring it up before you set foot in China when you negotiate.

The bottom line is I would like to know what the Administration thinks we should do if we do not toe a hard line. I am glad that my colleague from Kentucky talked about the high inside pitch because we are all exasperated here. We see China thumbing its nose at what is fair. We see thousands of jobs lost. Some of it, of course, is related to just the way capitalism and free enterprise work. But some of them are lost unfairly because of the pegging of the currency.

The evidence is very clear, Mr. Secretary. China is playing around with the yuan. This view has been backed by economists, including the bipartisan United States-China Trade Commission. It is truly baffling that this report would reach its audacious conclusion. Something has to change here.

I would ask that my entire statement, Mr. Chairman, be put in the record.

Chairman SHELBY. Without objection, your entire statement will be made part of the record.

Chairman SHELBY. Senator Dole.

STATEMENT OF SENATOR ELIZABETH DOLE

Senator DOLE. Thank you, Mr. Chairman, and thank you, Secretary Snow, for joining us here today. It is no surprise to anyone here that I and some of my colleagues on this Committee are focused on the currency policies of the Chinese Government.

The loss of American manufacturing jobs in recent years has decimated communities across the country, many of which I represent in North Carolina. The loss of one in six factory jobs cannot occur without great stress to individuals, families, neighborhoods, and States. Nearly 3 million manufacturing jobs have been lost since 1998. According to the Bureau of Labor Statistics, in September 1995, there were approximately 818,400 manufacturing jobs in North Carolina. According to last month's figures, we have lost more than 200,000 of these jobs. It is clear that this is a trend that many overlooked when economic times were good. But since the recovery is slow and times are still hard, this trend has lately been given greater emphasis.

One of the factors that has led to this job loss, in my view, is the manipulation of the Chinese currency by the Chinese leadership. I am disappointed that this Treasury report fails to acknowledge the seriousness of the China currency peg.

At the same time, I am glad that the President, having recognized the problems with the Chinese currency peg, has been willing to confront the issue with his Chinese counterparts. I also want to thank you, Secretary Snow, for your attention to this issue and for making it a major focus of your trip to China last month. I was pleased to receive your call from China reporting on your efforts. In addition, Commerce Secretary Evans should be thanked for his remarks in China on Monday, when he stated, "China is moving far too slowly in its transition to an open, market-based economy. Time is running out. We need to see results." And he continued, "The U.S. Government may take action against China under the WTO rules." And I am interested in whether that is a policy that Treasury supports.

While the Administration continues to examine possible solutions, we must recognize that the Chinese will not be easily convinced to remove their exchange rate controls. Nevertheless, this is no reason to curtail our efforts. We must demonstrate the depth of our convictions. To this end, six Members of this Committee and I support legislation to impose a 27.5-percent tariff on Chinese imports if further negotiations with the Chinese fail. Admittedly, this is an extreme measure that could not be imposed without some mutual difficulty. Nevertheless, it appears that this may be the only way to get the attention of the Chinese leaders. We are the largest export market for Chinese goods, and this may be the only way to convince the Chinese of our seriousness on this issue. They must realize the importance of playing by the rules or risk the potential loss of American consumers.

The best result would be for the Chinese to take steps to allow their currency to freely float, hopefully then without our having to resort to this legislation. I will continue to work with the Administration and with my colleagues to achieve this goal, and I want to thank you, Chairman Shelby, for arranging today's hearing, and

Ranking Member Sarbanes, for your strong interest. This is a critical issue to the people of North Carolina and the United States.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Bayh.

STATEMENT OF SENATOR EVAN BAYH

Senator BAYH. Thank you, Mr. Chairman.

The Department of Commerce held some Midwest field hearings, Mr. Chairman, some time ago and took testimony from a variety of individuals, including some prominent business leaders in our State. And I would respectfully request that their statements be included in the record here today.

Chairman SHELBY. Without objection, so ordered.

Senator BAYH. Including the head of the Indiana Manufacturers Association, Pat Kiley, who is the former head of the Ways and Means Committee in the Indiana House of Representatives. He is a good card-carrying member of the Republican Party, demonstrating that concern over this issue is not partisan. It is substantive and is of great importance to people across the country.

Mr. Secretary, thank you for coming today and being with us. I want to personally thank you for your courtesy in calling me from China when you were over there discussing this issue. I am grateful for your efforts in this regard. As you know, I have a longstanding interest in this.

Echoing the comments of my colleagues, our State has lost one out of every six manufacturing jobs during the last 3 years. That is a total of 143,000. So we do have a crisis in the manufacturing sector that you are aware of, and I think it is undeniable that these currency issues have played a significant role in that.

It is always best, I think you would agree, Mr. Secretary, to be candid. Some of my colleagues have been candid. You know, what is going on here is the integration of China into the global trading system. This is going to involve dislocations for them and dislocations for us.

The subject of these hearings today is how we manage this transition, whether it is fair, and how the costs are distributed amongst the countries that are involved. And exchange rates are going to be a big part of determining the outcome of that.

There are several important questions that we need to confront here, all relating to how much leeway China should be given to manage some of the challenges that they face. For example, how much leeway should we give them to absorb the more than 100 million excess workers in the agricultural sector into other parts of their economy? How much leeway should they be given to strengthen their financial system, which would possibly suffer adverse consequences through abrupt change? How much weight should be given to other noneconomic issues, such as security issues on the Korean peninsula? Most importantly of all, what burdens should American workers and businesses be expected to bear as we make this transition, as we seek to accommodate these other interests?

Mr. Secretary, I would echo the comments of my colleagues in saying that it is undeniable that China and several of our other trading partners, as Senator Sarbanes' chart illustrates so clearly, are manipulating their currencies. And I use the word "manipu-

late" advisedly. I know that is a technical term, but we damage our credibility when we deny the obvious because of semantic or definitional disputes.

The report that has been issued today raises the question: What would it take to reach a finding of currency manipulation if not the current state of facts as we all know them to exist today?

We seriously erode the support for free trade policies in the U.S. Congress and across our country, Mr. Secretary, when we willfully choose to turn a blind eye to other countries' efforts to subvert a system of free and open trade and markets. I know of many of my colleagues, indeed many business people in my own State, who are seriously revisiting their own previous commitments to free trade agreements because of the manipulation that is allowed to exist.

Mr. Secretary, again, let me conclude by saying it is undeniable that there is a crisis in the manufacturing sector today. We could afford to be more accommodating when times are good. But now is the time to insist upon tangible steps and a long-term commitment on the part of China to a currency policy that accurately reflects economic reality. And now is also the time, Mr. Secretary, to send a loud and clear signal that there will be tangible steps on our part if such steps are not forthcoming on the Chinese part.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Carper.

STATEMENT OF SENATOR THOMAS R. CARPER

Senator CARPER. Secretary Snow, in your last job, you ran a big railroad company, CSX. Today, when I rode the train down from Wilmington, we rode by the Daimler-Chrysler plant in Newark, Delaware, where the University of Delaware is located. A lot of CSX cars were there bringing in parts, engines, metal parts, and transmission systems to help assemble cars. And there were a lot of CSX cars there to take finished vehicles to other parts of the country to be sold.

That plant was built in 1957—actually, it was built before that, in 1951. They built tanks there for 6 years and got out of the tank business, and now they build cars. All the Dodge Durangos in the world are built in that plant.

When that plant opened in 1957, over 90 percent of the autos sold in the United States—cars, trucks, vans—were made by the big four, which included, I think, at the time American or Rambler. Today, American car manufacturers are struggling to keep a 60-percent market share and continue to see their market share erode.

CSX can carry Japanese-made vehicles on their trains as well as cars that are made at the Daimler-Chrysler plant. But the erosion of a job market for GM, for Daimler-Chrysler, and Ford has implications for other sectors of our employment with which you and I think we are all familiar. It is not just the people who work in the assembly plants. There used to be 4,500 people who worked at that plant. Today, there are 2,500. There is a GM plant not far away where they make Saturns that used to have 4,000 people that worked there. Today, they have about 1,500. Suppliers who build the components for those cars do not have the kind of employment they had in Delaware or other places. The plants are still alive. We

are grateful for that. But the economic hit is, as you know, significant.

A number of us wrote to you—and I know you get a lot of letters. A number of us wrote to you earlier this summer. We did not write about the Chinese currency. We wrote about the Japanese currency. And we wrote about the encroachment that we see occurring with respect to automotive sales. Obviously, I am preaching to the choir here with Senator Stabenow sitting next to me. It is one thing for us to be concerned about the Japanese manipulating their currency. It is one thing for us to worry about the Chinese. We know the Japanese are doing it, and their interventions in markets this year just in the space of the first 9 months of this year. What they have done before pales by comparison to what they have done previously to try to keep the value of the yuan low.

So as we focus on our concerns about China and what is happening, whether it is the loss of manufacturing jobs or other jobs to China, I would just ask us to keep in mind our friends in Japan, our allies in Japan, and what they are doing and the implications that the manipulation of their currency has for whether it is the Daimler-Chrysler plant in Newark, Delaware, or plants in New Jersey, Georgia, Indiana, Kentucky, North Carolina, or Michigan. They are real and they are severe.

Thank you.

Chairman SHELBY. Senator Miller.

STATEMENT OF SENATOR ZELL MILLER

Senator MILLER. Thank you, Mr. Chairman, and thank you, Mr. Secretary, for being with us. I will only take a couple of minutes.

I want to read a handwritten letter that I recently received from Joyce Williams of Trion, Georgia. I will only read part of it, but I would like the entire letter to be included in the record.

Chairman SHELBY. The entire letter will be made part of the record.

Senator MILLER. Joyce Williams writes,

> I am an employee of Mount Vernon Mills in Trion, GA. My employment stretches over 30-plus years. Our textile plants consist of 5,500 employees and we have been in operation since the 1840's. We have seen tough times in the past, but this is different. We need your help!
>
> Cheap imports from China and other countries are killing us. Factories are closing their doors every day. Free trade with China has flooded the market with low-priced textile and apparel goods and we cannot compete.
>
> We value our textile jobs and it hurts each time we hear of another plant having to close . . . permanently. We wonder if our plant will be next. We are desperate. You are our Senator . . . We are asking you to do the right thing and help save our jobs.

Mr. Secretary, I am getting many letters like this from different manufacturing industries in my State. It is not just textiles. I am hearing from the automotive industry, I am hearing from the paper industries. I am also hearing from the agricultural sector. These industries have complained that the dollar is making it difficult for them to export profitably and easier for imports to take market share here in the United States. Paper company executives tell me of all they have done to improve efficiency and that there just is not much left to be done. There have been huge consolidations in the industry already, so they do not think that they will get there on efficiency gains alone.

Furthermore, they are often competing with products from countries that subsidize their industry, either through currency policies or direct government support. For example, in the paper industry, more than 90 percent of the growth in U.S. markets has been captured by imports.

Mr. Secretary, I know you have a tough job, and I admire and respect you greatly, and I am looking forward to your remarks, because I want to know what to tell my constituents. I want to know how to respond to Joyce Williams. I want to know if you think any foreign countries are engaging in currency manipulation with the U.S. dollar for purposes of preventing effective balance-of-payments adjustments or gaining an unfair competitive advantage in international trade.

Thank you for helping me come up with some answers.

Chairman SHELBY. Senator Stabenow.

STATEMENT OF SENATOR DEBBIE STABENOW

Senator STABENOW. Thank you, Mr. Chairman and Ranking Member. I would ask that my full statement be placed in the record.

Chairman SHELBY. Without objection, your full statement will be made part of the record.

Senator STABENOW. Secretary Snow, thank you for being here. I hope that more than anything else what you will take away from this hearing today is a sense of urgency that we all feel about the issues of currency manipulation, whether it is China, Japan, or any other countries involved in manipulating currencies.

In Michigan, we are feeling it. We have lost 18 percent of our manufacturing base, more jobs than any other State. It is not just auto suppliers. Our manufacturing sector in terms of automobiles, which, of course, is critical to us, but furniture makers and a wide variety of those involved in manufacturing are feeling this in very serious ways.

I would join with my colleagues in indicating that Senator Schumer's legislation, which a number of us are cosponsoring, is an effort to indicate how seriously we feel about this and the fact that something needs to be done.

What we are really talking about here is a tax being placed on American goods. It is a tax being placed on American businesses, and American employees. When we look at just—there are so many different numbers to look at, but the Automotive Trade Policy Council, in speaking about Japan, gave us some information that indicated—and I will just read a portion of it: "Nowhere is this trade advantage more damaging to the U.S. economy than the U.S. automotive sector. In fact, the windfall cost advantage to Japanese automakers from the weak yen has been between $2,500 and $12,000 per vehicle." That is a tax. I cannot imagine if someone was proposing such a tax on our manufacturers in this country that the Administration would be supportive of that.

I would urge you to think of it in those terms because that is exactly what is happening to our manufacturers and to our employees. And from my perspective, it is not a question of time running out. Time has run out. And if not now, when will we act on this?

I would urge your leadership.

Chairman SHELBY. Senator Corzine.

STATEMENT OF SENATOR JON S. CORZINE

Senator CORZINE. Thank you, Mr. Chairman and Ranking Member, and I welcome the Secretary. I, too, can relate stories about the decline of manufacturing in my home State. We are actually in the process of closing the last two auto plants. We no longer have any textile manufacturing in the State of New Jersey, and the loss of these most important middle-class jobs is a very, very dangerous concept and I think is reflected at a really troubled regime with regard to our international economic relationships and certainly our exchange rate policy. And to that extent, I am joining some of my other colleagues with my concern that the sense of urgency and the depth of understanding of that problem is not reflected at least in some of the written testimony I have seen.

I also think, aside from the loss of jobs—and, by the way, manufacturing has gone from, I do not know, 25 years ago about 30 percent of the economy down to about 12 percent, some of that due to comparative advantage and free trade and all those good things that maybe lift the standard of living, but sometimes a good thing goes too far, and I think we have certainly found that.

I think we also have a terrifically unsustainable reality having to borrow $2 billion a day, business day, to balance out our current accounts, the analysis that the Ranking Member said I think is unsustainable and will lead to a deterioration of America's ownership of its own assets, and I do not think this is something that can be ignored unless we are willing to take the risk that we are going to have a shock one day, a one-time adjustment that we have seen happen periodically through economic history.

And I think one of the greatest problems in not dealing with this is something that you hear even in the intonation of my colleagues around the table: Protectionism is going to gain root in this country. The risks of that being called for as a result of what we are seeing and what I think is a limited response on the part of the Administration is a very real risk and one that will undermine everyone's long-run economic security. And we know from history that protectionism can lead to strategic risks as well.

I believe it is time for a clear and full, comprehensive review of both international economic policies and exchange policies among nations. I remember a period in time, another Republican Administration did an extraordinary job of pulling together the international community in September 1985—what was it called? The Plaza Accord—to set right, to find a new way that was done on a multilateral approach to these issues. And I think it is time for those efforts to go forward today.

I have serious problems with the valuation of the RMB, but it is not just China. It is all the other currencies that are tied to it and lead to a multiplicity of deficits in East Asia. And the problems that we face are also faced by other trading partners in Europe and other places.

I think the urgency is real and needs to be addressed. I have much sympathy for the program that I think the Ranking Member was outlining that a number of academics and others are talking about refixing the Chinese peg, acknowledging that their system is

not mature enough to take the shock of freely floating exchange rates at this point. But I think it is time for a coordinated international approach to resolving some of these international economic issues and exchange rate issues, which I believe really run long term into risks that we have in the strategic level.

I have a full statement that I would put in the record.

Chairman SHELBY. Your full statement will be made part of the record.

[The prepared statement of Senator Corzine follows:]

Senator CORZINE. I also would, for the benefit of the Committee, recommend that they read the announcement the Ministers of Finance and Central Bank Governors of France, Germany, Japan, United Kingdom, and United States—"Plaza Accord"—released on September 22, 1985. I think people will find that if you just substitute "Japan" with the name "China," you will find that much of the analysis and the conclusions are very much the same.

Chairman SHELBY. Senator Corzine, could you make a copy of that, have it made for the record?

Senator CORZINE. Yes, and I will make sure that—if you would put it in the record, I would appreciate it.

Chairman SHELBY. Without objection.

[The announcement follows:]

Senator SARBANES. Could I add to what Senator Corzine said? When they read the Plaza Accord statement, they should read it and contrast it with the recent statement in Dubai. It is nowhere near the same thing. And I think there is a very sharp difference in the strength of what the international community had been brought together to do in terms of what then-Secretary Baker did with the Plaza Accord.

Chairman SHELBY. Thank you.

Secretary Snow, we appreciate your patience this morning. This is a very important hearing. We do have a vote on the floor. We are going to recess the Committee, and we will come back and hopefully get into your testimony.

We will stand in recess.

[Recess.]

Chairman SHELBY. The hearing Committee will come back to order.

Senator Reed.

STATEMENT OF SENATOR JACK REED

Senator REED. Thank you, Mr. Chairman, and thank you, Mr. Secretary, and I think you have already realized this is a hearing not about currency but about jobs, particularly manufacturing jobs. And like every one of my colleagues, I have seen a tremendous deterioration in the manufacturing employment sector in my State of Rhode Island, and, frankly, Rhode Island many, many years ago was the beginning of the industrial revolution and manufacturing revolution in this country.

One of the reasons—not the only reason but a very significant reason—is the behavior of China. When China was admitted to the World Trade Organization, it made commitments that it would eliminate trade barriers, open its market to U.S. exporters, but, frankly, they have not lived up entirely to these promises. And one

of the major issues, of course, is their continuing policy of pegging the yuan to the dollar, but also in terms of enforcement of intellectual property rights, industrial quotas, export performance conditions, requirements that businesses use local content. All of these are inimicable to a free trade regime, which all of us would like to see, but we cannot close our eyes to the reality in the relationship.

We should not scapegoat China, but we should not give them a pass, either. And I think we have to take steps, and, unfortunately, the report today does little to point in the direction of a policy. It might be a diagnosis, but it is certainly not a prescription for what we should do.

We have lost these jobs, and these jobs go right to the heart of our communities, not just economically but socially. Although the Chinese have announced that they are going to buy billions of dollars in anticipation of the visit of their leadership, a one-time shopping spree cannot take the place of a systematic, continuous policy that recognizes the reality on both sides of the relationship.

So, I hope that as we go forward the Administration will craft a policy and not simply give us a diagnosis.

Thank you.

Chairman SHELBY. Mr. Secretary, thank you for your patience. As I said, this is deemed a very important hearing. Your written testimony will be made part of the record in its entire. You proceed as you wish.

STATEMENT OF JOHN W. SNOW
SECRETARY, U.S. DEPARTMENT OF THE TREASURY

Secretary SNOW. Thank you very much, Mr. Chairman and Members of the Senate Banking Committee, for this opportunity to appear before you and present the report as required by the Omnibus Trade Act of 1988.

The report reviews economic developments in the United States and examines, in documents, the wide variety of exchange rate policies that are employed throughout the world, and they vary quite a bit. A notable trend has been the move by many countries to adopt flexible exchange rates, and I was pleased to hear so many of the Members of the panel voice their support, including you, Mr. Chairman, for flexible exchange rates, which really do stand in marked contrast to the accords that were mentioned earlier.

The report concludes that no major trading partners of the United States meet the requirements set forth in the statute. But let me be clear, the Bush Administration believes strongly that an international trading system works best that relies on free trade, the free flow of capital, and market-based exchange rates. That is a message we have taken around the world, to Japan, to China, to Taiwan, to Korea, to all the Nations of the world, and a statement that is reflected in the G–7 communiqué that was released from Dubai recently. We believe that an efficient system of trade and finance, with fair rules and enforced rules, is essential for the United States and all nations to maximize the benefits of trade and to do what needs most importantly to be done, generate the highest levels of economic growth and jobs. And I heard all of you loud and clear on the jobs point. Senator Reed, you made that point very clearly. Other have, the Chairman has. And jobs are the ultimate

objective of good economic activity, and well-paying jobs, jobs that reward people for their efforts.

The report finds that a number of countries continue to use pegged rates, fixed rates, and/or intervene in the foreign exchange markets. But it is important to note that a currency peg or an intervention in and of itself does not satisfy the statutory test. After all, for many, many years, the United States was part of a pegged system following the Bretton Woods agreements. So the peg in and of itself does not satisfy the statute.

In rendering our decision here, as required by the statute—and this is important—Treasury has consulted with the IMF, the expert international agency on currency matters. And I, myself, spoke with both the Managing Director of the IMF and the Deputy Managing Director of the IMF, and I am pleased that the IMF management offered us their thoughts, offered us their consultation, and concurred in the findings of this report.

But let me make it clear that the Bush Administration is aggressively encouraging our major trading partners to adopt policies that promote flexible market-based exchange rates combined with clear price stability goals and a transparent system for adjusting their policy instruments. In my testimony today, I would like to discuss this with you in some more detail.

There was talk earlier, and, Mr. Chairman, you focused on it in your opening statement about the need for domestic-led growth. One of the problems with the world economy—and it is reflected in the U.S. economy—is the absence of more domestic-led growth, in Europe, Germany, France and Japan. I would like to take a moment to discuss the Administration's international economic strategy as it relates particularly to the issue of growth.

A stronger world economy is vital to sustaining U.S. economic growth and job creation. It is the absence of more growth in Japan, Germany, China, and in the EU which has hurt our manufacturing sector. So we have made domestic-led growth in those countries a priority.

We depend on Europe and Japan just as they depend on us. It starts, though, this issue of jobs and how to create jobs, with a strong domestic economy, and that is why the Administration came forward with the President's jobs and growth bill.

I am glad to see the really very good numbers that were reported at 8:30 this morning, numbers that show that the American economy is really getting back on path, numbers that show growth at 7.2, but in some ways even more importantly, that we are finally seeing some very sizable capital expenditures in this economy, expansion of plants and investment in manufacturing equipment, software, and PC's. As that happens, of course, jobs follow because somebody has to be there to operate that machinery and that software and those PC's.

Mr. Chairman, the other encouraging thing about today's numbers is the fact that we did not rob Peter to pay Paul. Inventories came down very significantly during the quarter. We now need to go through an inventory replenishment period in the United States, and that is going to lead to continuing strong economic activity, and with it, we should see a nice pick-up in jobs, which is what, Senator Reed, you said ultimately this is all about. We should see

a nice increase in jobs, and particularly in manufacturing jobs, which, as we all know painfully, have lagged so far behind.

At the core of our strategy for jobs and growth is having good economic policies in place. But it is also important here to encourage pro-growth and pro-stability policies in other countries. I want to underline that: Good economic policies in the rest of the world help the United States, and we have a stake in seeing those countries adopt good policies.

An important issue that has been mentioned by many of the Members and by the Chairman is the U.S. international accounts. There is a great appreciation worldwide that the United States is a force for strong growth. In fact, many people now talk about the United States, regrettably, as the only engine of growth in the world economy, and that is not adequate. That is not sustainable. We need more engines of growth. As somebody said, you may be able to take off on one engine, but it is hard to land on one wheel. We need more engines of growth in this world economy.

This strong performance is also reflected in the pattern of our external trade and current account balances, and if you will let me for a minute just talk about the essence of the current account.

The current account is best understood in terms of the relationship between investment and savings. As a matter of accounting, the current account deficit is equal to the gap between a country's savings and its investments. Thus, in a country like the United States where investment is considerably higher than domestic savings, we turn to foreign investors to make up the difference. And that difference is what is called the current account deficit.

Now, in Japan, they are on the other side of that. In Japan, by contrast, savings rates exceed investment, and, therefore, they have a sizable current account surplus.

Our current account surplus largely reflects the attractive investment environment and high productivity growth in the United States which attracts capital here. Increased savings, though, in the United States, along with stronger growth abroad—both, the combination of more growth abroad and higher savings rates in the United States—offer the long-term answer to this large current account deficit that many of you called attention to.

Let me talk for a minute about exchange rate policies, which is really the subject of the report.

Our report shows that countries around the world continue to follow a wide variety, really, of exchange rate policies, ranging, on the one hand, from flexible exchange rate regimes—this would be the EU—with no or little intervention, to currency unions and full dollarization. While the choice of what kind of a currency regime you employ is clearly a sovereign decision, it is up to each country, we have been pretty vocal in encouraging countries to use flexible exchange rates. And why? Well, basically because flexible exchange rates ease the adjustment to changing economic conditions in the international financial system. They lead to the best international allocation of resources, and, thus, they have an inherent element of fairness to them.

Of course, while flexible exchange rates have a lot to recommend them, they won't work unless a country also follows good economic policies. A good flexible exchange regime requires monetary policy

that focuses on the goal of price stability and has transparent procedures for setting the policy instruments.

And while we strongly recommend the use of flexible exchange rates with our major trading partners, a message I have taken around the world, we recognize that for smaller country there are benefits from hard exchange, pegs, dollarization, joining a currency union or a currency board, particularly, as I say, for small open economies.

These ideas were reflected in the G–7 statement that was adopted in Dubai. We think that statement was real progress. I called it a milestone because it focused on domestic-led growth, focused on the need for economies of the world to take the steps with their own economies to make them more flexible and resilient and deal with the problems that slowed growth and hurt domestic growth. And the statement also reflected broad-based support among the G–7 for flexible exchange rates, for letting markets set currency values.

Everything that came out of Dubai and everything that I have said today is entirely consistent in every way with our strong dollar policy, which I have reiterated consistently. As I have said often, a country cannot devalue its way to prosperity, and a strong dollar is very much in the U.S. national interest.

I think we are making progress with the world community in pushing this idea of greater flexibility. We have engaged China on it. We have engaged Japan on it. I will talk to you later about clear progress I think we are making, Mr. Chairman, on China. And let me conclude simply by saying that strengthening the economic recovery in the United States, jobs in the United States, is our key objective. High disposable income levels in the United States is our key objective.

The way the rest of the world manages their economic conditions, the currency regimes they have affects us, and where we see other countries throughout the world not adopting policies that make good economic sense, that allow jobs and growth in the United States, we will be vigilant and we will intervene. And as I say, I am in discussions with any number of countries on that subject today.

I thank you very much and look forward to your questions.

Chairman SHELBY. Mr. Secretary, you stated that a peg or intervention does not meet the definition of what we call currency manipulation and that the IMF concurs in this assessment.

Secretary SNOW. Yes.

Chairman SHELBY. If what the Japanese are doing and what others are doing in Asia, especially the Chinese, if they are not manipulating their currency, what are they doing? In other words, could you tell us what conditions, in your opinion, would meet the technical definition of manipulation, at least your definition?

Secretary SNOW. Well, yes, Mr. Chairman.

Chairman SHELBY. That is troubling. You know, I think most people and a lot of economists are saying, Mr. Secretary, the opposite of what you are saying.

Secretary SNOW. Let me try and address that. That is an issue that I am sure is on the minds of many of the Members of the panel.

The end product of this statute, that is, the objective of this statute is negotiations, is discussions. It is engagement with countries with whom we want to advance some currency objective. That end product, that engagement is going on. I can assure you of that. We are fully engaged with the Chinese.

Chairman SHELBY. We know that, but are they listening?

Secretary SNOW. I think they are, Mr. Chairman. I think we have really got their attention. I think the President got their attention. I think I helped to get their attention. They have now committed to going to market-based flexible rates. They have indicated that they will be and are taking a number of steps to get ready for it, because, as was mentioned by various Members, they are probably not ready right now to go to it.

Chairman SHELBY. What kind of timetable did they tell you?

Secretary SNOW. They said as soon as possible.

Chairman SHELBY. What does that mean?

Secretary SNOW. Mr. Chairman, that means as soon as they get these interim steps put in place, and they are moving on the interim steps.

Chairman SHELBY. Could that take years?

Secretary SNOW. I hope it is sooner——

Chairman SHELBY. Not weeks or months?

Secretary SNOW. No, not weeks or months. But hopefully weeks or months to see concrete steps. Weeks or months to see concrete steps that allow for some of these balance-of-payments adjustments that we so much want to see.

I think we are on a good course. I believe financial diplomacy here of the sort that we are engaged in is the surest course to get the result we want.

Chairman SHELBY. Mr. Secretary, do you believe that a timetable by the end of which the currency peg must be lifted or China becomes ineligible for continued IMF assistance and WTO membership benefits would make sense? And if not, why not?

Secretary SNOW. Senator, I think we should move them, encourage them to move as fast as possible. I would be reluctant to set up a fixed timetable because of concern as to how currency markets would respond to that timetable. That is, you would set up one-way bets for or against the yuan, which would not be helpful. But gradual easing, maybe widening the band over time, maybe going to a basket of currencies with expansion of the capital—liberalization of the capital controls, all of that will move in the right direction and help with these larger adjustments in their current account.

Chairman SHELBY. Mr. Secretary, I was not satisfied with your answer, and maybe you did not answer it, of what you thought would be currency manipulation.

Secretary SNOW. The past circumstances it has been found. China was designated, I think in the early 1990's. There they had a discriminatory dual rate system that precluded the adjustments that you would expect and looked manipulative and was found to be manipulative. I am not saying there are not circumstances where it would be appropriate to find manipulation.

Chairman SHELBY. Mr. Secretary, a flexible exchange rate is clearly an indicator of a more developed economy. Some observers have expressed concerns about the ability of China's financial sec-

tor to handle an immediate move on their currency. How would you assess the ability of the Chinese banking system at the moment to make such a transition?

Secretary SNOW. This has been a matter of discussion, Mr. Chairman, with the Chinese authorities, their very able chairman of their central bank, Chairman Zhou, and other leaders there, including Premier Wen.

I think it takes some time. I think it will take some time for the Chinese to put in place the financial architecture to sustain a well-functioning system of floating rates or flexible rates. Their banking system has a very heavy ratio of bad loans, and the asset side is weak. And I would be worried that if they moved precipitously to relax capital controls as part of movement to freely fluctuating rates, you would see the asset side of the banks weakened enormously as yuan left the banking system.

Chairman SHELBY. Is this mainly state-owned banks making loans to state-owned industries?

Secretary SNOW. Precisely.

Chairman SHELBY. And it is a never-ending cycle, is it not?

Secretary SNOW. It is something they recognize needs to be addressed. It was very much the subject of my discussions with their economic and political leadership. And they are addressing it. They are moving on it. They know they have to move on it, and that is the precondition that has to be dealt with before you can really go to liberalized capital controls and a floating rate.

Chairman SHELBY. I know my time is up, but, last, do you agree that basically a continued imbalance in our current account is a ticking time bomb?

Secretary SNOW. Senator, we have the best access to capital and credit in the world now, and I think, as I said earlier, the issue here really is one of getting more growth in the world economy so more of our goods get purchased. I think we are on a course for that. World growth rates, the numbers I have seen, are going to be higher next year, but we should get savings rates up in the next year.

Chairman SHELBY. Secretary, but how do we sell more goods if people are keeping their currency down in price and ours up in price? In other words, manipulating the currency.

Secretary SNOW. That is part of the whole story, and that is precisely why I have gone to China and engaged on that issue.

Chairman SHELBY. Thank you.

Senator Sarbanes.

Senator SARBANES. Thank you very much, Chairman Shelby.

I actually want to start off by following up on a couple of points that Chairman Shelby made which I thought were right on target. The first was his reference to a ticking time bomb. Mr. Secretary, this is the U.S. trade deficit. Look at that beauty. Look at this. This is over a $500 billion trade deficit. Current account, well, over $500 billion. Look at the way this thing is going.

I think we have a disaster waiting to happen. The accumulation of these negative figures over these years, beginning in about 1980—actually we were in plus figures right at the beginning of the 1980's in the current account. This is the U.S. net international investment position, $2.5 trillion negative. Negative. Claims others

have on us. It is no wonder Warren Buffett was talking about losing our assets. It is like that Blanche DuBois statement in the Tennessee Williams' play, you know, "depending on the kindness of strangers." That is what has happened to the U.S. economy.

Now, Senator Shelby asked you about finding currency manipulation, what is your definition of it, how do you get there, and you said, well, we have in the past found that China manipulated its currency. That is quite true. Let me show you this chart.

In 1992, the Treasury under Bush I found that China had engaged in currency manipulation. The trade surplus with the United States at an annual rate, China-United States, when Treasury found that, May 1992, $12.7 billion; December 1992, $16.7 billion. Today, October 2003, when you do not find currency manipulation, the trade surplus, $116.8 billion. Back in 1992, when Treasury found currency manipulation, as a percent of GDP, 3.1 percent and 3.5 percent, now, 8.7 percent.

It is just dramatic. Global current accounts, same performance. And then accumulation of reserves, back in 1992, $14 billion, $6 billion over the course of 1992. Now, it is $111 billion. I mean, it boggles the mind to explain how we could find currency manipulation on the basis of these figures in 1992, when you can come in this morning and say it is not happening.

Now, I want to quote a statement made recently by Fred Bergsten, Director of the Institute of International Economics, before the U.S.-China Economic and Security Review Commission. He said in terms of criticizing the approach that was being taken by the Administration.

> They are proposing that China float the renminbi, and that is a worthy long-term goal. But if we put our efforts in that direction, it will not happen for 5 years or more. The Chinese are correct not to float their currency because to do so, in a meaningful way, they would have to eliminate their capital controls, and Secretary Snow was consistent in asking them to eliminate their capital controls as they go to a floating rate.
>
> The problem of course is that China has a bankrupt banking system, that the vagaries of international capital flows are such that no country wants to expose itself to those uncertainties when its internal financial system is not sound. To put it pragmatically, if China actually floated the currency and freed up its capital controls, the renminbi would probably go down in value not up.

And then he discusses why that would happen.

He says,

> Their comparative position would improve. The situation would get worse. So, on both conceptual and pragmatic grounds, our Government was asking for the wrong thing. What they should be asking for, and what I believe is eminently doable, is for the Chinese to keep their fixed exchange rate system, but to change the price, revalue the currency by 20 to 25 percent on a one-shot basis, tell the Chinese we respect their desire to maintain a fixed exchange rate and maintain some restrictions on the capital account as long as they have a bankrupt banking system, move toward correction and reform of that over the long-run.
>
> But in the short-run, to deal with the problem, we want a one-shot revaluation of a substantial amount which would give a substantial improvement to our international position and convert them into a sustainable position.

What is your response to that analysis?

Secretary SNOW. Senator, my response to Mr. Bergsten's analysis is that it is better to work on the banking system now, it is better to fix the problems now, it is better to continue to press the Chinese to do that, and I think we will get a better result long term proceeding that way.

With respect to two of your other observations, if I could respond, we are not really in the position of Ms. DuBois in *A Street Car Named Desire.* We really are not dependent on the kindness of strangers—hardly. These are international financial markets, and people invest in the United States, as you know, Senator, because of the good returns. The risk-based returns in the United States are higher than in other parts of the world, and that is because we have a productive economy, lower inflation, and we honor capital.

Senator SARBANES. Do you think the Japanese are buying in the currency market, as heavily as they are doing, unrelated to trying to affect the valuation of currency and their trade position?

Secretary SNOW. Senator, I was dealing with your concern that we depend on the kindness, as you said, of strangers. We do not depend on the kindness of strangers to attract capital.

Finally, I would say that, with respect to your chart, there are a lot of differences between today and 1992, 1993, and 1994, back in that time frame, when China was cited. China had a dual exchange rate system, as you know, with very heavy capital controls that interfered with the play of market forces and the balance-of-payments adjustments process. It had significant restrictions at that time on payments for current account transactions that very much limited their ability to import. They have relaxed those a lot now.

The system that was in place in the period when the designation was made has disappeared. We have a new system now. It has lasted for some 10 years, and I am the fourth Secretary in a row who has looked at the question and concluded that no designation was called for.

We are not happy with the way the Chinese deal with their currency. We are committed to changing it. We are engaged in changing it, and I think we are making real progress.

Senator SARBANES. Mr. Secretary, God save us from the new system. In the old system in 1992, they were showing about 3.5-percent trade surplus with the United States as a percent of GDP. Now, they are up to 8.7 percent. In 1992, they were accumulating reserves at about $10 billion over a 12-month period, and now it is $111 billion. The statute actually requires that they show a trade surplus with the United States and a global current account surplus.

Secretary SNOW. Right.

Senator SARBANES. They have both of those, but in dramatic numbers.

Secretary SNOW. It says "material," and by most economists' estimates, 2.8 is not material on the global current account basis. But however we parse that, the fact is we are engaged in the very actions that the statute contemplates. We are fully engaged with the Chinese, and I think the way we are engaged is going to produce results.

Senator SARBANES. Well, I will close out and do it in the next round, but let me just point out, while the long-run objective of flexible rates I think is desirable, and that is where we need to go, I do not think you are going to get the Chinese there in the short run because they have this concern about capital controls and the weakness of their banking structure. And for the life of me, I do

not understand why the Administration is not pressing, does not have another arrow in their quiver, that they should revalue, in the short-run, which would make a significant difference and, of course, the Chinese currency is a linchpin for Asian currency appreciation.

Frank Vargo, of the NAM, said the other day:

> The Chinese currency is the key not just because of the huge bilateral imbalance, but also because other Asian countries are all looking over their shoulders at Chinese competition and are reluctant to allow their currencies to move up against China's. Once China's currency appreciates, though, they will be less reluctant to allow theirs to move upward as well.

And we mentioned earlier the figures of Japan, Korea, and Taiwan. I think your short-run strategy is to get a revaluation of the peg—in the context of a long-run strategy, to go to flexible rates.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Allard.

Senator ALLARD. Thank you, Mr. Chairman.

I would like to start out with a few comments to let you know, Mr. Secretary, where I am coming from. I may be the only free trader sitting on this panel today. I do not know. But when you talk about manufacturing jobs, those jobs have been decreasing for the last 2 decades. Now, it has been a combination of things, in my view. Number one, part of it has been due to the fact that we are modernizing our factories so workers can get more done. We have increased efficiency. We have increased production, and I think this has all served our country very well.

Also, you know, our manufacturing sector is being plagued more and more with rules and regulations that have a real cost to the value of the goods that they are kicking out, and this has also had an impact. To be competitive in a world market, sometimes we lose jobs to other countries because of the regulatory burden in this country.

I want to pull up this chart here that my colleague had pointed out where it talked about the trade deficit. If you will notice the lower parts on those charts, do you know what was happening at those times? You take this little part right here. This is when we had the misery index. Remember double-digit inflation, double-digit interest rates, double-digit unemployment. We go down here to the 1980's, and the economy was not doing particularly good there. We go clear back to the Depression. Our trade deficits were more favorable, but certainly I do not think that is what we want for this country.

I would hope that we not go too far in criticizing the trade deficit. Because when our economy is doing well, consumers are doing well, they are purchasing goods, and that is a reflection on a prosperous economy that is doing well.

I would hope that you would counsel the President to let us not have any more trade tariffs like we put on lumber and steel. There are lumber companies in Colorado who are reporting to me today that since those lumber tariffs were imposed, the cost of lumber in Colorado has gone up dramatically. That impacts the home-building industry. It is a fundamental industry, and eventually, if we continue impose tariffs, it is going to have, in my opinion, an adverse impact on the economy, as well as steel.

And we have had some Members on this panel say, what they want is tariffs, but I hope that we will avoid that. If you look at the poorest countries in the world, they are the ones that have the most trade restrictions, and they are doing the poorest, as far as their economy is concerned.

Milton Friedman, a Nobel Prize winner is a free-market economist, and he was an advocate of free markets, and I happen to agree with that. He said that the dollars are pretty much like a commodity. He said that if you will treat them like that and not overreact, they will adjust.

Looking at some of these charts put out by the IMF, they show that Japan and China both have horded—it looks like $800 million if you look at these charts here. They are not getting any interest on that money. They are not producing. They are not doing anything. South Korea and Taiwan, you pull them in, and it is over $1.1 million.

Now, would you agree that there is a point of no return where the countries that are trying to hold onto these American dollars to help with the exchange rate are going to have to release some of these dollars; where they are going to have to deal with the market at some point in time? Would you agree with that?

Secretary SNOW. Well, there is always an adjustment process going on, Senator. I certainly agree with that and with your broader statement on the power of free trade. Free trade benefits all parties of free trade. It creates jobs, and it creates more wealth, and it is critical to the success of the world economy to continue to push for free trade. And we think, going hand in hand with free trade, as Milton Friedman argued years ago, are fluctuating exchange rates. He is one of the fathers of the idea of freely fluctuating exchange rates.

I agree with your views on the need and the importance of trade, and the importance of keeping the avenues of trade open, that trade benefits us, and that there is a continuing adjustment process going on in the world economy.

Senator ALLARD. Now, much of today's discussion has centered on the effect on the manufacturing center. We have seen a depreciation in this particular sector, but the question that I wanted to bring up has to do with the parameters in which you evaluate whether there is manipulation of the market by the country.

What do you look at to know whether that is happening? Do you look at their total dollar reserves that they hold, or is it much more complicated than that. I wonder if you would share with this Committee what parameters illustrate that a country is not complying with our agreements in 1988, and that they are not complying with our exchange policies?

Secretary SNOW. Senator, you would look at the things you mentioned. Is the country involved in some set of practices, currency practices, which frustrate normal balance of payments adjustments processes? Are they engaged in a set of practices which are motivated, are motivated by a desire to disadvantage U.S. exporters and competitors? Those are the sorts of things you look at.

And then you look at the question what is happening to their bilateral balance of trade and their multilateral balance of trade over time? You try and come to a common-sense conclusion on it. And

you consult with the IMF, as required by the statute. Those are the general factors that we used and took into account.

Senator ALLARD. Mr. Chairman, I would just raise a word of caution. Mr. Secretary, as you know, I am a veterinarian, and sometimes you have to look at the disease, and you have got to decide is the treatment worse than the cure or is the treatment worse than not doing anything?

I am not saying that we should not do anything in this particular case, but I think we have to be awfully careful about the treatment that we might apply. We might dig a big hole for ourselves, and our economy will not continue to do as well as it has been doing.

I am surprised today to see the gross domestic product figures. They are better I think than most economists were predicting, and I think this is a sign of recovery that is being stimulated by the Bush economic stimulus package. The tax cuts played a large part in getting that part of the economy going that needed to go in order to create more jobs.

And if we look at the overall job picture, at least in my State, we are beginning to see some things happen there that make us think we are very solvent and on the way to growth. So, I hope we are very careful about the way we analyze this issue and how much importance we put on these exchange rates.

Secretary SNOW. Thank you.

Thank you, Senator.

Chairman SHELBY. Senator Stabenow.

Senator STABENOW. Thank you, Mr. Chairman.

I feel compelled, as someone representing a State with great manufacturers, both businesses and employees, to say that, given a level playing field, our businesses and our employees can compete anywhere, any time. This is really about giving them a level playing field.

I am extremely concerned that they are being placed at a disadvantage through currency manipulation as well as a number of other factors.

Mr. Secretary, as I said in my opening comments, this is about jobs. This is about real people and real jobs. This is about my opening up the paper every morning and seeing another auto supplier, tool and dye maker, small furniture maker finding themselves in a situation where they may have to go out of business or, in fact, are going out of business, not because they are not smart, they are not effective or competitive or do not work hard, but because of the situations that they face.

I cannot think of a more important issue for us as a country than the question of losing jobs. We have to make things and grow things in this country. That is what we do in Michigan. We cannot all be in the service business. We have to have a manufacturing base on which to build in this country, I believe.

My concern is that, in listening to your comments about how you come to a conclusion about manipulation, you have indicated you look at whether or not the country was motivated by a desire to disadvantage foreign competitors. How could we look at that and not say yes? How could we look at this situation and not say that is exactly what is happening?

So one question—I actually have two questions, but the first is your report concludes that no major trading partners of the United States meet the technical requirements set forth in the Omnibus Trade and Competitive Act of 1988—it could be 1888, I think.

Secretary SNOW. 1988.

Senator STABENOW. Yes, I know it is 1988, but given the way it is being used, I would like to know is it time to change that Act? Are the technical requirements of this Act so out of touch with what is happening, as it relates to these situations, that we need to create different definitions?

Secretary SNOW. Senator, I have to think about that to offer you a thoughtful and informed opinion on it. But whether that is the case or not, the end objective of this statute, which is discussions, engagement, involvement with other countries, has occurred. We are deeply engaged, and we are engaged for the reason that you raise. We want to make sure that other countries are using regimes that are fair and do not prejudice opportunities for American jobs and American manufacturers.

I could not believe more strongly, support more strongly, your statement about American workers and American manufacturers. They can compete with anybody. All they really need is a fair set of rules that are fairly and fully enforced. That is why Don Evans right now is over in China, and I have had any number of discussions with constituents of yours from the auto companies and auto supply industry on these subjects.

If you will just let me offer a personal note on this, I take these responsibilities as Treasury Secretary very seriously, and I am deeply honored to be here, but I know it is heavy responsibilities and none more important than jobs, none more important than waking up every morning and saying what you have really got to be concerned about here is American workers, and jobs for Americans, and rising standard of living for Americans.

I know what it means to not have a job. I have been in that position, and I know what it means to have a job and the dignity that goes with having a job. I could not agree with you more, and we have to make sure that national economic policy at home is designed to create job opportunities, with higher standards of living, and we have to make sure that the international trading and currency arrangements are consistent with doing that as well.

Senator STABENOW. I would just indicate again that time is of the essence on this question. Our businesses and workers are looking to all of us for action. One other point, we have been talking a lot about China, and I agree with the concerns that have been raised by my colleagues regarding China, but I do also want to speak about Japan for a moment, equally concerning.

For 3 years, Japan has used massive currency interventions to intentionally manipulate the value of the yen against the dollar and keep it artificially weak. In fact, Japan has spent over $200 billion since January 2000 on intervention actions, including $120 billion this year alone. They have done this with the stated goal of gaining competitive advantages for their exports—the standard that we were just talking about, particularly the United States.

By maintaining this weak yen, Japan has been providing a de facto subsidy to their automakers. In fact, automotive exports rep-

resent 60 percent of Japan's exports to the United States, which means that U.S. automakers have been competing against a substantial export subsidy. In fact, a recent article in *Automotive News* cited a figure of $18,000 per vehicle as the level of export subsidy received by Japanese autos this year alone.

Mr. Secretary, does the Administration acknowledge that this is having an extremely negative impact on the auto sector and how will you specifically address Japan's unfair trade advantage in the automotive sector, which was one of the largest bilateral trade deficits we have with any nation and any product.

Secretary SNOW. Senator, that was a subject that was on my agenda for my meeting in September with Mr. Koizumi and his finance and economic team. We raised those issues and indicated, on the subject of currencies, our strong support for fair currency regimes that reflect market forces and that let rates adjust to the marketplace.

We did not designate Japan because I did not think they met the specific criteria of the statute. The yen has moved quite a bit. It was at 117 or 118 3 months ago. Today, it is at about 107, 108. Two years ago, it was at about 135, 137, range. Today, it is at 108. So we have seen some movement of it in response to market forces. That is what we want to see. We want to see market forces driving currencies, and that is a position that we have reiterated time and time again. But I understand your point, and I have talked with your constituents in the auto and auto supply industry and other industries very much about that issue.

Senator STABENOW. Again, we can compete anywhere any time, but $18,000 per vehicle difference, in terms of a subsidy, is not fair competition.

Thank you.

Secretary SNOW. Thank you.

Chairman SHELBY. Senator Dole.

Senator DOLE. Secretary Snow, Economist John Makin, of the American Enterprise Institute, suggested at an October 15 conference that the current growth of the Chinese economy is not sustainable and warned of a bubble in the Chinese economy. What kind of impact would such a bubble have on our economy, especially with the Chinese holding more than $357 billion in exchange reserves?

Secretary SNOW. We certainly are interested in seeing China have stable growth. They are growing at a rapid rate, as you know—7.5 to 9 percent. The numbers are a little hard to pin down with particularity, but very sizeable growth rates.

And one reason we are pressing the Chinese, as we are, to move to more flexible exchange rates is that we think—and open capital controls—that it would deal with pressures that appear to be building up inside their economy, inflationary pressures that seem to be building up inside their economy, and that was a discussion we had with their central bank, and with their finance ministers and with the premier because the peg, and the whole arrangement they have with the capital controls appears to be generating some internal inflationary pressures that need to be taken into account. I do not see them as creating precipitous problems, but I do see, over time,

those problems being something they need to deal with, and they have acknowledged that. They have acknowledged that.

Senator DOLE. Have these large exchange reserves held by the Chinese given us caution in exerting greater pressure for reform?

Secretary SNOW. No, not in the least. As I indicated earlier, the United States can finance its obligations. We are perfectly capable of financing our obligations, but we are not happy with the peg. I want to be just as clear as I can. We do not like it. We see it as a distortion of the world trading system, and we would like to see them eliminated. We would like to see them move off of it.

We recognize that moving too quickly, moving precipitously would create the very problems that Mr. Makin of AEI talked about. But at the same time we think they are an economy that is much different today than the one in 1992, 1993, or 1994. They have matured. They have grown. They are now in a position they can begin to move in this direction and, in fact, I think, Senator, the risks for them of not moving in this direction are greater than the risks of doing so.

It is with that framework in mind that we have urged them to move forward with and to move quickly, not to wait on this because these pressures inside their economy are very real, and there needs to be a safety valve for them.

Senator DOLE. Mr. Secretary, you are doing a fine job looking out for the interests of the U.S. Treasury and Representative Zoellick, in looking out for our U.S. trade interests. My responsibility is to represent 8 million people in North Carolina, and many of them feeling very concerned about the fact that we have lost more than 200,000 manufacturing jobs since 1995. Of course, I regularly meet with these people when I am in North Carolina. I see the reports constantly, day after day, with the plants closing, coming across my desk. I am committed to looking at every available option to help remedy this situation.

I recently joined Senator Voinovich in calling on Representative Zoellick to initiate an investigation under Section 301 of the Trade Act of 1974, and I would be interested in your views on that. I would hope that the Administration would not oppose a Section 301 investigation.

Secretary SNOW. Senator, I was not aware of that so I have not had a chance to examine it. I think that the course we are on is one that is promising. I want to make sure that the Committee is aware of my strong view that we are making a lot of progress here. This is not just talk. This is progress. They have reaffirmed their commitment to move to exchange rate flexibility. They have taken a number of very important and specific steps to do so. I won't take you through all of them, but they have allowed greater ownership in their banking and financial system. They have allowed Chinese Nationals to take more currency out of the country. They have allowed foreigners to take more currency in. They have established a whole new banking regulatory regime to go at this issue of the banking system's problems.

This is working. We are making real progress. We are going to have a financial attaché in Beijing. We have established technical talks with the Chinese, and to indicate how serious they are about this, the Chinese have entered into a memorandum of under-

standing with the Merc, the Mercantile Exchange in Chicago, to develop foreign exchange derivatives in China. Now, you do not have foreign exchange derivatives unless you have some movement in your currency.

So, I think we are making really positive progress here. I wish it could go faster.

Senator DOLE. Let me just ask you very quickly, certainly Canada, Europe, and other trading partners are also feeling the effects of a loss of their manufacturing base to China, and it seems sometimes like we are just a lone voice on this issue. Shouldn't our other trading partners be joining us in putting pressure on the Chinese to make necessary reforms? Shouldn't we be building a coalition in this area? What are we doing in that respect?

Secretary SNOW. Well, in that regard, Senator, I was extraordinarily pleased by the statement that came out of Dubai from the G–7 Ministers meeting, which addressed the issue head on and expressed a strong commitment for all the major countries of the world to embrace freely floating rates with elimination of capital controls. So we have now the G–7—actually, Russia was part of those meetings—the G–8 embracing the idea of open competitive capital markets and open competitive currency markets.

I think there is real movement here. I am encouraged. I wish it would go faster, but I am encouraged.

Chairman SHELBY. Senator Corzine.

Senator CORZINE. Thank you, Mr. Chairman.

Mr. Secretary, with all due respect, I read the Dubai communiqué, and while it certainly embraces the concepts you are talking about, in no way does it, in my view, set metrics, timetables, or an outline, a specific program for moving to the benefits that one might argue would be the case with flexible exchange rates and some of the other issues. I believe part of the topic of discussion today is timing. I think that the reasons that I outlined in my opening statement, both the unsustainability of our current account deficit, the growing embrace of protectionist ideas that are being both advocated and actually, in some instances, followed by the Administration, do not seem to me in the context of the job losses that we have seen in this country. By the way, I am concerned that there may have been some sense that we have grown jobs from one of my colleagues' comments earlier, when by latest calculations I think we have lost 3 million jobs in the last 3 years. And while all of us are pleased with the GDP growth, there was a decline in jobs again in the third quarter. I hope that the growth we see will lead to the pick-up in job growth because that is what we are interested in. I hope your numbers that you projected last week actually come to pass.

But it strikes me that there is an urgency with regard to these trade and exchange rate policies that is not reflected in either the report or the comments today. I continue to believe that we need to—and this actually is why I mentioned the Plaza Accord, and I know that Senator Dole mentioned broadening out the coalition. We are dealing now with much of the concern in the developing Asian economy, which is not just China. It is all of those other currencies that are tied very closely to it, and it is the competitive position that each of them have with it. It strikes me that we need

to be sitting down and talking about this in a much broader, comprehensive context than we are doing it now.

I happen to be a believer, not unlike the Ranking Member, with regard to an intermediate step before we get to flexible exchange rates with China, that there needs to be some adjustment with respect to the peg. That is not an endorsement of the peg concept. It is just saying that before we take off exchange controls, before we get all of these revisions in the economic system, we should not sit here and continue to lose these jobs in manufacturing and other sectors because we are not willing to take steps in the interim.

And I think it is in the interest of the global economy, not just in the interest of the United States with regard to these issues. This is hurting European expansion, Japanese expansion. There needs to be a fundamental understanding that there is a linchpin element here to where the RMB works. I think the same institute that Senator Sarbanes was talking to talks about a 20-, 25-percent revaluation would create somewhere between 250,000 and 500,000 jobs here, but that has implications around the globe for growth that then feeds back in everybody's domestic economy that you are talking about.

I do not understand why we would not want to try to take some interim steps, understanding that China has to move on a paced basis to change with regard to where they are with regard to the peg. And it would be something that I think we as a Nation should be the leaders of bringing about. It is good for China in the same way that you responded to Senator Dole's question. They have huge buildups of inflationary pressures and bubbles in certain parts of their economy because they are growing their reserve base. Money supply is exploding with this increase in reserve holdings.

I am concerned that I do not hear the urgency that is represented by the current account position in the country relative to the jobs, relative to growing protectionism, and growing weakness that we see in other parts of the globe, or at least sustained weakness in other parts of the globe that are being held back because we are not doing something now.

Senator SARBANES. Jon, would you yield for just a moment?

Senator CORZINE. Sure.

Senator SARBANES. I just wanted to add, this revaluation of the Chinese currency many see as a linchpin for Asian currency appreciation. It is not plausible that other Asian currencies will appreciate without a revaluation of the Chinese currency. As the NAM Vice President said, they are all looking over their shoulders at Chinese competition and are reluctant to allow their currency—so the point that Senator Corzine is making is right on target in terms of this wider context in addressing this question.

Senator CORZINE. I think that is actually true with the Japanese as well, and you know, I can ask for your response to the tirade, but I would recommend that the Treasury give very serious consideration in their bilateral conversations with the Chinese. But I think this is actually a multilateral issue, much broader, and I actually think the Dubai communiqué is too general and does not deal with the real specific issue, which is, I think, undermining this exchange and currency problem.

Chairman SHELBY. Senator Schumer.

Senator SCHUMER. Thank you, Mr. Chairman. I appreciate the hearing. I am sorry we had many things going on, so I apologize for being a little late.

As you know, Mr. Secretary, it is not a surprise to you that I am very disappointed in the report today, and hearing my colleagues—well, I was not here to hear, but it was reported to me, just about everybody else seems to be, too, on a bipartisan basis. And it leads to a question. We cannot quite figure this out. You have said let diplomacy work, but the Chinese seem to say do not even bring this up. We do not see any progress whatsoever, any progress in this area. The Chinese just seem to feel they can get away with whatever they want.

The question I have is this: Is there some kind of deal? Do we tell the Chinese you help us in foreign policy and we won't bother you on this issue? Because certainly this report lets the Chinese off the hook. Now the Chinese can say to any U.S. official, from the President on down, you found we are not violating any laws, we are not doing anything wrong.

All the pressure that you have been trying to build up on them, you have pulled the rug out from under yourself with this report. And I do not get it.

So can I ask you this: Before you issue these reports or go to China, do you talk to the State Department people? They traditionally put economic issues second and diplomatic issues first. Many of us are incredulous here about what is going on because we, in a different position than you, have to live with the exodus of the jobs. And, you know, I am well aware of the fact that not every job is going to be saved by a fair valuation of the Chinese currency. But it sure means some of them would, and it also means that everyone who loses a job thinks that this is related. The good economic news today is growth. The bad news is jobs. And what we are talking about here, is directly related to jobs.

I guess my question to you is: Has some kind of deal been struck either about North Korea, about some other foreign policy area, something not related to economics, or even related to economics, well, we will leave you alone if you buy some planes from us or you do this or you do that? I mean, tell me what is going on here.

Secretary SNOW. Senator, we are, in your words, not "leaving the Chinese alone." We are engaged on a number of points with them to get them to open up their economy, to get them to relax capital controls, and to get them to move to a freely floating rate.

I have been over there. I have been to Beijing. I have talked to the leadership of the country, from the Premier on down. I have talked to the Finance Minister and the central banker in a meeting of the World Bank, IMF in Phuket, Thailand. I just came back from Oralia, Mexico.

Senator SCHUMER. Have we made any progress? I know you are trying hard.

Secretary SNOW. We are. I heard you say we are not making progress. We, I think, are making genuine progress. You were not here a few minutes ago when I commented on some of this progress. I will not repeat it all.

Senator SCHUMER. Okay. I will look at the record.

Secretary SNOW. But one important element of progress that is really pretty startling is the interest which the Chinese are taking in talking to the Chicago Merc, about derivatives on their currency and options on their currency. And I confirmed that in a discussion I had with Governor Zhou, the counterpart to Alan Greenspan, and Governor Zhou has endorsed this project with the Merc in which they have asked the Merc to help develop a currency futures market in China.

Now, Senator, there is no point in having a currency futures market unless you let your currency——

Senator SCHUMER. Right, but they have not done anything. They are talking.

Secretary SNOW. Well, I understand they are entering into or have a memorandum of understanding to retain the Merc to do this for them.

Senator SCHUMER. But they could wait 2 years before they did it. They could say we need time, we need time, we need time. No one is saying all of this has to be done in 6 months, but we do not see one inch of progress other than talking. And talking is not going to get us anything done if the basic situation is unfair.

Secretary SNOW. Senator, since I started this discussion with them, U.S. financial institutions can now own a larger share of Japanese financial institutions than had been the case before.

Senator SCHUMER. Right.

Secretary SNOW. And insurance companies. Non-Chinese, your constituents, can take more hard cash into the country. It is not as much as we want. They are not moving as fast, you know. But we are pressing them, and we will not relent here. We will not stop. We are going to keep the pressure on.

Senator SCHUMER. Let me ask you just one other thing. I know my time has expired. Just one more question with the Chair's indulgence, and that is, what is the Administration's position on the legislation that the group of us have put in about the tariff? And let me ask you this: Even if you do not have a position yet, which I do not think you do, isn't it fair to say that if this were to pass the Senate, it would increase your leverage and your ability to negotiate with China?

Secretary SNOW. Senator, I think we are making good progress, and I would rather continue down the path we are going.

Senator SCHUMER. You do not think it will help you, it will help your leverage?

Secretary SNOW. As I say, I think we are really on a good path and are making progress, will continue to make progress. If I thought otherwise, I would respond differently to your question.

Senator SCHUMER. Okay.

Thank you, Mr. Chairman.

Chairman SHELBY. Mr. Secretary, we have seen such an acceleration, it seems to me, in the loss of manufacturing jobs in the United States, more so than any time in economic history that I am aware of. We understand trade and we understand people doing this and doing that better than we are. But if the currency is manipulated to help them reach their goal of a better economic condition for their people and so forth, stable growth, but at whose expense, ultimately? I think on both sides up here today you heard

concern about the loss of manufacturing jobs, not in just my State of Alabama but all over America. And you are the Secretary of the Treasury. We know you have a tough job to do. But these are real concerns to us as Senators, as legislators. And I think that is the message we are sending out today.

I believe that although it is delicate dealing with China, Japan, and the other countries in Southeast Asia, they are going to have to be dealt with because people, if they are not going to play by the rules—and I know the rules are different. But if we are going to play by a set of rules and they are not, we are going to lose the ball game and we are going to lose it in our current account, in the loss of jobs. I wonder where we are going to be in 20 years if we continue to hemorrhage manufacturing jobs.

Mr. Secretary, I think there has been a lot of concern here about the need for the Chinese to move to a flexible rate exchange policy. How you get them to do that is very difficult for a lot of reasons. But as an interim measure, would we see a measurable effect, a real effect if the Chinese allowed their currency to trade in a wider band than it does at present as part of a transition to a flexible rate regime? In other words, you loosen it up a little bit with a band or a basket or anything like that.

Secretary SNOW. Senator, I raised precisely that question with the economic and political leadership of the country, and I think it is something that they are looking at, the market basket idea, widening the band. No commitments were made, but I think that is clearly one of the things that is being looked at. I urged them to look at that hard and see if they could not embrace movements in that direction. It would be in their interest as well as our interest to do so. And I agree with you 100 percent. We have to make sure that our workers, our firms, and our companies are not being prejudiced because of policies and practices of other countries. We can compete anywhere, but it has to be a fair, level playing field where the rules are really enforced.

Chairman SHELBY. Well, I think Senator Dole raised the question in a very articulate way, and so did Senator Miller when he read you part of the letter from the worker there. What do we tell our workers at home who have been displaced in manufacturing—textiles, steel, automotive-related? Do we say, gosh, we are going to stabilize somebody else but at their expense? You know, that is a tough thing to say.

Secretary SNOW. I would not say that, Senator.

Chairman SHELBY. I have not said it.

[Laughter.]

Secretary SNOW. I would not say that. I would say, look, we are working hard on this economy. We are committed to seeing the economy grow. We are committed to creating more growth and income for Americans, and as more growth in income, after-tax income, is available, it will play out in a way—and it always has—that creates more jobs.

This recession is different. It really is, by the gap that developed in the recovery between the normal recovery and the manufacturing sector.

Chairman SHELBY. Why?

Secretary SNOW. In part because of astonishing productivity in our manufacturing sector.

Chairman SHELBY. You are talking domestically now. You are talking about the gains in our computer manufacturing, design, and everything.

Secretary SNOW. The whole manufacturing sector has shown tremendous productivity growth over the last 3 or 4 years, and what that productivity growth has translated into is the ability to do more work, more output, with fewer workers.

I am encouraged by the number——

Chairman SHELBY. You are not saying that this is going to be a recovery without jobs?

Secretary SNOW. No. I am confident we are going to see jobs. I think we have already begun to see it.

Chairman SHELBY. Yes, sir.

Secretary SNOW. The 57,000 in the last report.

Chairman SHELBY. The news today.

Secretary SNOW. The news today, and 5 of the last 6 months reduction in initial claims, the fact that aggregate hours worked are rising. There are some good, positive signs, and all the economists I talk to say that the linkage between growth and job creation has not been severed. It has been delayed, but not severed, and with the growth rates we are seeing, they are all projecting a very sizable pick-up in employment next year.

Chairman SHELBY. There is always lag time, but this recovery, we have seen more lag time, have we not?

Secretary SNOW. Yes, and the reason I think, Mr. Chairman, is the fact that we have had this astonishing productivity growth.

Chairman SHELBY. Senator Sarbanes.

Senator SARBANES. Thank you very much, Mr. Chairman.

Secretary Snow, I am going to read a series of quotes that appeared in major publications between March and October of this year, the period about which the Treasury report is concerned.

Financial Times, May 31, 2003.

The Bank of Japan conducted its largest ever intervention in the foreign exchange markets in May, using ¥3.9 billion to weaken the yen against the dollar.

Japan's foreign exchange reserves soared, providing further evidence that the government has stepped up efforts to weaken the yen.

And this shows what is happening to Japan's stock of foreign reserves, a very sharp rise. Of course, this is happening in all of those Asian countries. That is China. This is South Korea. And this is Taiwan.

New York Times, August 27.

Japan is spending heavily to pursue a weak yen policy. The Japanese Government is defying the logic of the foreign exchange market by keeping the yen from rising sharply in value against the dollar.

New York Times, October 1.

Yen declines after Japan moves to stem its rise. The yen fell against the dollar in New York trading yesterday after Japan's Ministry of Finance sold yen to stem a gain that had pushed the currency to its highest since December 2000.

How do you justify the conclusion in your report that Japan is not manipulating its currency?

Secretary SNOW. Senator, as I tried to respond earlier, the yen has fluctuated in both directions. The yen has appreciated about 10

percent or so from the beginning of the year. More than that, actually. I think the yen is now about 22 percent stronger than it was at the beginning of 2002. Over the last couple of years, it has fluctuated I think a low of 135 or so to yesterday 108-something. Three-year fluctuation, about the same, 137 to 108.

There has been considerable movement of the yen. The current account surplus has fluctuated between, 2 and 3 percent, and as I said earlier, that basically reflects the excess of Japanese savings, their high savings rates, versus their investment rate. And their investment rate is low because they do not have their domestic economy growing faster.

Senator SARBANES. But you have no problem with their intervention in the markets in order to affect the currency?

Secretary SNOW. I do not want to comment on their interventions as such. I will reiterate our policy, which is we prefer fluctuating exchange rates, we prefer use of the market.

Now, when asked about those interventions, their response is they intervene to avoid undue fluctuations which take the currency away from fundamental values. We prefer a world of fluctuating rates, and we continue to reiterate that, and that was the statement that came out of Dubai. It is not just us. It is all the G–7, including Japan as a signatory to that.

Senator SARBANES. Well, Mr. Secretary, I want to address the Dubai thing. I am glad you brought that up. In September 1985, when the U.S. trade and current account deficits reached the worrisome level of 3 percent of GDP, the major industrial countries' Finance Ministers met at the Plaza Hotel in New York to make an explicit commitment to raise the value of foreign currencies. The Ministers agreed, and I quote—this is from the Plaza Accord, "Some further orderly appreciation of the main non-dollar currencies against the dollar is desirable. They stand ready to cooperate more closely to encourage this when to do so would be helpful." So they came out of there committed to some further orderly appreciation of the main non-dollar currencies against the dollar.

Now, 18 years later, our deficits have surpassed 5 percent of GDP, even more troubling. The G–7 Finance Ministers met in Dubai last month and issued a statement, "We emphasize that more flexibility in exchange rates is desirable for major countries or economic areas to promote smooth and widespread adjustments in the international financial system based on market mechanisms."

Afterwards, the U.S. sought to claim that this ambiguous language signaled a major change. Other Finance Ministers claimed otherwise. Since Dubai, the Japanese have continued to intervene to prevent appreciation of the yen. Should we not be seeking a Plaza Accord type of the statement rather than this Dubai type of statement?

Secretary SNOW. Senator Sarbanes, the circumstances today and then I think are quite different. There was an effort to weaken the dollar, consciously weaken the dollar, as I recall the Plaza Accord. I think we have made the better commitment, and that is the commitment to let market forces rather than central banks and ministers of finance set currency values.

Senator SARBANES. If you sit and say, we are going to let market forces work and others are intervening in the market forces in order to gain advantage, apparently with considerable success, then are we not a patsy in all of this? It is one thing to say that the rules should apply, we have these international trading rules and people should abide by them. But if you have major actors who do not abide by them and depart from them in a calculated way in order to gain substantial advantage, if we just sit there and tolerate that, we are a patsy in this situation or so it seems to me.

Secretary SNOW. Senator, as you know we are continuously engaging the world on this issue and pressing forward our view that true flexibility reflecting market forces works best for the world trading system, for the country in question, and for the United States. You cannot devalue yourself to prosperity.

Senator SARBANES. Do you think it is fair to American manufacturers and workers to be competing against products produced in other countries where they have anywhere from a 25 to a 40 percent trade advantage because of currency manipulation?

Secretary SNOW. Senator, we oppose currency manipulation. We think that would be unfair, and we assert as strongly as we can the need for a world trading community based on open capital flows and fluctuating exchange rates.

Senator SARBANES. One final. Is a general appreciation of Asian currencies plausible without a revaluation of the Chinese currency?

Secretary SNOW. Senator, one of the things that I have learned the Treasury Secretary should not do is comment on the specifics of relative exchange rates, so I had better avoid making a comment there, if you will permit me.

Senator SARBANES. Thank you.

Chairman SHELBY. Mr. Secretary, I know you do not want to move a market in any direction and you are wise to do this.

With reference to Japan here, is there not a lot of difference, Mr. Secretary, between a country intervening in the market, that is buying or selling our currency in order to keep theirs at a desired exchange rate, as opposed to a nation that lets the market actually work and they do not try to intervene or manipulate, or as Senator Bunning used the term, cheat in the market? What we are trying to do is promote a situation in the world, as far as monetary policy, where the market sets the rate of exchange, short of nations trying to manipulate or actually manipulating the rate.

Secretary SNOW. Absolutely. That is our view entirely.

Chairman SHELBY. Now how do we get there?

Secretary SNOW. We get there by engaging in the dialogue we had in Dubai and getting the finance ministers of the world and the central bankers of the world to embrace this idea. That is what came out of Dubai was a strong statement embracing a point of view, a philosophy, one that we are in the forefront of.

Chairman SHELBY. But Mr. Secretary, how do we really get countries to change their ways when it is to their economic advantage at home to intervene in the currency market, to peg the market, peg the currency, or to intervene in the market buying and selling like the Japanese do?

Secretary SNOW. We have the types of discussions and engagement that we are having right now, and we bring the full force of our arguments to bear on them.

Chairman SHELBY. But will not these countries continue, by nature, to do what is in their best interest as they see it for their own economy and their own people even at our expense?

Secretary SNOW. Mr. Chairman, as Alan Greenspan I think testified before your Committee sometime recently, it is not in China's interest to pursue this policy. It is not in their interest because it is creating these adjustment processes within their own economy. That was not the main message I took to them.

Chairman SHELBY. But it is creating some distortions elsewhere, is it not?

Secretary SNOW. Yes, exactly.

Chairman SHELBY. Senator Sarbanes.

Senator SARBANES. Mr. Chairman, I would like to include in the record an article from the *Washington Post,* "U.S. Debt to Asia Swelling. Japan, China Lead Buyers of Treasuries," in the course of which it is commented, this has caused some analysts to even envision the day when China could use threats of selling Treasuries to try to influence U.S. economic or foreign policy. "'The U.S. dollar is now at the mercy of Asian governments ' said Joan Zheng, a former official at the People's Bank of China, the country's central bank and now an economist at J.P. Morgan Chase & Co. in Hong Kong. 'If China wants to influence the market it can. Its financial power is just so strong.'" They go on and on with a detailed statement of holdings.

The Japanese Government also has massive amounts of dollars because of its efforts to hold down the value of its currency, the yen, against the dollar, to boost exports to the United States. To do so, Japan's central bank used yen to buy billions of dollars this summer but then it had to invest the dollars in U.S. assets.

China has pegged its currency . . . to the dollar for nearly a decade. Manufacturers and labor groups in the United States have complained bitterly about what they say are undervalued currencies in Japan and China that effectively make those countries' goods unfairly cheap overseas. Some economists estimate the yuan is undervalued by as much as 40 percent, causing some U.S. business groups to blame China for the loss of millions of manufacturing jobs at home.

I think this is right on the mark. There are lots of tensions that come from a free trading environment. There are also benefits that come from it. But there is no way, at least that I know of, under any free trade regime, that justifies currency manipulation to the extent that some estimate the yuan is undervalued by as much as 40 percent. Even if it is 20, 25, or 30 percent, what do we say to our people? It is one thing to say to them, you have to compete on a level playing field, and we get pluses and minuses out of that. What do you say to them when they are losing their jobs, the manufacturers are going under, the workers are getting laid off and they come and—by general agreement I think these currencies are not where the market value "would put them" and people are losing jobs. It is happening every day.

Secretary SNOW. Senator, what we are doing is I think what you as one of the authors of this statute wanted done. We are engaging the Chinese in a very direct and forceful way. We are letting them know that we think a manipulated currency is unfair. We want a currency that reflects the realities of the marketplace, not one that

is manipulated. The only way to test that though is to get to the market. That is why we are pushing the marketplace.

Senator SARBANES. Mr. Secretary, under the statute there is a 6-month follow-up to this report. We look forward to receiving that. Presumably we will have a future hearing. But in the meantime, I am sure you are going to continue to hear more about this and you are going to have to deal with these various legislative proposals that are now coming forward which are a reaction or a response to this situation.

Secretary SNOW. Senator, let me assure you that in this interim 6 months I am going to be deeply engaged in pressing forward on this agenda that I have talked to you about today to make sure we have fair currency regimes across the world.

Chairman SHELBY. Mr. Secretary, we appreciate your appearance and your ability to go through the tortuous process.

The hearing is adjourned.

[Whereupon, at 1 p.m., the hearing was adjourned.]

[Prepared statements, response to written questions, and additional material supplied for the record follow:]

PREPARED STATEMENT OF SENATOR WAYNE ALLARD

I would like to thank Secretary Snow for appearing before the Committee today to discuss international economic and exchange rate policy and its impact on our economy. The issue of exchange rates and, in particular, the use of anticompetitive tools, has become an issue of increasing concern in recent years. While promoting fair and free trade, it is important that the United States be firm against certain practices that occur in the global marketplace that can ultimately hurt our industries.

The United States is committed to promoting and encouraging free and open markets, providing the ability for capital to find its most productive home. This flexibility implies that markets in goods and services will see growth beyond national boundaries. However, commitment to encouraging free markets means a commitment to eliminating unfair practices, such as the use of market restrictions and capital controls, that inhibit the free exchange of capital and goods through economies of the world. Tight control of either goods or capital can create imbalances in the economy and inhibit fair competition in the marketplace.

I look forward to hearing about the interactions of national economies and the impact of those interactions on the U.S. economy. The health of Colorado's economy depends a good amount on the success of its agriculture industry, so I am particularly interested to hear about how it might be impacted by international economic and exchange rate policies. I also anticipate hearing ways in which the United States can both promote free markets, and ensure that those markets provide the appropriate forum for free and fair trade. Secretary Snow, thank you again for appearing before the Committee. I look forward to your testimony.

PREPARED STATEMENT OF SENATOR CHARLES E. SCHUMER

Thank you Mr. Chairman and Ranking Member Sarbanes. This is an extraordinarily important hearing. As you know, I have more than a passing interest in Treasury's views on China's currency, as well as the policies of other Asian nations.

My concern about China's policies is not simply about jobs, or our manufacturing sector, or even, currency. Those are critical issues—we hear about them every day in our States. But even more is at stake.

This is now about the strength of our international systems and U.S. laws. It is about whether we stand up for the rules or turn a blind eye. It is about whether the trade agreements we spend so much time negotiating are worth the paper they are written on. And it is about whether our Government will have the courage to stand by its convictions.

Some try to frame this debate as "free trade vs. protectionism" that those who think China should change its currency practices risk a global trade war. In fact, the reverse is true.

As we know, free trade is a delicate balance. It rests on certain conditions—multiple nations both weak and strong abiding by a common set of rules and responsibilities. When those conditions are violated, the system must respond or else the actions of one nation will upset the whole global balance. So it is in the interests of free trade—in defense of free trade—that I am urging action. We cannot turn our backs and allow one major nation to engage in mercantilist policies.

It is the view of many economists, and many here, that the Chinese Government, as well as other nations, manipulates its currency to gain an illegal and unfair trade advantage. Let me briefly review that case. I think it is one that has been amply covered in hearings and testimony before Congress.

IMF Article IV, Section 1, states that members of the IMF should "avoid manipulating exchange rates . . . in order . . . to gain an unfair competitive advantage over other members."

The IMF definition of currency manipulation is very explicitly defined in Article IV. It refers to currency manipulation as "protracted large-scale intervention in one direction in the exchange market." That is the standard. Let us look at the data.

The monthly foreign exchange purchases by the Chinese Government have been huge. They have gone from an average of $3.8 billion a month in 2001 to over $10 billion a month in 2003. A sharp upward trend. During that period of time, total Chinese foreign exchange holdings have more than doubled from $166 billion to now $357 billion. These are staggering levels of intervention. In fact, this amount of intervention, according to some economists, is far beyond the levels ever seen by the IMF.

Putting it all together, let me read a statement that came out 2 weeks ago from the United States-China Security Review Commission, a bipartisan group established by Congress to look into these very matters. They state:

> China, in violation of both its IMF and WTO obligations, is in fact manipulating its currency for trade advantage, and we recommend that the Treasury Department immediately enter into formal negotiations with the Chinese Government over its undervalued currency.

That is an unequivocal statement.

But, frankly, none of this really matters. The Treasury Department is the key voice on these issues. Treasury has the responsibility under our laws.

Under Section 3004 of the United States' Omnibus Trade and Competitiveness Act of 1988, the Treasury Department is obligated to consider whether any countries manipulate the rate of exchange between their currency and the dollar for the purpose of preventing effective balance of payments adjustments or gaining unfair advantage in international trade. If such violations are found, the Secretary of the Treasury is required to undertake negotiations with the manipulating countries that are running significant trade surpluses.

The Nation looks to Treasury for leadership on these issues. And that is why we are here today.

Many of us have supported the Administration's efforts in using diplomatic channels to encourage China to freely float its currency. Secretary Snow has gone over to China. The President has gone over to China. Secretary Evans is in China right now. The G–7 even endorsed a policy of market based exchange rates.

Well, I think it is clear that diplomacy is not working. China is not listening or they do not care. The Chinese Government has made it crystal clear that they have no intention of allowing the yuan to trade at market levels anytime soon.

China is now a major player in the global economy. If China enjoys the benefits of membership in the international community, as they clearly have, shouldn't they abide by the community's rules and responsibilities?

The Chinese Government wants stability and continued growth—don't we all. But China's interests do not trump those of its neighbors or its international partners. Their desire for the status quo cannot put the long-term health of the international economy at risk.

I hear from some very smart people in the financial community that the real risk with China is in doing nothing. China's continued and massive government intervention is helping drive enormous export lead growth which is overheating their economy which will eventually cause a global economic train wreck. Unfortunately, the Chinese Government's intransigence on this issue leaves us no choice but to consider more forceful measures.

The lack of real action undermines support for free trade in this country. When we do not hold a country accountable for violating the rules of free trade, and good U.S. jobs are lost, people start to question whether the free trade system itself works.

The Administration has taken made bold moves in the interests of our economy in other areas. I hope we will see some boldness again. If we really care about jobs and U.S. businesses—if it is not just rhetoric—and if we are really concerned about the problems in this country—not all the problems over in China—there can be few other actions that would have a more immediate and beneficial economic impact than eliminating China's and other nations' unfair currency advantages and currency manipulation.

And, I can tell you this, if the Administration does not act, we, the Congress, will.

PREPARED STATEMENT OF SENATOR DEBBIE STABENOW

Thank you, Mr. Chairman. I appreciate your calling this hearing today. While the purpose of today's hearing is to look at the Treasury Department's Report to Congress on International Economic and Exchange Rate Policy, what this hearing really boils down to is a discussion of the future of American jobs and the crisis we are facing in our domestic manufacturing sector. Whether it is furniture makers in West Michigan or auto suppliers throughout Michigan, it is a challenging time.

Indeed, our economy has lost 3.3 million private sector jobs since January 2001—2.5 million or 75 percent of those jobs in manufacturing. More specifically, 162,300 Michiganians have lost their jobs in the manufacturing sector. That is a mind-boggling 18 percent of the State's manufacturing base. One out of six jobs.

This loss of U.S. jobs, in large part due to illegal trade practices, should be the number one priority of the Congress and the Bush Administration. We must demand that foreign countries play by the rules of international trade agreements.

In particular, I am concerned about foreign currency manipulation and the lack of action from the Administration on this front. I hope that Secretary Snow, in his testimony today will be able to tell us what new steps the Administration is going to take, given its current inability to get China, Japan, and other countries to stop manipulating their currencies.

Mr. Chairman, there is no question that China and Japan, in particular are actively and aggressively intervening in the currency markets to—illegally—protect their domestic businesses.

By manipulating the markets, they artificially depress the prices of their exports and raise the prices of their imports. And what does this mean in simple terms? It is the functional equivalent of a tax on American goods.

A "currency manipulation tax" imposed on our American companies by China and Japan. And, a tax that is forcing our U.S. companies to lay off good hardworking employees.

These employees are now struggling to find new jobs, to provide for their families, to ensure that their loved ones have health care and that their basic needs are covered. We need the President and his Administration speaking out forcefully.

The Administration has said that the United States has a strong dollar policy, but I want to see them using all of their resources to put it into effect.

I want Administration officials to be able to tell laid-off workers in Michigan and around the country that China is finally going to allow its currency to rise the 15 to 50 percent it is undervalued relative to the dollar. And, that the 12 percent undervaluation of the Japanese yen will stop right away. Not at some vague point down the road. But, right away.

These percentages are really startling when we think about them, Mr. Chairman. Let me put them into more concrete terms. I will use the example of a car which is a product that we in Michigan certainly know a lot about. We are very proud of our Michigan-made cars.

A 2003 Ford Taurus SEL has a manufactured suggested retail price of $23,965. This car, when exported to Japan, faces an estimated tax of $2,876 solely due to currency manipulation.

Conversely, a similar car made in Japan by Nissan would have the same estimated artificial price advantage over U.S. cars. Should we give a Japanese car a $2,876 price advantage over the exact same car made in America?

Who is paying for these special advantages that the Chinese and Japanese governments are creating for their people? U.S. companies are paying for this tax. Our workers are paying for it. And, it has to stop.

I wonder if my colleagues can imagine what the response would be if the Administration proposed raising taxes on all of our goods an additional 12 percent or more and gave all the revenue away to people in other countries? By failing to end this currency manipulation tax, this is the practical effect.

Mr. Chairman, there is a lot of interest in the Senate and in this Committee in putting a halt to these illegal trade practices. Recently, as Senator Schumer has mentioned, I teamed up with him and others on a bipartisan bill to stop Chinese currency manipulation. Cosponsors on this Committee include Senators Bayh, Bunning, Dodd, Dole, and Enzi.

China's policies violate the IMF and WTO agreements, and it is within our rights to take action. In fact, we are creating a bad precedent if we do not demand that our rights within these agreements are fully respected. America should not allow other countries to cheat us out of our full international rights.

I hope that all of my other colleagues will work with me, Senator Schumer, and other advocates to resolve this problem. We should be doing everything within our power to protect our American manufacturing jobs.

Thank you again, Mr. Chairman for calling this hearing. Thank you Mr. Secretary for agreeing to appear before us. I look forward to your testimony.

PREPARED STATEMENT OF JOHN W. SNOW

SECRETARY, U.S. DEPARTMENT OF THE TREASURY

OCTOBER 30, 2003

Chairman Shelby, Ranking Member Sarbanes, Members of the Banking Committee, thank you for the opportunity to appear before you this morning to discuss

Treasury's Report on International Economic and Exchange Rate Policies as well as related economic issues. The Report reviews developments in the United States and examines exchange rate policies in major countries across five regions—the Americas, Europe and Eurasia, Africa, the Middle East and South Asia, and East Asia. The Report documents the wide variety of exchange rate policies that are used around the world. A notable trend has been the move by many countries to adopt flexible exchange rates.

The Report concludes that no major trading partners of the United States meet the technical requirements set forth in the Omnibus Trade and Competitiveness Act of 1988. But let me be clear, the Bush Administration believes that the international trading system works best with free trade, the free flow of capital, and with market-based exchange rates. An efficient system of trade and finance, with fair and enforced rules, is essential for the United States and all nations to maximize the benefits of trade and generate the highest levels of economic growth.

The Report finds that a number of countries continue to use pegged exchange rates and/or intervene in the foreign exchange market. It should be noted that a currency peg or intervention does not in and of itself satisfy the statutory test. Treasury has consulted with the IMF management and staff as required by the statute, and they concur with the findings of the Report.

The Bush Administration is aggressively encouraging our major trading partners to adopt policies that promote flexible market-based exchange rates combined with a clear price stability goal and a transparent system for adjusting the policy instruments. In my testimony today, I would like to discuss this work with you and the progress we are achieving.

Policies to Raise Economic Growth in the United States and the World

The Administration's international economic strategy aims for higher economic growth throughout the world. A stronger world economy is vital to sustaining U.S. economic growth and job creation. This is a reality of our increasingly interdependent world.

At the core of this strategy are the good economic policies we are implementing in the United States. But also at the core is our diplomatic work to encourage pro-growth and pro-stability policies in other countries. Good economic policies in other countries benefit the United States and the whole world. It is widely recognized throughout the world that free markets and market-determined prices are best able to allocate scarce resources to their most productive use. This is as true for domestic markets as it is for international markets. We strongly believe that the goals of raising growth and increasing stability can best be accomplished in an international financial system that relies on the principles of free trade, free capital flows, and market-based exchange rates among the major economies.

Free trade, in particular, improves the standard of living across countries. Thus, the Administration will continue to promote free trade through bilateral, regional, and global trade agreements. In this respect, the outcome at Cancun was a missed opportunity. The United States stands ready to work with others who seek liberalization. Our free trade initiatives, including the U.S. proposal to cut tariffs to zero for manufactures, will continue.

Implementing this broad international strategy is an ambitious endeavor, but it is an agenda that the Bush Administration is determined to pursue. Convincing others to contribute to further improvement in global growth prospects is a top priority for the President. In furtherance of this agenda I traveled to Europe, China, and Japan this summer to deliver this very message. Growth was also the key focus of my discussions with Asian financial leaders in Thailand. Change has already begun among several major economies. For example, Germany is pursuing critical labor market, tax and pension reforms under its Agenda 2010, and France is also moving forward through its Agenda 2006.

With President Bush's leadership, the Administration has made reform and economic growth a priority goal throughout the world. In addition to my own travel, Commerce Secretary Don Evans, U.S. Trade Representative Robert Zoellick and other senior Administration officials all continue to press nations to put in place pro-growth policies that will result in higher rates of productivity and growth both here and abroad

The Administration has urged Japan to implement comprehensive reforms to bring about lasting recovery. These reforms involve ending deflation, strengthening the banking system, and undertaking structural reforms that promote flexibility. Indeed, the Bank of Japan has aggressively increased the money supply to counter deflation, and the Koizumi Government has made important headway on improving the health of the banking system.

Treasury is actively engaged with the Japanese on monetary, fiscal, and exchange rate policies both bilaterally and through meetings of the G–7 finance ministers and central bank governors.

At the recent G–7 meeting in Dubai, we made progress, gaining agreement on a new "G–7 Agenda for Growth." Under this milestone agreement, G–7 countries have committed to concrete structural reform actions to increase productivity, spur growth, and create jobs. And for the first time they have agreed to a process for benchmarking and reporting on their performance.

Each country will identify its own policy plan under the Agenda. For example, the United States will work to lower health care costs, reduce frivolous lawsuits, and streamline regulations and needless paperwork through the President's Six Point Plan to promote economic growth. Other G–7 countries will implement policies appropriate to their situations. Countries in the European Union will be looking at further ways to revitalize investment and create jobs. Japan has reiterated its commitment to reform.

The Agenda for Growth must be about action and results, not just plans and platitudes. When we met in Dubai, my G–7 colleagues agreed to be ambitious in embarking on reforms and pursuing growth. In coming months, we will be working to evaluate proposals and assess the results of our efforts. As the United States assumes chairmanship of the G–7 in 2004 that focus will be maintained.

The Administration is also engaging in other initiatives, both bilateral and multilateral, to advance growth and stability in emerging markets and developing countries. For example, Treasury is working with Brazil through a new "Group for Growth" to identify steps to expand economic potential; the Millennium Challenge Account targets assistance to countries that perform on pro-growth policies and delivering results for people; and in the international financial institutions, Treasury is advocating a sharper focus on measurable results, economic policy performance, and promoting private sector development.

Recent Economic Developments

The world economy has strengthened during the course of this year, and the United States is leading the way. Thanks to timely fiscal and monetary policy responses, economic growth in the United States is picking up now after the severe shocks of the terrorist attacks, corporate accounting scandals, and stock market decline of 2000. Growth accelerated to 3.3 percent in the second quarter, with fixed investment as well as personal consumption posting large gains. The President's Jobs and Growth plan, along with low interest rates, put the U.S. economy in an excellent position to achieve sustained, robust growth. The President's Six Point plan to enhance growth and job creation will further boost our performance. We will not be satisfied until we see strong and sustained job growth.

Looking beyond the United States, global growth is also improving. There are signs of stronger growth in Japan, as well as in the United Kingdom, Canada, and several emerging market countries. Much of Europe, however, is still falling short of a strong economic recovery. While we can be pleased with the progress made, growth in the major economies around the world, as a whole, has been too slow for too long.

The U.S. International Accounts

From my discussions with my counterparts in other countries, there is a great appreciation worldwide that the United States is a force for strong growth. This strong performance is also reflected in the pattern of our external trade and current account balances.

Developments in the current account are best understood in terms of developments in investment and saving. As a matter of accounting, the current account deficit is equal to the gap between national investment and national saving. Thus, when investment in the United States is higher than domestic saving, foreign investors make up the difference, and the United States has a current account deficit.

Our current account deficit in large part reflects the attractive investment environment and high growth of productivity in the United States. Increased saving in the United States along with stronger growth abroad will reduce the deficit in the current account.

Exchange Rate Policies

The Report shows that countries around the world continue to follow a variety of exchange rate policies ranging from a flexible exchange rate regime with no or little intervention to currency unions and full dollarization. While the choice of an exchange rate regime is up to each country, we have been encouraging countries to use flexible exchange rates. Flexible exchange rates ease the adjustment to changing economic conditions in the international financial system. Of course, a flexible ex-

change rate will not prevent the economic damage that is caused by a bad economic policy. For example, even with a flexible exchange rate, an inflationary monetary policy would lead to a weak, constantly depreciating currency with negative effects on economic growth. A good flexible exchange rate regime requires a monetary policy with a focus on the goal of price stability, and has a transparent procedure for setting the policy instruments.

We are encouraging the use of flexible exchange rates with our major trading partners, we recognize that, especially in the case of small open economies, there are benefits from a "hard" exchange rate peg, such as dollarization, joining a currency union, or using a credible currency board. Of course, just as in the case of flexible exchange rates, a "hard" peg will not prevent the economic damage caused by a bad economic policy.

The G–7 statement from Dubai, which I mentioned earlier in the context of the "G–7 Agenda for Growth," also addresses exchange rate policy. Here is what that statement said:

> We reaffirm that exchange rates should reflect economic fundamentals. We continue to monitor exchange markets closely and cooperate as appropriate. In this context, we emphasize that more flexibility in exchange rates is desirable for major countries or economic areas to promote smooth and widespread adjustments in the international financial system based on market mechanisms.

All G–7 Ministers and Central Bank Governors—including Alan Greenspan and myself—agreed with that statement. And let me be clear: the G–7 message is consistent with our strong dollar policy which I have consistently reiterated since my confirmation hearing. As I have said often, a country can not devalue itself into prosperity. A strong dollar is in the U.S. national interest. The G–7 message is also consistent with the Agenda for Growth, which is about a stronger world economy and flexibility.

Among the many currencies discussed in the Report, China's received special attention. China does not meet the technical requirements of the 1988 Trade Act—the same finding for nearly 10 years of past reports. China's global current account surplus has declined, and China has had a peg over a long time period during both upward and downward pressures on the currency. But it is clear that a flexible, market-based, exchange rate is appropriate for China. Given China's strong growth and substantial foreign exchange reserves, following on a series of economic reforms, China now has an opportunity to show leadership on the important global issue of exchange rate flexibility.

Greater exchange rate flexibility would allow China greater scope to maintain a low-inflation, pro-growth monetary policy. It would also enable China to enjoy the benefits, while helping mitigate the risks, of a more open capital account. And it would help improve the allocation of resources and the quality of financial intermediation in the Chinese economy. More broadly, a more flexible rate would help reduce macroeconomic imbalances.

A rules-based system of trade and finance is essential for all nations to maximize the benefits of trade and generate the highest levels of economic growth. A pegged exchange rate is not appropriate for a major economy like China and should be changed.

For all these reasons, we are continuing our efforts to urge the Chinese to adopt a flexible exchange rate. I took this case to Beijing last month, emphasizing the need for exchange rate flexibility, along with reductions in barriers to trade and capital flows. And last weekend, following immediately on the heels of the President's meeting with President Hu, I met with the Chinese Finance Minister and Central Bank Governor in Mexico.

China's response to this engagement is encouraging:

- Earlier this month China's Central Bank Governor said: "With the role of the market becoming increasingly important, the exchange rate of the RMB will be finally determined decisively by the market forces and have great flexibility."
- China's central bank is undertaking a number of capital market liberalization measures. In addition, Governor Zhou has endorsed a project in which the Chicago Mercantile Exchange and the Foreign Exchange Trade System & National Interbank Funding Center of China will develop a currency futures market in China.
- Vice Premier Huang Ju has accepted my invitation to come to Washington for an in-depth, high-level discussion of these issues.
- A new technical cooperation agreement on financial issues related to exchange rates was announced by President Bush and President Hu. China's Central Bank Governor and I will be responsible for implementing this program.

- The G–7 finance ministries and the Chinese finance ministry and central bank have begun talks on economic and financial market issues for the first time ever. Their first meeting was last month in Dubai.

We are encouraged by the steps the Chinese are taking, but we urge continued and speedy progress toward the goal of exchange rate flexibility. The Chinese are discussing exchange rate policy in international fora, and at home. China's leadership recently called for active advance of the reform in the financials system and exchange rate policy. The leadership also recognized that opening up of its capital market is seen by Beijing as an important step in moving to a flexible exchange rate. Further, the establishment of a strong regulator will help China's banking system see much needed improvement. Success will require daily engagement with the Chinese. For this reason, the Treasury Department is establishing an attaché presence in China.

As this example of China indicates, I recognize the need to address exchange rates as part of our overall international economic strategy. But, as the example of China also indicates, I believe that the course we are on of financial diplomacy is the right course and the most effective way to bring about change.

Conclusion

Strengthening the economic recovery in the United States is our key economic objective. I am very concerned about job creation in the United States. The President's Six Point Plan is designed to remove impediments to growth and job creation. We have undertaken an ambitious drive to remove rigidities and barriers wherever they exist and to thereby create a level playing field that promotes increased international trade. The G–7 Agenda for Growth is an important step forward. So, too, are the bilateral discussions we have had with many countries on economic and financial issues. We will continue to work hard to accomplish our objectives.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR CARPER FROM JOHN W. SNOW

Q.1. The Treasury report concludes that "no major trading partners of the United States manipulated exchange rates." However, according to Japan's Ministry of, Finance, the Japanese Government has intervened more than 60 times since January 2000 in currency markets, spending over $220 billion on such actions. How do Japan's repeated and massive interventions square with your findings of no manipulation to gain trade advantages, particularly given the fact that high-ranking Japanese officials, including Prime Minister Koizumi, have indicated they are intervening in part to provide their exports with a competitive advantage?

A.1. The Omnibus Trade and Competitiveness Act of 1988 (the Act) directs the Treasury to analyze the exchange rate policies of other countries and consider whether these countries manipulate the rate of exchange between their currency and the dollar for purposes of preventing effective balance-of-payments adjustments or gaining unfair competitive advantage in international trade. We concluded, on careful examination, that Japan did not meet the technical requirements to be designated under terms of the Act. In carrying out the most recent analyses of exchange rate policies we consulted with the International Monetary Fund, as required under the Act. IMF management and staff concur with our assessment regarding Japan.

This year, Japan has increased its money supply sharply to overcome deflation. Japan has also taken more vigorous steps to address its banking sector problems in an effort to provide a foundation for domestic, demand-led growth.

In these circumstances, Japanese authorities have expressed concern that a strong and rapid appreciation of the yen would be inconsistent with Japan's underlying economic fundamentals and would jeopardize a fragile recovery.

Even though we concluded that Japan did not meet the technical requirements under the Act, we have made clear to Japanese authorities that they should allow market forces to play a greater role in exchange rate determination.

Q.2. Japanese automakers have received substantial benefits of a direct export subsidy over the last several years from a weak yen, which is kept weak by the massive interventions by Japan. The weak yen has allowed Japanese automakers to reap a roughly 20 percent windfall cost advantage over the past 3 years, which they have used in a variety of ways to gain market share here in the United States, as well as make record profits. Given that 60 percent of the U.S. trade deficit with Japan is in the automotive sector, is it U.S. Treasury policy to allow a foreign government to continue to provide such a substantial direct export subsidy when it makes up so much of our bilateral trade deficit with Japan?

A.2. The market for yen financial assets is very large and deep and Japan has no restrictions on capital flows that would limit pressure on its currency. Although Japan's intervention may have slowed the pace of yen appreciation, the yen has still strengthened materially over the last year. The yen has risen close to 10 percent against the dollar since the beginning of this year and over 20 per-

cent since the beginning of 2002. Over the last 3 years the yen has fluctuated in a range of 135 to 108 yen per dollar. The yen's value, in terms of the dollar, is currently roughly the same as it was 3 years ago.

Q.3. Mr. Secretary, I have auto plants in my State, which provide good jobs for good people. If this trend continues—if the yen is allowed to continue in its overly weak state—those auto plants and the good jobs they provide are going to be in danger. Over the past 3 years, Japan's auto exports to the United States are edging back up to near-historic levels, despite increased production facilities in the United States. How do you expect the U.S. auto industry to compete with Japanese automakers when Japanese automakers have a 20 percent cost advantage?

A.3. Japan's intervention has not resulted in growing exports to our market. Our bilateral trade deficit with Japan currently stands at $64 billion (average through September at an annual rate), down from a record high of $81.6 billion in 2002.

In particular, merchandise imports from Japan have been on a downward trend since peaking in 2000 and so far this year are running about 21 percent below their 2000 level. As a result, goods imports from Japan as a share of nominal U.S. GDP have fallen to 1.1 percent—the lowest since 1980—from the 1.5 percent share that prevailed in the latter half of the 1990's.

Although imports of Japanese automotive products (cars, trucks, and parts) reached record levels in 2002, they have since moderated and through September were roughly 3 percent below their year-earlier level.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR MILLER FROM JOHN W. SNOW

Q.1. Mr. Secretary, Paul O'Neill, your predecessor, came before this Committee on May 1, 2002. I told him then, as I am telling you now, that as a Senator from Georgia, I have to be a little bit parochial. I have to look out for those 8 million people in Georgia. There are some industries in our State—forestry, textiles, automotive, agriculture, who have been complaining to me for over a year, pretty loudly, that the dollar is making it difficult for them to export profitably, and easier for imports to take their market share here in the United States. The paper industry has seen more than 90 percent of the growth in their U.S. markets captured by imports.

How would you respond to my constituent industries that are so very concerned about this matter? How would you respond to Joyce Williams?

Are you seeing any foreign countries engaging in currency manipulation with the U.S. dollar, for purposes of preventing effective balance of payments adjustments or gaining an unfair competitive advantage in international trade?

What actions have you taken to date to encourage other governments to seek to strengthen their currency vis-á-vis the dollar? Is there anything further that you think should be done?

A.1. We are concerned about the difficulties that a number of U.S. industries have experienced. Soft domestic demand and weak growth abroad (which has hindered export growth) have been prin-

cipal reasons for sluggish recovery in many industries. The U.S. economy is now showing healthier growth. The early and timely fiscal response of the Administration, working with Congress, and the Jobs and Growth Tax Relief Reconciliation Act enacted in May, have spurred an acceleration of real growth in GDP. Private analysts forecast this growth to continue at above 4 percent, or around 1 percentage point above the growth in potential output, over the next year. We are now seeing the beginning of a turnaround in the labor market and sustained growth above potential should trigger stronger job gains, with several private sector estimates predicting the creation of about 2 million new jobs by the third quarter of 2004.

The Administration's international economic strategy aims for higher economic growth throughout the world. For example, at the recent meeting of the G–7 Governors and Finance Ministers in Dubai, we gained agreement on a new "Agenda for Growth." Under this milestone agreement, G–7 countries have committed to concrete structural reform actions to increase productivity, spur growth, and create jobs. They have agreed, for the first time, to a process for benchmarking and reporting on their performance.

The Department of the Treasury, in carrying out its responsibilities under the Omnibus Trade and Competitiveness Act of 1988 (the Act), analyzes the foreign exchange policies of foreign countries, in consultation with the International Monetary Fund, and considers whether countries manipulate the rate of exchange between their currency and the dollar for purposes of preventing effective balance-of-payments adjustments or gaining unfair competitive advantage in international trade. In the October 2003 "Report to Congress on International Economic and Exchange Rate Policies," Treasury concluded that no major trading partner of the United States met the technical requirements to be designated under terms of the Act. But in submitting the report, Secretary Snow explained that the Bush Administration believes that the international trading system works best with free trade, the free flow of capital and market-based exchange rates among the major economies. An efficient system of trade and finance, with fair and enforced rules, is essential for all nations, including the United States, to realize the greatest benefits from trade and to generate the highest levels of economic growth.

This view was affirmed, in the context of the G–7 "Agenda for Growth," in the Dubai communiqué statement on exchange rates: "We reaffirm that exchange rates should reflect economic fundamentals. We continue to monitor exchange markets closely and cooperate as appropriate. In this context, we emphasize that more flexibility in exchange rates is desirable for major countries or economic areas to promote smooth and widespread adjustments in the international financial system based on market mechanisms."

Q.2. In *Fortune,* from Sunday October 26, 2003, Warren Buffett said, "But as head of Berkshire Hathaway, I am in charge of investing its money in ways tha t make sense. And my reason for finally putting my money where my mouth has been so long (investments in foreign currencies) is that our trade deficit has greatly worsened, to the point that our country's "net worth," so to speak, is now being transferred abroad at an alarming rate."

Mr. Secretary if Warren Buffett is worried, why aren't you?

A.2. The October 2003 Report to Congress on International Economic and Exchange Rate Policies described how developments in the overall trade or current account balance reflect developments in national investment and saving. The current account deficit is conceptually equal to the gap between investment and saving. When investment in the United States is higher than domestic saving, then foreigners make up the difference, and the United States has a current account deficit. In contrast, if saving were to exceed investment, then the United States would have a current account surplus.

In recent years, foreign interest in investing in the United States has permitted the United States to invest more than it otherwise would have been possible. Investment in the United States creates "net worth." This additional U.S. investment allows business to pay better wages, and earn higher profits even after paying foreigners an appropriate return on their investment.

Q.3. The U.S. automotive sector believes Japan is manipulating its currency to maintain an unfair trade advantage. The industry believes the Japanese may be violating Article IV of the IMF Charter and Section 3 of the 1988 Omnibus Trade Act.

Do you agree with them?

A.3. The Department of the Treasury, in carrying out its responsibilities under the Omnibus Trade and Competitiveness Act of 1988 (the Act), analyzes the foreign exchange policies of foreign countries, in consultation with the International Monetary Fund, and considers whether countries manipulate the rate of exchange between their currency and the dollar for purposes of preventing effective balance of payments adjustments or gaining unfair competitive advantage in international trade. In its most recent report, Treasury concluded, on careful examination, that Japan did not meet the technical requirements to be designated under terms of the Act. IMF management and staff concur with our assessment regarding Japan.

Over the last 3 years, the yen has fluctuated in a range of 135 to 108 yen per dollar. The market for yen financial assets is very large and deep and Japan has no restrictions on capital flows that would limit pressure on its currency. Although Japan's intervention may have slowed the pace of yen appreciation, the yen has still strengthened materially over the last year. The yen has risen close to 10 percent against the dollar since the beginning of this year and over 20 percent since the beginning of 2002.

This year, Japan has increased its money supply sharply to overcome deflation. Japan has also taken more vigorous steps to address its banking sector problems in an effort to provide a foundation for domestic, demand-led growth. In these circumstances, Japanese authorities were concerned that a strong and rapid appreciation of the yen would be inconsistent with Japan's underlying economic fundamentals and would jeopardize a fragile recovery.

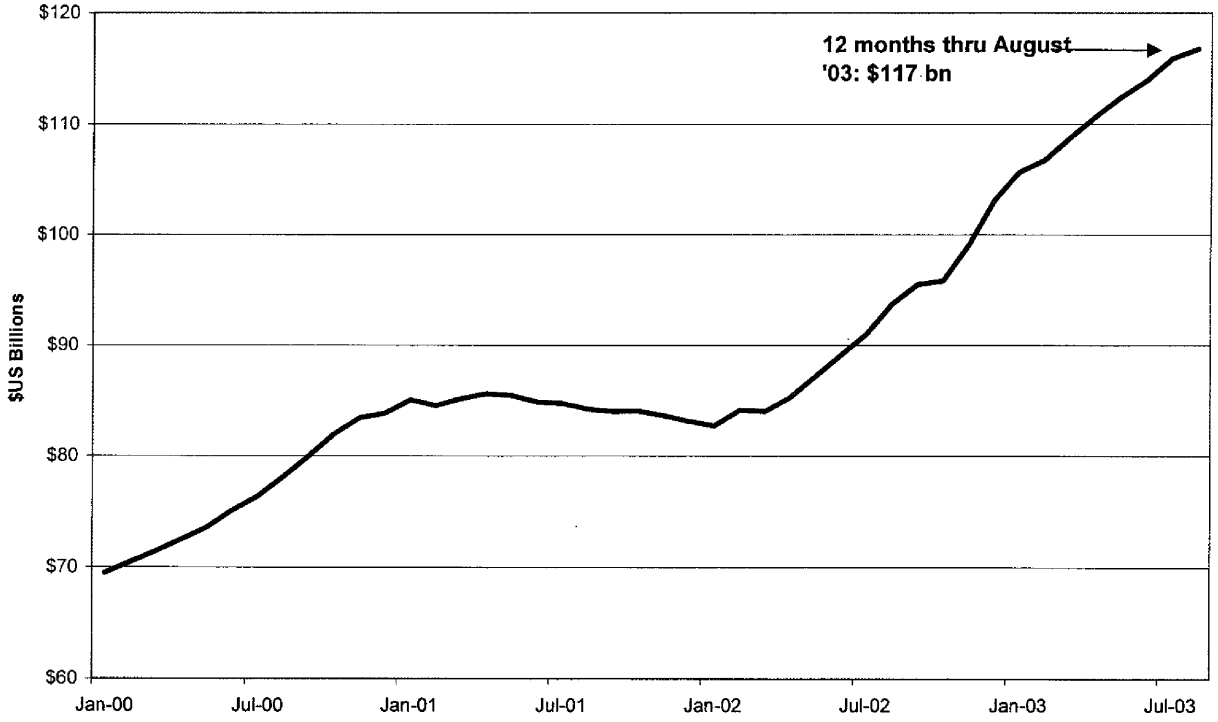
Even though we concluded that Japan did technical requirements to be designated Act, we have made clear to the Japanese they should allow market forces to play exchange rate determination.

Meeting the Criteria for Currency Manipulation Under the 1988 Trade Act

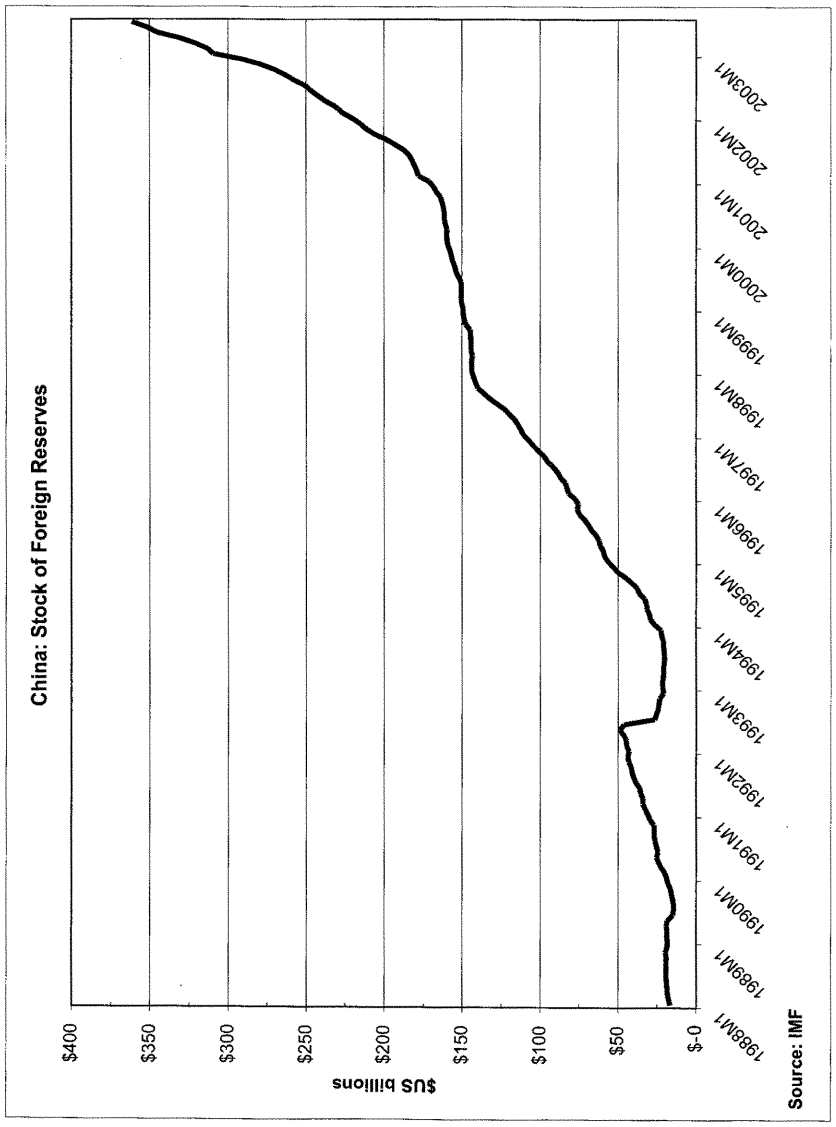
	Trade Surplus with United States Most Recent 12 Months		Global Current Account Most Recent Year		Accumulation of Reserves Most Recent 12 Months
	(Billions of Dollars)	Percent of GDP*	(Billions of Dollars)	Percent of GDP	(Billions of Dollars)
China	116.8	8.7%	35.4	2.8%	111
Japan	68.8	1.7%	121.1	2.9%	103
Taiwan	14.6	5.1%	24.4	8.5%	27
South Korea	12.5	2.5%	8.2	1.6%	17

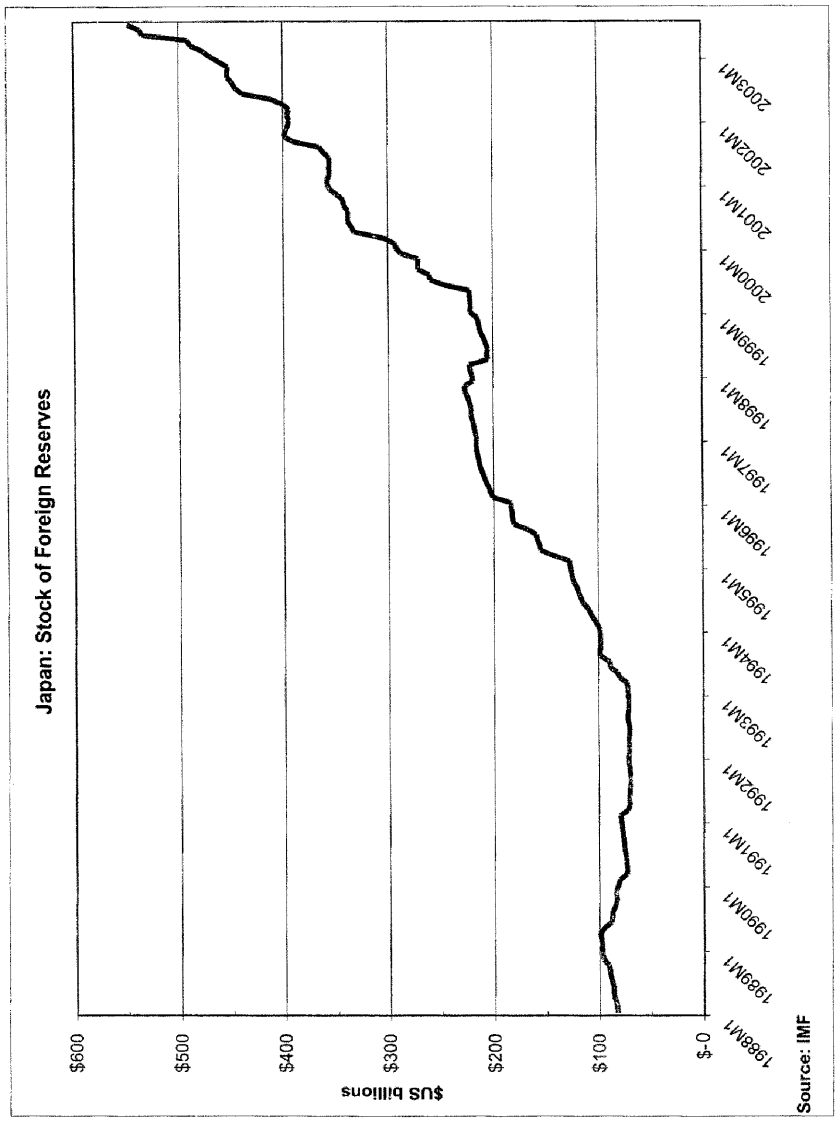
Source: IMF International Financial Satistics and World Economic Outlook and Central Bank of China (RoC); *estimates for relevant GDP period

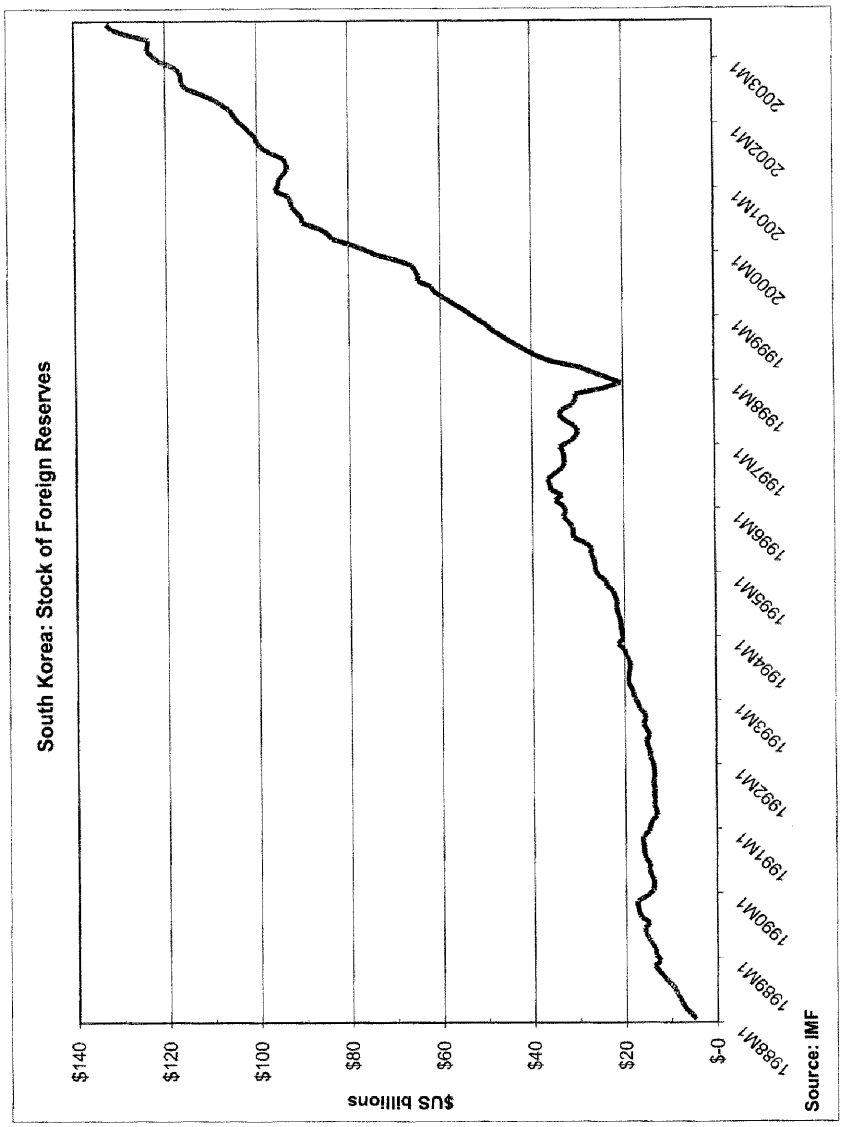
China's Trade Surplus with the US, 12 Month Moving Sum

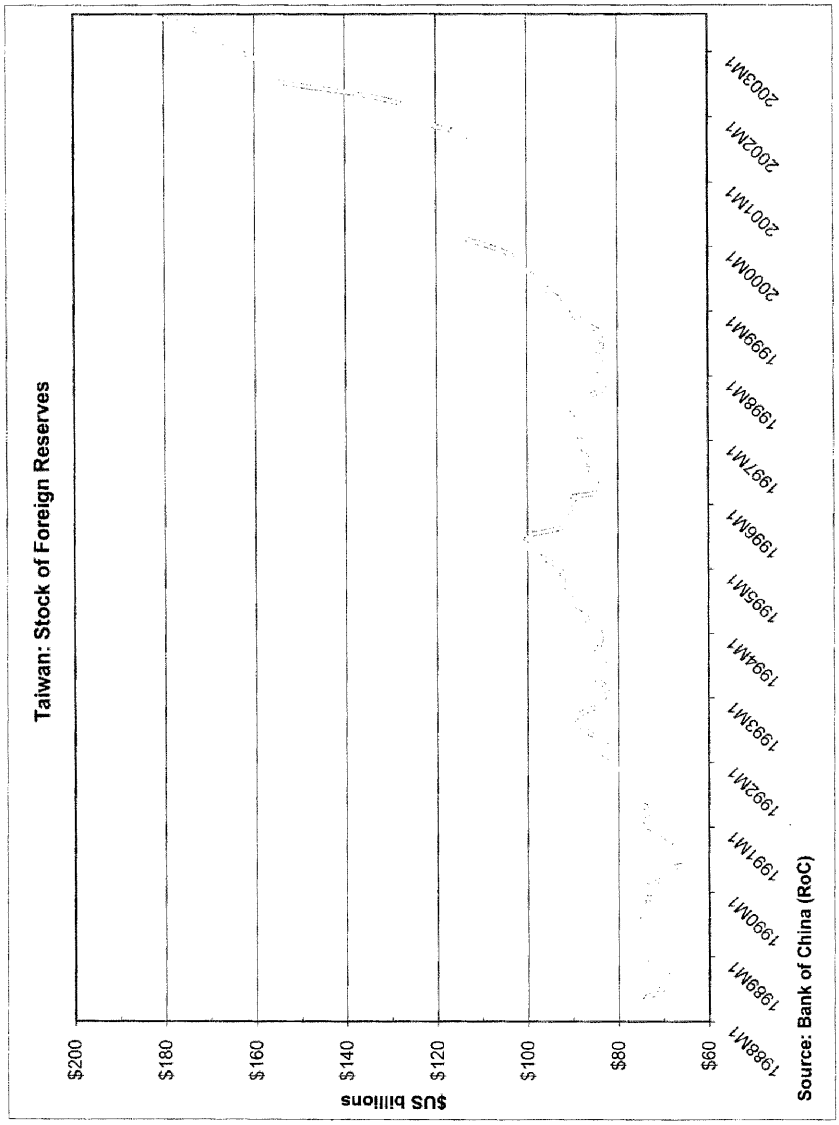


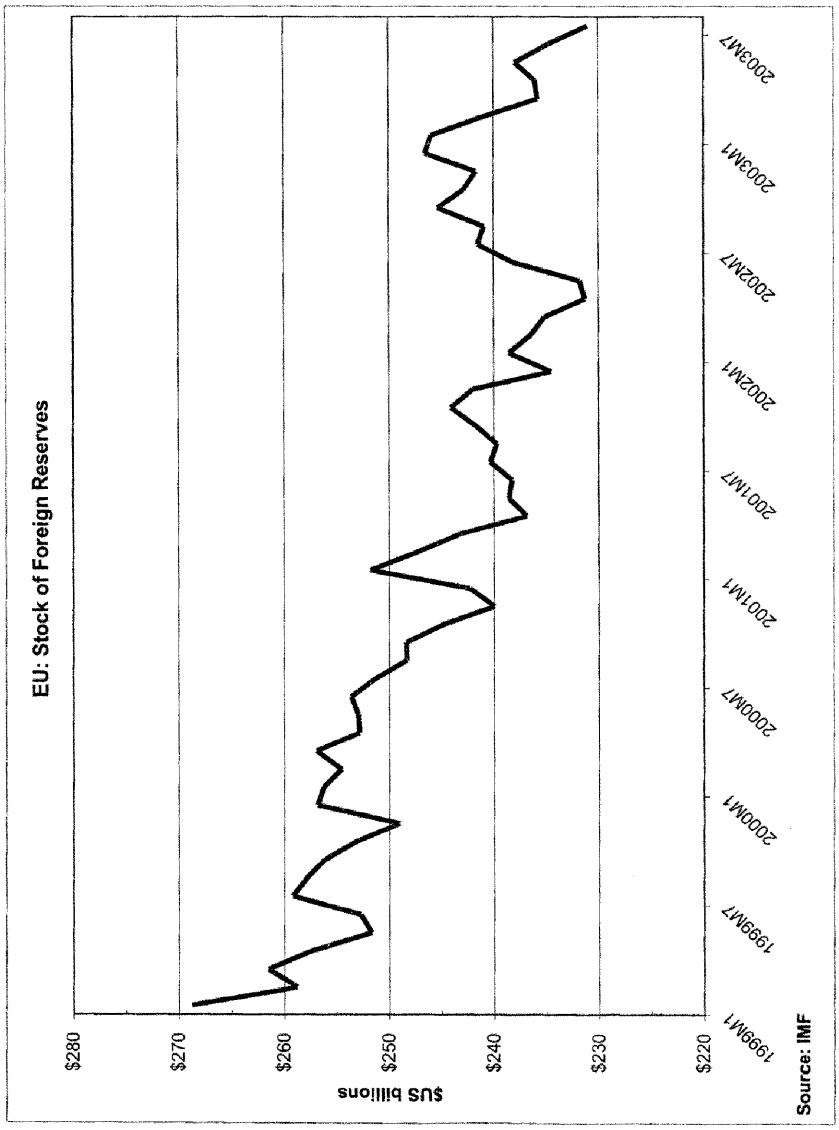
Source: US Census Bureau

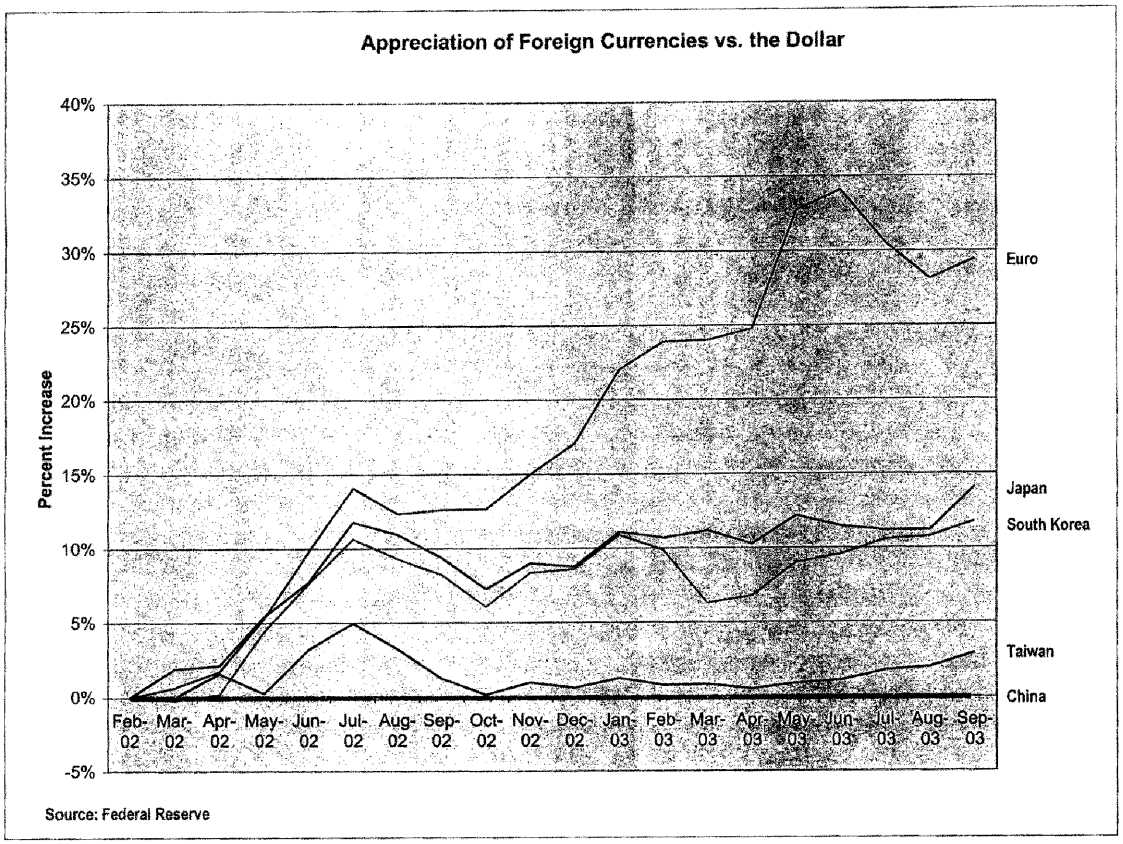

China: Stock of Foreign Reserves
$US billions
$400
$350
$300
$250
$200
$150
$100
$50
$-0
1988M1
1989M1
1990M1
1991M1
1992M1
1993M1
1994M1
1995M1
1996M1
1997M1
1998M1
1999M1
2000M1
2001M1
2002M1
2003M1
Source: IMF


Japan: Stock of Foreign Reserves
$US billions
$600
$500
$400
$300
$200
$100
$-0
1988M1
1989M1
1990M1
1991M1
1992M1
1993M1
1994M1
1995M1
1996M1
1997M1
1998M1
1999M1
2000M1
2001M1
2002M1
2003M1
Source: IMF


South Korea: Stock of Foreign Reserves
$US billions
$140
$120
$100
$80
$60
$40
$20
$-0
1988M1
1989M1
1990M1
1991M1
1992M1
1993M1
1994M1
1995M1
1996M1
1997M1
1998M1
1999M1
2000M1
2001M1
2002M1
2003M1
Source: IMF


Taiwan: Stock of Foreign Reserves
$US billions
$200
$180
$160
$140
$120
$100
$80
$60
1988M1
1989M1
1990M1
1991M1
1992M1
1993M1
1994M1
1995M1
1996M1
1997M1
1998M1
1999M1
2000M1
2001M1
2002M1
2003M1
Source: Bank of China (RoC)


EU: Stock of Foreign Reserves
$US billions
$280
$270
$260
$250
$240
$230
$220
1999M1
1999M7
2000M1
2000M7
2001M1
2001M7
2002M1
2002M7
2003M1
2003M7
Source: IMF


Appreciation of Foreign Currencies vs. the Dollar
Percent Increase
40%
35%
30%
25%
20%
15%
10%
5%
0%
-5%
Feb-02
Mar-02
Apr-02
May-02
Jun-02
Jul-02
Aug-02
Sep-02
Oct-02
Nov-02
Dec-02
Jan-03
Feb-03
Mar-03
Apr-03
May-03
Jun-03
Jul-03
Aug-03
Sep-03
Euro
Japan
South Korea
Taiwan
China
Source: Federal Reserve

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U.S. Debt to Asia Swelling

Japan, China Lead Buyers of Treasurys

By Peter S. Goodman
Washington Post Foreign Service
Saturday, September 13, 2003; Page E01

Advertisement

SHANGHAI -- Asia's largest economies are aggressively sinking the spoils of their trade surpluses with the United States into the purchase of U.S. government securities, financing much of the widening U.S. federal budget deficit.

Over the first six months of the year, Japan and China together purchased more than $96 billion in new U.S. government securities, according to Treasury Department data. Japan, the world's largest buyer of Treasurys, now owns a portfolio worth more than $440 billion, an amount greater than one-tenth of all outstanding issues. China, the world's second-largest buyer, owns more than $122 billion. Hong Kong, South Korea, Taiwan, Singapore and Thailand together own more than $166 billion.

While Japan has long been a hungry buyer of U.S. government debt, China's share has spiked dramatically in recent months as its reserves of U.S. dollars have grown, a result of China's increasing trade surplus with the United States and surging U.S. corporate investment in China. China's purchases of U.S. government securities rose 20 percent over the first half of this year and have increased by more than 150 percent since the beginning of 2002.

This flow of capital from Asia's central banks, which are the primary buyers of the securities, into the coffers of the U.S. Treasury supplies the Bush administration with a crucial artery of cash as it presses ahead with plans to pursue extended military operations in Iraq and Afghanistan, and as the federal government's budget deficit nears half a trillion dollars.

Moreover, foreign investment in the United States -- whether through buying Treasurys, stocks, real estate or other assets -- finances the much broader U.S. current account deficit, the amount by which Americans spend and invest more than they produce and save, or more generally the degree to which they go into debt to foreigners in order to live beyond their current means.

Should the day arrive when overseas holders of U.S. dollars, whether in Asia or elsewhere, decide not to buy so many U.S. assets or begin selling their holdings, that would reduce the overall demand for U.S. dollars, driving the value of the currency lower. That would raise the cost of imported goods in the United States, possibly fueling higher inflation and interest rates and slowing overall economic growth.

Economists have warned for years about the potentially painful consequences of such a shift in global investment patterns.

This has caused some analysts to even envision the day when China could use threats of selling Treasurys to try to influence U.S. economic or foreign policy -- for example to quash efforts by U.S. lawmakers to keep out Chinese exports or to pressure Washington to withhold support for Taiwan, the

self-governing island that Beijing considers part of its territory.

"The U.S. dollar is now at the mercy of Asian governments," said Joan Zheng, a former official at the People's Bank of China, the country's central bank, and now an economist at J.P. Morgan Chase & Co. in Hong Kong. "If China wants to influence the market, it can. Its financial power is just so strong."

For now, though, most analysts view strong-arm tactics as extremely unlikely. If China really did sell Treasury securities, it might damage the U.S. economy, thereby harming the ability of American businesses and consumers to buy its goods. Key to the wealth that Asia is generating is its continued access to a healthy, growing U.S. market. Also, if China began to sell substantial amounts of Treasurys, that could be costly to China because it would drive down the value of its remaining Treasury holdings.

Altogether, $1.347 trillion worth of Treasury securities, more than a third of the total, were in foreign hands on June 30, according to Federal Reserve data released last week. Worldwide holdings of Treasurys by central banks rose about $51 billion in the first half of the year, which indicates that a substantial share of China's and Japan's central banks' purchases came as the result of selling by other central banks. Private holdings of Treasurys by foreigners increased by more than $80 billion, the figures show.

Asia's purchases of American debt are largely the result of the huge stocks of foreign exchange building up in the region as it claims larger pieces of global trade. Asia now holds about half the currency reserves on the planet, more than $1.5 trillion, according to FinanceAsia, a financial Web site in Hong Kong. By 2008, Asia will hold two-thirds of the world's reserves, according to a forecast by ING Barings. As much as 80 percent of this money is flowing into U.S. Treasurys because they have long been a haven for central banks seeking reliable returns.

Asia's role as financier of U.S. debt is peaking just as complaints grow in Washington about the very source of its wealth -- its soaring trade surpluses with the United States. China and Japan each have annual trade surpluses with the United States in excess of $100 billion.

The Japanese government also has massive amounts of dollars to invest because of its efforts to hold down the value of its currency, the yen, against the dollar, to boost exports to the United States. To do so, Japan's central bank used yen to buy billions of dollars this summer, but then it had to invest the dollars in U.S. assets.

China has pegged its currency -- the yuan, also known as the renminbi -- to the dollar for nearly a decade.

Manufacturers and labor groups in the United States have complained bitterly about what they say are undervalued currencies in Japan and China that effectively make those countries' goods unfairly cheap overseas. Some economists estimate the yuan is undervalued by as much as 40 percent, causing some U.S. business groups to blame China for the loss of millions of manufacturing jobs at home.

Some members of Congress have called for measures to force China to allow its currency to rise. But many analysts here construe such talk as largely political theater aimed at assuaging voters in key Rust Belt states ahead of next year's elections. Treasury Secretary John W. Snow recently visited Tokyo and Beijing, where he tread lightly, declining to complain about Japan's cheap currency while embracing as good news China's reiteration that some day -- not any day soon -- it plans to move toward a free-floating currency.

More than one factor explains the Bush administration's inclination toward the soft approach. Washington is counting on Tokyo's financial support for the war in Iraq, and it needs the cooperation of both Japan and China to try to coax North Korea back from the brink of developing nuclear weapons. The Bush administration also has learned that even if it does complain, China and Japan will probably pursue their economic self-interest anyway, maintaining lower currencies.

Special correspondent Akiko Kashiwagi in Tokyo contributed to this report.

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Interim House Study Committee on International Trade and Labor Issues August 13, 2003

Comments submitted by Jean Ann Harcourt, President of Harcourt Industries, Inc. Milroy, Indiana

Mr. Chairman and members of this Indiana House Study Committee, thank-you for taking time to listen to some very concerned Indiana manufacturers.

I am Jean Ann Harcourt, President and co-owner of Harcourt Industries, Inc. located 50 miles southeast of Indianapolis in the small town of Milroy.

Milroy is proud to be the hometown of Senator Bob Jackman. Harcourt Industries, Inc. is also proud to be the employer of Indiana State Representative Tom Saunders.

Harcourt Industries, Inc. is a manufacturer & distributor of school supplies with our primary product being PENCILS. We sell to over 17,000 schools all across America.....we sell to approximately 75% to 80% of the schools in Indiana under our dba....Harcourt Outlines, Inc.

Our annual sales average is between $12,000,000 & $13,000,000. Over half of our annual sales are sold through vending machines which we also manufacture. These gray vending machines are "loaned free to schools" with the understanding that the products for the vending machines must be purchased from our company.

Schools use our vending machines to provide a service to the students so they have access to pencils, pens, notebooks, erasers, etc. throughout the school day. Schools or school organizations also sell our products as a fundraiser.

We employ 100 people full-time with good benefits from Health Insurance to a 401K Plan which includes Profit-Sharing. Our work environment is safe and our employees work in air-conditioned manufacturing areas. We care about our employees because they are, in many cases, family or friends. During the summer months, we employ 15 to 32 college or high school students – mostly children of our employees - for our "Back-to-School" season.

Our annual payroll is $3,751,000 and when benefits are added, this cost jumps to $4,200,000 which plays a major role in the economic well-being of small Rush County. When we calculated the taxes paid by our individual employees ....it is stunning....*see attachment*.....

Total Federal Income Taxes paid by employees: Approximately $500,000
Total State Income Taxes paid by employees: Approximately $100,000
Total all taxes paid by employees or by the company for employees before Corporation Income Taxes: Almost $1.2 million

Our corporation did NOT make a profit last year.....competition has made margins too thin on top of the loss of sales. Our company is projected to break even again this year. Businesses need to make a profit to continue operating.

We are manufacturers today....we are still surviving in a very difficult economy. We may or may not be in business tomorrow.

Our business of tomorrow will have an entirely different face because of unfair trade practices....instead of manufacturing the products we sell, we will be forced to cut our labor force in HALF OR MORE and become a distributor.

EVERYONE SUFFERS FROM THIS ACTION....Employees who lose jobs.....the State of Indiana loses its income tax revenue from these former manufacturing jobs, property taxes will be lost— many will be forced to sell their homes with no jobs in the area that pay them a good, fair wage.

Let me explain what I mean by unfair trade.

Four years ago, we manufactured 50 million pencils annually and imported from China 20 million pencils.

Pencils are manufactured on three machines.
Step 1 Groover.....takes a wood slat, cuts 9 grooves for the graphite
Step 2 Leadlayer .... Glues the graphite between two wood slates
Step 3 Clamp....pencils bond over night in clamps forming sandwiches
Step 4 Shaper....pencil sandwiches are cut into raw sticks

The last time we ran these 3 machines was May 2002.
Groover 1 person; Leadlayer 2 people; Shaper 2 operators = 5 people
On occasion these machines were run on a second shift = 10 jobs

This $250,000 worth of equipment sits idle collecting dust, and this once extremely active manufacturing building is NOW A WAREHOUSE.

Harcourt Industries, Inc. now buys all RAW PENCIL STICKS from China because our importer can sell THE STICKS TO US BELOW OUR COST OF BUYING THE INDIVIDUAL MATERIAL PARTS.

Please note....we can buy the completed raw pencil stick for less than the individual material cost.

When we add our LABOR COST to the manufacturing of the actual pencil, the cost of the pencil nearly doubles.

WHY so much more expensive? We pay our employees a decent wage, provide them with good benefits, a safe work environment and we must spend thousands and thousands of dollars annually to comply with government regulations.....

My Human Resources Director, Jennifer Sturges, wanted me to share with you some regulatory overkill numbers....*time does not allow me to review with you; therefore, I have a copy of her comments on "The Small Business Disadvantage in Regulatory Compliance." Mrs. Sturges points out "the great paper chase."*

We are not here for a government handout. Tax credits do little to help when a company is already at break even.

We are here because we want OUR GOVERNMENT TO DO THE RIGHT THING - protect Indiana businesses from UNFAIR TRADE PRACTICES. I have always believed that government CLOSEST TO THE PEOPLE or local government is where individual citizens and small business owners should start. So thank-you again for giving us this forum.

Yes, we know, TRADE ISSUES generally fall into the category of FEDERAL ISSUES.....following today, I will personally contact Indiana's U.S. Senators and Indiana's Congressmen about this issue of UNFAIR TRADE PRACTICES.

The buzz words today are, "it's a global economy." Yes, we understand about a global economy. Indiana manufacturers are UP TO THE CHALLENGE. We are truly entrepreneurs....we are business owners who assume risk for the sake of making a profit.

Entrepreneurs....always looking for new ways to provide VALUE ADDED PRODUCTS TO OUR CUSTOMERS..... "Back to School Packs" where we package for the students and parents the list of school supplies that the teacher has requested at the beginning of a new year.

Currently, we are manufacturing the paper products that go into this VALUE ADDED PRODUCT.....paper converter....buy the rolls of paper and print the blue lines and red margin lines on the paper....in our opinion, it is ONLY a matter of time before these notebooks will also say MADE IN CHINA.....and 5 to 10 more Harcourt employees will lose their jobs because of LACK OF GOVERNMENT PROTECTION from Unfair Trade practices from China.

Two questions I want to answer before you ask them....

1. Have you lost business from major customers due to Chinese Pencils? ***The answer is YES...attached is a document which lists five commercial pencil customers showing a loss of over $534,509 in pencil sales from 1999 to 2002 (nearly a 5% decline of our total sales volume).***

2. Has your company actually employed fewer people due to loss of business from imported Chinese Pencils? ***The answer is YES....the attached document shows that in July 2001 (Month 7)....summer employment reached 134 employees and July 2003 (Month 7)...summer employment at 116 employees or 18 less than two years earlier. Plus summer employees this past summer worked two to three weeks less time than 2001.***

I want to close by saying that I do NOT personally know very much about our country's trade agreements.....I do NOT offer an opinion on them, I am here today to say that INDIANA MANUFACTURERS HAVE SERIOUS PROBLEMS.

You as State Leaders need to hear directly from us....manufacturers.... You need to be able to put real faces with real businesses who manufacture real products such as PENCILS and NOTEBOOKS for school children.

I guess what my company is asking you to do is to PUT PRESSURE ON OUR FEDERAL ELECTED OFFICIALS TO STOP UNFAIR TRADE PRACTICES FROM CHINA....*stop them from taking their government subsidized products or companies who pay $.30 per hour with no or limited benefits and dumping products in our American market.*

The Chinese do NOT play by the same rules when it comes to intellectual or copyrighted property....they are not policed or punished for doing knock offs of American Designs.

Unfair Trade Practices from China are putting Hoosiers out of work!

ATTACHMENTS:

The Effects of Chinese Competition on Harcourt Industries, Inc.

1. **Annual Payroll, Annual Benefits, & Taxes**
2. **Loss of Business**
3. **Reduction of Workforce**
4. **Small Business Disadvantage in Regulatory Compliance**
5. **Human Resources and the Great Paper Chase**
6. **Regulations Can Be Fixed—Examples**

The Effects of Chinese Competition on Harcourt Industries, Inc.

1) 2002 Payroll Statistics

Harcourt Industries, Inc. Annual Payroll Statistics for 2002

2002 Gross Wages	$2,[illegible]

2002 Total Payroll Taxes	$[illegible]
2002 Federal Income Tax	$496,559.17
2002 Fed Unemployment Tax	$6,632.32
2002 Fed Employer FICA	$253,939.20
2002 Fed Emloyee FICA	$253,939.20
2002 Indiana Income Tax	$97,922.96
2002 Local IN Income Tax	$35,802.26
2002 Indiana Unemployment	$801.03

2002 Estimated Total Compensation & Benefits
Regular Wages x 148% $4,205,624.85

2) Loss of Business

Sales Decline due to Imports for Select HPC customers

CUSTOMER	1999	2000	1999-2000	2001	1999-2001	2002	1999-2002
Dicksons	$ 439,363.00	$ 310,018.00	$ (129,345.00)	$ 235,785.72	$(203,577.28)	$ 118,431.63	$ (320,931.37)
Economy Pen & Pencil	$ 754,095.00	$ 730,158.00	$ (23,937.00)	$ 639,817.64	$(114,477.36)	$ 633,142.28	$ (120,952.72)
Industries of the Blind	$ 190,720.00	$ 602,787.00	$ 412,067.00	$ 83,405.41	$(107,314.59)	$ 147,704.10	$ (43,015.90)
MB Pencil Co	$ 35,285.00	$ 33,669.00	$ (1,616.00)	$ 19,599.28	$ (15,685.72)	$ -	$ (35,285.00)
Pencil Wholesale Co	$ 98,013.00	$ 11,939.00	$ (86,074.00)	$ 60,726.22	$ (37,286.78)	$ 83,688.53	$ (14,324.47)
[illegible]							[illegible]

3) Reduction of Workforce

Harcourt Industries, Inc. Employment Analysis
*totals from Indiana Unemployment Quarterly Reports

	2001	2002	01 to 02 Diff	2003	02 to 03 Diff	01 to 03 Diff
Month 1	94	89	(5)	95	6	1
Month 2	98	91	(7)	93	2	(5)
Month 3	96	90	(6)	95	5	(1)
QTR 1	111	93	(18)	99	6	(12)
Month 4	99	85	(14)	94	9	(5)
Month 5	105	88	(17)	96	8	(9)
Month 6	131	113	(18)	107	(6)	(24)
QTR 2	140	120	(20)	123	3	(17)
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Month 8	107	110	3			
Month 9	94	92	(2)			
QTR 3	139	134	(5)			
Month 10	90	95	5			
Month 11	90	96	6			
Month 12	88	97	9			
QTR 4	95	100	5			

4) Small Business Disadvantage in Regulatory Compliance

The Society for Human Resource Management's statement before the U.S. House of Representatives' subcommittee on Regulatory Reform and Oversight eloquently describes the small business' challenge of doing business in the U.S. today.

"The greatest regulatory burdens are when laws are regulated by two different agencies (e.g. DOL and IRS oversee ERISA) or when two laws begin to conflict with each other because they fall under two or three different agencies or sub-agencies (e.g. FMLA and ADA). Often when two agencies have authority to regulate the same law, there is a disconnect between one agency's regulations and the others."

Example 1—FMLA vs. ADA & Workers Compensation: Small employers have a hard enough time struggling to comply with having to hold open a job for an employee for 12 weeks but they must also be able to determine on the first day that an employee calls in sick whether the absence is FML because the clock doesn't start ticking until the employee has been notified. The difficulty of tracking FML that can be taken by the hour is further complicated by the Americans with Disabilities Act which the courts have determined can expand an employee's leave of absence as a REASONABLE ACCOMMODATION for a disability in essence negating the very intent of the FMLA. To complicate the issue even more, add in coordination with Workers' Compensation. If a worker was injured on the job and we returned them to work after a 6 month leave, has that set a precedence that we must now allow an employee with a "serious health condition" a 6 month leave as a "reasonable accommodation"? No longer can an employer rely on the regulations to tell them what to do. In our company, we develop policies and procedures so that we have a reference guide to follow for consistent treatment of all employees, but with Federal and State laws, we are subject to someone else's interpretations (the courts) which can change from year to year.

Example 2—the FTC (Federal Trade Commission) and Sexual Harassment investigations: When a company needs to conduct an investigation of an employee for possible discrimination, not only should they consult one of the 7 handbooks issued by the EEOC, but they better know the Fair Credit Reporting Act (FCRA) as well. A reasonable deduction would interpret the unrelated banking bill that amended the FCRA in 1996 to only apply to credit checks. However, the language of the statute has been interpreted broadly. In an opinion letter released in 1999, the FTC staff held that outside consultants who regularly engage in assisting employers for a fee with investigations of alleged sexual harassment are categorized as "consumer reporting agencies" providing "consumer reports" to the employer. Accordingly, consultants and the employers using this information are subject to the various notices and disclosure requirements associated with consumer reports. Because the ruling requires employers to obtain written permission from the accused before proceeding with an investigation as well as providing the accused with a copy of the investigation prior to any adverse action can be taken, it becomes much more difficult to obtain complete and accurate information in many harassment inquiries.

Our HR manager's orientation for new employees has become a three-hour disclaimer. How we manage not to scare all of them away before they get out to the shop floor is a miracle.

~~How about we ask the employees to serve on a company committee to help management determine what is~~ "fair?" Oh, wait, that would be an "employer-controlled group" and would violate their rights.

5) HUMAN RESOURCES AND THE GREAT PAPER CHASE

Regulatory overkill—it's all in the numbers:

- 18 pages—Our form 5500 that was filed in July for our 401(k) plan which is a standard plan with less than $ 4 million in assets and covers only 89 participants.
- 27 pages--Our Affirmative Action Plan to prove that we haven't discriminated against anyone in case we ever want to get a government contract.
- 40 pages—Our company handbook.
- 54 reference manuals in the HR manager's office for guidance, all of which will be out of date before the end of the year.
- 5 seminars that the HR manager will attend this year to hear attorneys and consultants interpret the regulations.
- 7 monthly subscriptions to trade publications for additional guidance.
- 18 websites for Federal and state regulatory agencies in the HR manager's list of "favorites"
- 7 four-drawer filing cabinets in the HR manager's office to store the documentation of what we do in case we have to go to court.

6) REGULATIONS CAN BE FIXED--EXAMPLES

A) FMLA—Two major issues of the FMLA are the definitions of "serious health condition" and "intermittent leave." In the 108th Congress, Rep. Biggert and Senator Gregg introduced H.R. 35 and S.320, respectively. Both bills would amend the FMLA by repealing the DOL's current regulations for "serious health conditions" and replacing them with the Democrats' Committee report defining the types of medical conditions the act was intended to cover. H.R. 35 and S.320 also clarify intermittent leave use to allow employers to require employees to take intermittent leave in blocks of four-hour minimums. Last, both bills shift the burden to the employee to request that leave be designated at FML, and require that for a foreseeable leave, the employee provide written notice within five working days. For an unforeseeable leave, the bill requires the employee to provide oral notification at a minimum.

B) FLSA(Fair Labor Standards Act)—The DOL has proposed long overdue revisions to the white-collar exemption definitions making determinations of an employee's exempt status from overtime pay easier. Unfortunately, what began as an administrative rule is now being fought out in Congress. July 10th, the House of Representatives narrowly defeated a proposal that would prohibit the DOL from using fiscal year funds to promulgate or enforce the rule changes. The same cause is now expected to be taken up in the Senate during the debate on the Labor, Education and Health and Human Services appropriations bill slated to begin after Labor Day.

C) FCRA—The House is expected to consider H.R. 2622 upon return from Recess Sept. 3, 2003. The bill is a narrow technical correction that does not tamper with FCRA protections for investigations into credit worthiness. In addition, the bill does not leave those suspected of misconduct without protection: it still requires that an employer, who takes adverse action against an employee based on information from an investigation, provide the employee with a summary of the nature and substance of any investigative report.

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www.heartwoodmfg.com

August 13, 2003

Chairman Dobis and Members of the China Study Committee
Indiana State House of Representatives
Indianapolis, Indiana

Dear Sir:

Heartwood Manufacturing was incorporated in Indiana in March of 1992 and we have had a very successful beginning. Our company produces furniture for hospitals, store fixtures, residential furniture and other wood products.

During recent years we have experienced a decline in sales that is directly related to the rising quantity of low-cost, imported furniture. Our growth has been stopped. We employ fewer people than we did in 1999 and 2000.

We have made significant investments in equipment to make our manufacturing facility competitive, but it is not enough to offset the difference in price for those imported goods. Our sales of residential furniture will probably end unless we become an importer ourselves. This seems to be the choice we must make. Become an importer or abandon the residential furniture business.

Sadly, we will no longer need many of the fine people we currently employ. Heartwood is not alone in this situation. This is a serious problem for many manufacturers today in the United States.

Today, I will address the Study Committee along with a few other business owners from the Batesville area. Those who precede me will discuss many of the issues, which concern us all regarding foreign trade. While all of those topics are important to me, I will limit my talk to a discussion about what Indiana is communicating to business owners.

Sincerely,

Dale Meyer

Dale F. Meyer
President, Heartwood Manufacturing

Intro Letter

- Good morning and thank you for hearing me this morning.
- My name is Dale Meyer and I own Heartwood Manufacturing in Batesville.
- Heartwood Manufacturing was incorporated in March of 1992 and we have had a very successful beginning.
- Our company produces furniture for hospitals, store fixtures, residential furniture and other wood products.
- During recent years we have experienced a decline in sales that is directly related to the rising quantity of low-cost, imported furniture.
- Our growth in that area has been stopped.
- We employ fewer people than we did in 1999 and 2000.
- For our part, we have made significant investments in equipment to make our manufacturing facility as competitive as possible, but it is not enough to offset the difference in price for those imported goods.
- Our sales of residential furniture will probably end unless we become an importer ourselves. This seems to be the choice we must make. Become an importer or abandon the residential furniture business.
- Sadly, we will no longer need many of the fine people we currently employ. Heartwood is not alone in this situation. This is a serious problem for many manufacturers today in the United States.
- Others before me today have done a good job explaining several issues.
- I won't waste your time by repeating them.
- The one thing I want to discuss is the way the State of Indiana is communicating with business owners like myself.
- I have two examples.

- About a year ago I was invited to attend a forum in New Albany regarding Foreign Trade.
- I went there hoping to learn how my business could benefit.
- Most of the day was spent listening to representatives of various countries explaining the benefits of doing business in their country.
- Chile, Malaysia. Taiwan, China, probably about 20 countries were there and as I understand it, the representatives are paid by the State.
- The disappointing thing for me was that almost all of them tried to entice business owners like myself to move our manufacturing operations to their country.
- The gentleman from China said quite clearly, that we should set up a manufacturing facility in western China because we would be able to get an unlimited number of employees for about $400 per year.
- After the presentations, I met individually with my Trade Specialist.
- I described my business to him as I have here today and asked him what I might do to benefit from trade with some of those other countries.
- His response was an offer to introduce me to 13 buyers from China.
- When I asked what they wanted to buy, he told me, timber.
- I explained that my business was processing that timber into furniture.
- His reply was "Mr. Meyer, you need to think outside the box."
- It seemed to me that this man, who represented the State, thought I should give up on manufacturing and become an exporter of raw materials.
- I could do that. But does the state really want to forfeit all of the jobs that follow the timber industry? The sawmills, the lumber driers, the secondary processors like my company.
- An awful lot of payroll taxes will disappear if we lose so many of our manufacturing jobs.

- And those people who lose their jobs will probably need financial support from the State because there are not a lot of places for them to get a new job.

- Recently, I received an invitation to attend another program here in Indianapolis that was hosted by the Municipality of Jinhua, China and organized by the Indiana Department of Commerce, Office of International Trade.
- I did not attend but I can tell you that the invitation included the statement that "Jinuhua is looking for manufacturing companies."
- I don't understand why the State would encourage business owners like me to move our manufacturing jobs out of the country.
- When I started business in 1992, the State was promoting "Job Creation"
- The message I am hearing today is that I should take our manufacturing jobs overseas.
- I do not have the answer to this problem.
- And I doubt that it can be solved at the State level.
- But I believe it is our duty to our fellow citizens who earn their living with their hands, to make you, our legislators aware of the situation and hope that you can begin working on a solution before it is too late.

- Thank you for your time.

Notes for Aug 13 Meeting

Harcourt Industries, Inc.

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August 13, 2003

Honorable Chet Dobis, Chairman
Members of Interim House Study Committee
On International Trade and Labor Issues
Indiana Statehouse
200 West Washington Street
Indianapolis, IN 46204

Dear Chairman Dobis and Committee Members,

Thank-you for the opportunity to share with you a very serious problem which is destroying many Hoosier manufacturing companies! Manufacturing has always been a vital part of Indiana's economy. Manufacturing has always been considered the backbone of the U.S. economy.

My testimony today is based on my own personal manufacturing business, Harcourt Industries, Inc. My brother, Joe Harcourt, and I are 50-50 partners of our small town manufacturing company that today employs 100 people full-time and between 18 and 32 part-time seasonal workers.

Our primary market is selling school supplies to elementary, middle and high schools. Our primary product is wood case pencils. We also sell in other markets such as to commercial accounts, Christian bookstores, political and golf industry. Our annual sales run from $12,000,000 to $13,000,000.

You will be given lots of research and documentation on how the Chinese government is undervaluing its currency which makes all their exports extremely cheap. This unfair trade practice makes it impossible for Hoosier manufacturers to compete.

I am here today to help you understand that unfair trade practices from China are truly causing Hoosiers to lose their good paying manufacturing jobs. It's important that our state leaders know that we are talking about *REAL INDIANA PEOPLE, REAL MANUFACTURED PRODUCTS AND REAL JOBS BEING LOST!*

Respectfully,

Jean Ann Harcourt, President
Harcourt Industries, Inc.

THE FURNITURE OF
ROMWEBER

August 13, 2003

Chairman Dobis and Members of the State of Indiana House Study Committee

Re: China and its impact on Indiana Companies

The Romweber Company, is a 124 year old upper end residential furniture manufacturer headquartered in Batesville, Indiana. The Company's facilities are in excess of 450,000 sq feet and Romweber is one of a handful of furniture manufacturers that manufactures its products exclusively in the United States. The Company employs 180 and has an annual payroll of approximately $4,000,000. The Company has invested in excess of 5% of its annual revenues the last five years in plant automation.

Romweber products are marketed through national retailers such as Macy's, Lazarus, L.S.Ayres, Kittles, Crate and Barrel, and Bloomingdales.

China is now the single largest importer of furniture in the United States. Most U.S. furniture manufacturers now import a significant portion or their entire product line from China. As an example The Lane Company has closed all of its U.S. case goods manufacturing operations to become an importer. The job losses in the U.S furniture industry is staggering, over 30,000 people have lost their jobs since 1994. There are now millions of square feet of empty furniture plants in N.C, the unemployment rate in Catawba County, N.C. is over 9% primarily due to furniture, and textile plant closings as a direct result of imports..

As a result of the tight employment market and increased product demand in the mid- nineties many manufacturers turned to China as a source for parts or entire products. The furniture industry transferred its knowledge base to the Chinese and many critical vendors have opened plants in China to support their furniture industry. Many of the larger U.S. furniture manufacturers now have engineering and quality engineers located in China.

THE ROMWEBER COMPANY P.O. Box 191 • Batesville, IN 47006-0191 • 812.934.3485 • 812.934.5042 FAX • www.romweber.com

A major U.S. furniture manufacturer last year imported $100 million dollars in product from China, their goal for the coming year is to increase that amount to $500 million. Based on industry statistics that will result in the loss of another 4000 furniture industry jobs.

Labor in China is less than 30 cents per hour, the government subsidizes many aspects of their industry. Industries in China are not as heavily regulated in terms of worker safety and environmental issues. Benefits are mandated by the Chinese government and workers are expected to work as many hours as are required by their employer. Products coming in from China are generally less than ½ of the price that it costs to manufacture here in the U.S.

Deflation is running rampant in the industry as a result of products being imported from China. Bedroom prices have fallen 15% in the last 5 years. U.S. furniture manufacturers that have gone to an import strategy are now faced with Chinese selling to U.S. retailers directly. This practice is further reducing prices of furniture in the U.S.

Retailers are starting to suffer from the deflation that is taking place as they discover that the lower prices are not netting higher sales to cover their basic overhead.

Manufacturers that have utilized niche marketing have faired better than generalists have, however, that is now changing. With the advent of the U.S. Supreme Court decision relating to trade dress referred to as the Wal-Mart case it is much tougher to meet trade dress requirements for design protection. We have been knocked off a number times by Chinese manufacturers. Recently, a major U.S. importer copied a piece of our furniture that we have manufactured for a number of years. The importer's defense of their action is that the Wal-Mart Supreme Court decision now interprets the law so that they can copy designs freely as trade dress laws no longer prevent them from copying.

Prior to this Supreme Court decision furniture manufacturers could use Trade Dress laws to protect their designs. Obtaining patents has not been cost effective or timely enough to be meaningful for the furniture industry. This Supreme Court decision will now give the Chinese additional momentum in getting products that compete on the basis of design to market taking away U.S. manufacturers advantage of offering unique product design.

The Chinese manufacturers typically do not view other Chinese manufacturers as their competitors. Firms that are struggling for business are often times helped by what we would view as their competitor. Three years ago a major U.S. furniture manufacturer introduced a major collection that was primarily manufactured in China. Within six months there were reported to be 23 copies of the bed from the collection in the marketplace, all from China.

North Carolina is not the only state affected. Indiana has been affected as well. Southern Indiana has lost a number of furniture manufacturers as well as vendors to the furniture industry, Jasper Cabinet, Paramont Plywood, a number of Kimball plants have closed, Jasper Wood Products, Benchmark of Indiana, English Furniture, Midwest Veneers, Can American Veneers, Swain Industries to name a few.

Most of these closings have been related to the import situation in the U.S. either directly or indirectly. The impact of these closings to the State goes beyond unemployment claims. It is projected that most of the employees will be unemployed for a prolonged period of time and many will end up on Medicad or Medicare and as a result which will cause health care costs to rise as they are no longer will have private insurance. Hospital reimbursement factors are significantly lower for Medicaid than it is for most private pay customers. Empty plants will reduce the tax base for the counties and as a result the schools will suffer due to funding.

The country's economic leaders view of the loss of industrial jobs as a non priority due to a plan to move the U.S. economy to a high tech playing field. According to a recent article in the Indianapolis Star almost half of the adult population in Indiana has low literacy skills. Some of the criteria of the test included balancing a checkbook and finding the intersection on a map.

The majority of applicants that we have applying for jobs every day that do not have the skills to read a ruler, do basic fractions or count to 100. These people are not going to have the skills to be trained into high tech jobs. This applies to recent high school graduates and older adults as well.

On 8/8/03 Nightline aired a segment on the condition of the U.S. furniture industry and the closing of a Hooker Furniture Company plant closing in Kennetsville, N.C. An economic consultant that was interviewed stated that it is going to be extremely difficult for these unemployed people to find work due to their skill set.

As legislators I ask that you pass resolutions requesting Congress to establish fair trade laws that provide a balance playing field. The Governor should bring this issue to the Governor's round table as an agenda item in meetings with the Bush administration. Encourage Congress to enact laws that provide design protection that is enforceable on an international basis. Additionally, as a State we should look for ways to provide significant incentives to small to mid size manufacturers to automate their plants beyond tax credits.

Thanks you for your consideration.

The Romweber Company

Bruce M. Rippe
President

BATESVILLE TOOL & DIE, INC.

177 Six Pine Ranch Road, Batesville, Indiana 47006
Phone (812) 934-5616 ; Fax (812) 934-5828

August 12, 2003

House Summer Study Committee
Attn: Chet Dobis

I would like to start my testimony by thanking Chairman Dobis for allowing me to speak at this most worthwhile event.

My name is Jody Fledderman. I am the President and CEO of Batesville Tool & Die located in Batesville Indiana. Our company makes metal stampings mostly for the automotive industry. Our sales for 2003 will be about $60,000,000. We employ 407 people. Our payroll to those people is over $10,000,000 per year. We also have a company located in Queretaro, Mexico with sales of $5,000,000 employing 60 people. It was a necessity for us to locate a plant in Mexico to try to stay competitive in our industry.

Today, I would like to share my opinion and perspective on the damage being done to our State and our Country that is a direct result of the trade agreements being made between the USA and China. I want to state that I am a proponent for FAIR trade. I will put our workforce up against anyone in the world when it comes to ingenuity and high technology. However, it is difficult to complete when the playing field is so uneven. In this country, manufacturing has lost more than 2.6 million jobs since July of 2000. We are losing valuable skills that will be almost impossible to re-teach to future generations. For decades, manufacturing has been the center of America's economic strength. It seems a shame that when that very strength is being threatened, that our Country is closing the door in our face.

I would like to speak a little more about my opinion of the unfair advantage that China has over US manufacturers. I recently quoted a $5,000,000 program for an American automotive company. I had an employee spend about 50% of his time on this program for the last 12 months. He assisted the engineers in design concepts, supplied prototypes, and basically helped this product become a reality. When the bidding for production ensued, we felt confident we would be very competitive because we had so much knowledge about the program. Our pricing was better than anyone in North America and also in Europe. However, a quote came in from China that was 50% lower than our costs. Our material costs alone are nearly 60% of our quoted price. I find it impossible to believe that there are not unfair advantages being given to Asian manufactures when their DELIVERED cost to the USA is less than our material costs.

In our 25 years in business, we have faced many challenges and have answered every one to be a survivor. I'm not sure how to handle this threat on our existence from China. If our costs were a little but higher because of health care, steel tariffs, environmental requirements, or whatever, we found a way to become more efficient. However, when you have the situation that your competition is BELOW your material costs, it is simply a matter of time before you are out of business. Sooner or later I will probably be faced with the decision of moving more of our business to Mexico, or even a plant in China so we can compete. Either way, Indiana and the USA loose those jobs.

I believe the root of the problem lies in the trade agreements our country has made with China and other Asian countries. I believe this is a federal issue and will need to be handled in Washington DC. However, we need our elected State officials to help us carry the message. We must educate the policy makers on what is going on and what it is doing to our country. Even more important, we must convince them to have the vision to look at what this will do to our nation in the future. You also could go one step further and get behind a little known U.S. House bill that would establish an undersecretary of commerce for manufacturing in the Department of Commerce. The bill was introduced by freshman U.S. Rep. Thaddeus McCotter. In theory, the manufacturing undersecretary would become the nation's point person in developing a cohesive strategy for stemming the tide of lost jobs and encouraging states to collaborate.

I thank you for your attention today and I look forward to being a voice for manufacturing in Indiana before it is too late for all of us.

Sincerely,

Jody Fledderman
President/CEO

BATESVILLE TOOL & DIE, INC.

177 Six Pine Ranch Road, Batesville, Indiana 47006
Phone (812) 934-5616 ; Fax (812) 934-5828

Profile for China Impact Testimony

Presented by: Mr. Jody Fledderman ; President/CEO ; jody.fledderman@btdinc.net
Company Name: Batesville Tool & Die ; Established in 1978
Location: Batesville, Indiana
Queretaro, Mexico
Sales: $60,000,000 in Indiana
$5,000,000 in Mexico
Employment: 407 in Indiana
60 in Mexico
Product: Metal stampings and Assemblies mostly for the Automotive market.

Impact of China trade agreements on our business:

- Our Customers (The Big 3) are purchasing more and more from Asia. They are now telling us we need to also purchase from China or have plants there.
- China costs are forcing the market prices down. This in turn reduced our profits and reduces our ability to increase wages and provide opportunity for our associates.
- Employment: Our employment at our Indiana facility has dropped from 468 in 2001 to 407 now. **(A reduction of 61 people or -13%)**
- Loss of business: We recently lost a MAJOR new opportunity to an Asian supplier. This was a $5,000,000 opportunity. WE were the most competitive source in North America and Europe but Asia beat our pricing by %50! This business would have added 10-12 new jobs.

What will the manufacturing sector in the USA look like in 5 years if something isn't done?

- Continual loss of business to foreign competitors. Once this business is lost, it will NEVER return to the states. I estimate over 150 jobs lost at our Indiana facility in the next 5 years.
- Lack of Capital investment: With little or no profit returns, there are literally NO investments being made in capital equipment. This will eventually affect many other industries such as machine tool and construction.
- Loss of technology. As more of this work is completed outside the USA, generations never have the knowledge how to perform a specific skill needed.

Submitted for: At Issue: Stemming the job loss

By: Patrick J. Kiely, President
Indiana Manufacturers Association
One American Square, Suite 2400
Indianapolis, IN 46282
(317) 632-2474

The Indiana Manufacturers Association's motto of "What Indiana Makes, Makes Indiana" is torn and frayed but still valid. Manufacturing has long been recognized as the engine of Indiana's economic growth. The manufacturing sector grows the economy and spurs more traditional economic activity and jobs than any other economic sector. Every $1.00 of final demand for manufactured goods generates an additional 67¢ in other manufactured products and 76¢ in products and services for non-manufacturing sectors.

Manufacturing also invents the products of the future. It is responsible for almost two-thirds of all private-sector research and development dollars. Productivity gains are higher than those in any other industry, and manufacturing salaries and benefits average 25 to 30 percent higher than the average for the total private sector.

Manufacturing is also an important contributor to economic growth. During the 1990s, manufacturing corporations paid 30-34 percent of all corporate taxes collected by state and local governments, social security and payroll taxes, excise taxes, import and tariff fees, environmental taxes and license fees.

Some speak about "transforming" Indiana's economy into high-tech, high-wage industry. Those two goals, in reality, are manufacturing. Even with the recent downturn in manufacturing employment, Indiana still remains the most manufacturing-intensive state in the country with 20.4 percent of Hoosier jobs in manufacturing, which is 75 percent above the average state. However, Indiana continues to lose jobs at an alarming rate. Since January 2000, we have lost more than 150,000 total jobs and more than 90,000 manufacturing jobs. The number of nonfarm people employed in Indiana is at a six-year low, and manufacturing employment is approaching a 20-year low.

The solutions will not be easy or without political risk. International economies require international solutions. Far too long, Indiana has viewed other states like Ohio, Illinois and Michigan as competitors. Today the competition is Asia, Mexico, Europe and India. To be competitive among states, no longer assures success.

The good news is that the economy appears to be on track for a more robust expansion than was predicted just a few months ago by the state's forecasting group. GDP projections for the second half of this year and for all of next year have increased by a full percentage point or more. The question that needs to be answered for Indiana is to what level will our economy benefit from this recovery?

The manufacturing community understands the nature of the international manufacturing restructuring that is occurring, but policymakers have been slow to recognize the significance and scope of the problem. The U.S. Department of Commerce recently woke up in the past 90 days after Midwest field hearings attracted large crowds of business owners telling their stories and Senator Lugar's hearing on China in September. The 2004 elections will be won by the candidates who make the best case for improving the economy.

China is quickly becoming a major political issue. Testimony before both state and federal committees make it clear that trade with China is neither fair nor free. Trade policy must recognize the differences in governance. Can a country with free elections compete on a level playing field with a Communist regime?

U.S. companies face far more obstacles and higher costs than those in China and other nations. In the U.S., you have regulations covering everything from labor, health care, liability, environment, construction and taxes. China does not tolerate unions, workers' rights, environmentalists or trial lawyers. China has a national health care system, albeit poor, pays little attention to the environment and uses profits to expand the military and protect the regime. Corporate-driven social and charity initiatives are almost nonexistent. Is that a level playing field? Of course, the U.S. will not eliminate these regulations. However, China and other countries must be encouraged to provide adequate and appropriate benefits for its workforce and protections for its environment. Free markets cannot exist without free people.

The Midwest has a lot to lose if we don't inform our elected officials about competition and work on our own policies that make our cost structures uncompetitive. We need to work on a "total solution," which includes both federal and state considerations that recognize the realities of global competition and trade policies that are a two-way street. In the end, government does not or cannot ensure anyone's success; but as we all know, it can and has gone a long way toward destroying it. The Indiana and United States' standard of living and our future depend on actions we must take now.

September 15, 2003

968099 2

The Honorable Zell Miller
United States Senate
Washington, DC 20510

Dear Senator Miller:

I am a Republican and you have done many good things for the people you represent. I am an employee of Mount Vernon Mills in Trion, GA. My employment stretches over 30+ years. Our textile plants consist of 5500 employees + we have been in operation since the 1840's. We've been tough times in the past, but this is different. We need your help!

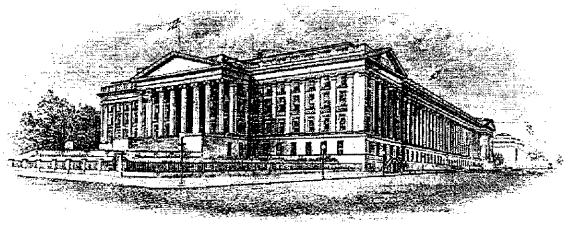
Cheap imports from China + other countries are killing us. Factories are closing their doors everyday. Free trade with China has flooded the market with low-priced textile and apparel goods and we can't compete. Nearly 300,000 jobs have been lost since 2001. These are American jobs. We are losing our jobs + creating jobs overseas. China has Never played by the rules and yet we continue to open our doors to them + cater to their desires in establishing trade policies. Our manufacturing base is being destroyed and we are becoming completely service oriented.

I'm angry that our President & representatives are allowing this to happen.

We value our textile jobs and it hurts each time we hear of another plant having to close its plant permanently. We wonder if our plant will be next. We are desperate. You are our Senator. Please help us by placing a limit on the items China and other countries can send to our country. We're asking you to do the right thing and help save our jobs.

Sincerely,

Joyce Williams
Secretary
Mount Vernon Mills
P.O. Box 7
Trion, GA 30753



DEPARTMENT OF THE TREASURY
OFFICE OF PUBLIC AFFAIRS

EMBARGOED UNTIL 10:00 am eastern **Thursday, October 30, 2003**

Report to Congress on
International Economic and Exchange Rate Policies

October 2003

This report reviews developments in international economic policy, including exchange rate policy, focusing on the first half of 2003. The report is required under the Omnibus Trade and Competitiveness Act of 1988, which states that "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 payments adjustments or gaining unfair competitive advantage in international trade."

After reviewing developments in the United States, the report examines exchange rate policies in major countries across five regions of the world: (1) the Americas, (2) Europe and Eurasia, (3) Africa, (4) the Middle East and South Asia, and (5) East Asia. To summarize, the report finds that

- Countries around the world continue to follow a variety of exchange rate policies, ranging from a flexible exchange rate with little or no intervention to currency unions and full dollarization. For example, Canada follows a flexible exchange rate regime with no intervention, Greece recently joined the European Monetary Union, and El Salvador maintained its dollarization regime.

- A notable trend observed over the past several years is the move by many countries to adopt flexible exchange rates, combined with clear price stability goals and a transparent system for adjusting monetary policy instruments. It is good news that nearly 100 countries have eschewed pegged exchange rates and have chosen to use a flexible exchange rate, dollarize, join a currency union, or create a currency board.

- The report finds that no major trading partner of the United States meets the technical requirements for designation under the Omnibus Trade and Competitiveness Act of 1988 during the first half of 2003. The report notes that while a number of countries continue to

use pegged exchange rates and/or intervene in foreign exchange markets, a peg or intervention does not in and of itself satisfy the statutory test. Treasury has consulted with the IMF management and staff, as required by the statute, and they concur with our conclusions. The Administration strongly believes that a system of flexible, market-based exchange rates is best for major trading partners of the United States.

- For this reason, Treasury is continuing to engage actively with countries and to encourage, in both bilateral and multilateral discussions, policies that promote a flexible market-based exchange rate combined with a clear price stability goal and a transparent system for adjusting policy instruments. For example, one important accomplishment was the communiqué of the G7 Finance Ministers and Central Bank Governors in September of this year endorsing an Agenda for Growth and stating that "more flexibility in exchange rates is desirable for major countries or economic areas to promote smooth and widespread adjustments in the international financial system, based on market mechanisms."

The United States International Accounts

In assessing the trade deficits and surpluses of individual countries with the United States, it is important to examine first the overall U.S. trade and current account balance.

Saving, Investment, and the Current Account

Developments in the overall trade or current account balance are best understood in terms of developments in investment and saving. The current account deficit is conceptually equal to the gap between investment and saving as a matter of international accounting. When investment in the United States is higher than domestic saving, then foreigners make up the difference, and the United States has a current account deficit. In contrast if savings exceed investments in a country, then that country has a current account surplus as its people invest abroad.

In the second quarter of 2003, for example, the U.S. current account deficit was $570 billion (at a seasonally adjusted annual rate and adjusted to a national income accounting basis)[1] or 5.3 percent of GDP. This $570 billion deficit equaled the gap between $1,977 billion in investment and $1,407 billion in saving[2]. That is, U.S. domestic investment was $570 billion more than domestic saving with net foreign investment making up the difference.

Viewed in these terms over the past year, the increase in the U.S. current account deficit was caused by an increase in investment, combined with a somewhat smaller decline in saving. Over the year ending in the second quarter of 2003 the current account deficit rose by $73 billion from the second quarter of 2002. During that same period investment rose by $40 billion and saving fell by $33 billion. The increase in investment reflected the acceleration in U.S.

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[1] Balance of payments statistics are compiled on a slightly different basis than national income statistics. The net foreign investment (-$570 billion) item in the national income accounts closely matches the current account balance (-$555 billion) in the balance of payments.

[2] Saving includes the statistical discrepancy between the income and product accounts.

economic growth during 2003. Overall, real GDP grew at a 3.3 percent annual rate in the second quarter, up from 1.4 percent in the first quarter. Business investment in equipment and software and residential investment posted large gains, and forward momentum in those sectors continued into the third quarter.

The current account was $555 billion in deficit on a balance of payments basis in the first half of 2003. How has the deficit been financed? The largest single part of financing the current account deficit has recently been net private foreign purchases of U.S. securities, which reached $436 billion in the first half of 2003. (Included in these were net foreign purchases of U.S Treasuries amounting to $151 billion.) In addition, foreign official institutions increased their U.S. assets by $197 billion. These items alone more than covered current account financing needs and the total of all other financing items were equal to a net $78 billion capital outflow.

Due to the current account deficit the net investment position of the United States (with direct investment valued at the current stock market value of owners' equity) fell to a negative $2.6 trillion at the end of 2002 from a negative $2.3 trillion at the end of 2001. Despite this large negative position, net income payments on investment assets were not significant in 2002, amounting to roughly $1 billion. These positive net income receipts are the result of large net inflows of income from direct investment offsetting net outflows of income on portfolio investment.

The U.S. Dollar

According to the Federal Reserve Board's "broad" nominal dollar index, the U.S. dollar registered a 5.1 percent depreciation during 2003H1. The decline was 8.3 percent against "the major foreign currencies" (largely the industrialized countries) and 1.5 percent against "other important trading partners" (largely emerging market economies). The broad index declined 9.2 percent from February 27, 2002, when it reached its recent peak, through June 30, 2003.

Inflation remained subdued during this period. The consumer price index rose 2.1 percent over the 12 months ending in June as energy prices increased, while the core rate (excluding food and energy) increased 1.5 percent. The Federal Reserve maintained the federal funds rate target at 1.25 percent through the first five months of the year, then lowered the rate to 1.0 percent in June. During 2003H1, U.S. interest rates declined toward historical lows, and interest rate differentials increasingly favored relatively higher yielding non-dollar placements.

As discussed below, the currencies of different economies showed varying degrees of flexibility relative to the dollar, as some monetary authorities sought to dampen or prevent movements of their exchange rates against the dollar while others did not intervene at all. The United States did not intervene in foreign exchange markets during the first half of 2003.

The Americas

Overall, nominal exchange rates in the region appreciated or remained relatively stable relative to the U.S. dollar during the first half of 2003, with the Canadian dollar noticeably

strengthening against the U.S. dollar. Interest rate spreads between the Latin American Emerging Market Bond Index (EMBI+) and U.S. Treasury securities continued to decline from the September 2002 high of 1366 basis points, ending June at 697 basis points above U.S. Treasuries.

A recovery appears to be emerging in many countries in Latin America following a disappointing year in 2002. The region saw real GDP decline 0.1 percent in 2002, but GDP is expected to grow 1.1 percent in 2003. Canada's GDP declined in the second quarter of 2003, but with stronger subsequent growth Canada is expected to achieve 2.0 percent growth for the year.

Canada

Canada's overall current account surplus rose to 2.0 percent of GDP in the first half of 2003, up from 1.7 percent in 2002H2, but still below the somewhat higher ratios recorded in 2000 and 2001. After little net change in 2002, the Canadian dollar rose 16.5 percent against the U.S. dollar between the end of 2002 and the end of June 2003, with the J.P. Morgan real trade-weighted Canadian dollar index up 11.4 percent over the period.

Canada has a flexible exchange rate and did not intervene in exchange markets during 2003H1. Canada has not intervened in foreign exchange markets since 1998, except to make a small contribution to the brief G-7 intervention in support of the euro in September 2000.

Argentina

Argentina has had a flexible exchange rate since the end of 2001 when it abandoned its convertibility law, which had pegged the peso one-to-one with the U.S. dollar. Argentina's currency continued to strengthen in the first half of 2003, moving from 3.36 pesos per dollar at end-December 2002 to 2.81 at end-June 2003 for a 19.6 percent appreciation. Argentina's trade surplus was $8.7 billion in the first half of 2003, with exports rising 16 percent and imports rising 38 percent compared with the same period the previous year. Argentina's gross foreign exchange reserves grew by $1.7 billion during the first half of the year to $12.2 billion at the end of June 2003. The economic recovery continued after the severe contraction in the first half of 2002, with real GDP growing 10 percent in the first quarter of 2003. Consumer prices were stable, with a net increase of 2.1 percent from end-December 2002 to end-June 2003, and conditions in the banking system continued to improve. Interest rates on saving deposits of 30-59 day maturities fell from over 20.7 percent at the beginning of 2003 to 9.6 percent by end-June 2003.

Mexico

Mexico has a flexible exchange rate. The Mexican peso depreciated 2.9 percent from 10.2 pesos per dollar at end-December 2002 to 10.5 pesos at end-June 2003, following an 11.2 percent depreciation in 2002. The real trade-weighted value of the peso depreciated 3.1 percent

in the first half of the year, following a 3.6 percent depreciation last year. The current account deficit fell to 0.6 percent of GDP in the period, with seasonally adjusted imports falling 6.5 percent and exports increasing 4.7 percent compared with the second half of 2002. Foreign direct investment in Mexico was $5.2 billion in the period, a decline of 26.4 percent from the comparable period last year. International reserves grew $4.6 billion over the period, reaching $55.2 billion by end-June. Economic conditions remain soft, with real GDP for the first half of 2003 growing at a 0.2 percent annual rate from the second half of 2002 and 1.2 percent from the comparable period last year.

Brazil

The real appreciated 22 percent in the first half of 2003. Brazil registered a current account surplus of $535 million for the first half of the year, driven by a $10.4 billion trade surplus. This performance compares with an $8.4 billion current account deficit for the first half of 2002. Net international reserves increased from year-end 2002 by $400 million to $14.6 billion at the end of June, while gross international reserves totaled $48.0 billion, up from $38.7 billion at 2002 year-end. (IMF disbursements are not included in the calculation of net reserves.)

Consumer price inflation was 17 percent for the twelve months ending in June 2003. In this environment, the central bank tightened monetary policy in January and February, raising the target monetary policy interest rate 150 basis points to 26.5 percent. The central bank began to ease monetary policy in June with a 50 basis point cut following declining inflation readings in May and June.

Europe and Eurasia

In the European Monetary Union, the euro appreciated strongly against the dollar, and in Russia, oil sales and an improved capital account supported the ruble. In Central Europe, weakness in the major economies led to weakness against their key trading currency, the euro.

The European Monetary Union

The countries in the European Monetary Union as a whole had a current account surplus during the first half of 2003 equal to $14 billion. Goods exports fell 3.8 percent in the first half of 2003 from the second half of 2002, and goods imports increased by a mere 0.8 percent. The current account surplus for 2003H1 was down 60.1 percent from that of 2002H2 (in dollar terms). The underlying movement behind this change appears to have been an increase in investment and a decline in saving in the Euro-zone. Gross capital formation (seasonally-adjusted) grew by 1.4 percent between the two time periods. Saving is estimated to have fallen 1.6 percent between 2002H2 and 2003H1.

The financial account for the Euro-zone was dominated in 2003H1 by a large deficit in "other investment" of $124.6 billion, down 15.2 percent from $146.9 billion in 2002H2. The biggest contributors to "other investment" were short-term loans by monetary financial institutions and loans from other sectors. There were smaller deficits in financial derivatives

$5.1 billion) and direct investment (- $4.5 billion). The Euro-zone saw surpluses in portfolio investment ($36.5 billion, down 48.8 percent from 2002H2) and accumulation of reserve assets of $16.2 billion (compared to a fall in reserves of $5.9 billion in 2002H2).

The euro appreciated 9.7 percent against the dollar in the first half of 2003, while according to the Eurostat index the real effective exchange rate appreciated 8.4 percent. The European Central Bank did not intervene in exchange markets during this period.

Russia

In the first half of 2003, Russia saw large net inflows of foreign exchange resulting from high oil prices and high foreign borrowing by Russian corporations. This led to a 5.3 percent appreciation of the ruble against the U.S. dollar compared to a 1.3 percent depreciation during the second half of 2002. Intervention by the Russian monetary authorities to moderate the appreciation of the ruble against the dollar led to a $16.6 billion increase in foreign exchange reserves to a record high of $64.4 billion.

Central Europe

After appreciating steadily for several years in real terms, the currencies of the major Central European economies began to show weakness in both nominal and real terms during 2003H1. Nominal depreciation of key regional currencies against the euro, the most important foreign currency for trade, combined with a slowdown in inflation in the major area economies to reverse the real appreciation trend.

In Poland, for example, the zloty weakened in both nominal terms (1.9 percent versus the dollar and 10.5 percent versus the euro) and real terms during the period as the fiscal deficit grew and confidence in the zloty faltered. The Czech Republic koruna depreciated in real terms due to deflation during the period and political uncertainty. In Hungary the forint saw extreme volatility against the euro. A strong appreciation in the beginning of the year prompted massive intervention by the central bank of Hungary. However, deteriorating macroeconomic conditions and market uncertainty concerning the course of fiscal reform led to capital flight and depreciation. The Bulgarian lev appreciated against the dollar as its value was fixed relative to the euro as part of its successful currency board arrangement.

Africa

Most key exchange rates in Africa depreciated against the U.S. dollar on a nominal basis during the first half of 2003. Notable exceptions were the South African rand, which appreciated 14.7 percent, and the currencies of the CFA zone, which are pegged to the euro. They appreciated against the dollar just as the euro did. The strengthening of the rand probably

reflected favorable interest rate differentials, improved investor sentiment following credit ratings upgrades, and the country's more sound economic fundamentals.

GDP growth in Africa remained resilient despite the weak pace of recovery in industrialized countries. For the continent as a whole, growth is expected to increase in 2003. The continent's overall current account deficit is expected to fall slightly in 2003 from 1.3 percent of GDP in 2002, though current account deficits in many countries in sub-Saharan Africa remain relatively high. Capital inflows are expected to increase, particularly from private sources. Since 2001, foreign exchange reserves have increased from $64.7 billion to a projected $86.7 billion in 2003, with the bulk of the reserve accumulation occurring in North African countries due to higher energy prices.

In Egypt the Egyptian pound is notionally floating but strongly managed. The pound did move substantially over the period, however, falling 23 percent against the dollar and 25 percent on a real trade-weighted basis. The current account surplus grew during the first half of 2003, reaching 1.5 percent of GDP in the second quarter compared to 0.4 percent in the same quarter the year before, due in part to a slight contraction in imports but more significantly to an increase in both oil and non-oil exports.

Middle East and South Asia

The Middle East has seen strong growth this year, largely fueled by high global oil prices. Regional growth in 2003 should end up greater than last year's 3.9 percent, with the growth largely centered in the oil-exporting countries.

Many countries in this region maintain inflexible exchange rate regimes, including narrow bands and explicit or implicit pegs to the dollar. The high price of oil has led to higher current account surpluses and official reserve accumulation among the oil exporters. In Saudi Arabia, for example, reserves increased 12 percent in the first four months of this year to reach $23.1 billion, the highest level in a decade. The current account surplus is expected to increase well above the 6.2 percent of GDP level in 2002. Among the non-oil exporting countries, the current account deficit is expected to widen in 2003 from the 0.5 percent of GDP deficit recorded in 2002. In addition to higher oil prices, these countries were also hit by declines in tourism revenues due to the uncertainty surrounding the conflict in Iraq.

India maintains a heavily managed exchange rate regime. While the rupee appreciated 3.4 percent against the dollar in the first half of 2003, the Indian authorities intervened to limit further appreciation. As a result, foreign reserves grew $11.6 billion in the first half of the year, reaching $78 billion by end-June. The current account returned to a small deficit (seasonally adjusted) after surpluses in 2002. Capital inflows, including FDI, increased due to the improved economic outlook and expectations of an appreciation of the rupee.

Turkey and Israel have flexible exchange rates. Both currencies appreciated significantly since the start of the year, buoyed by strong investor demand for emerging market assets. The Turkish lira appreciated 18.3 percent between the end of December 2002 and the end of June 2003, following a 12.7 percent depreciation in 2002. The current account deficit fell to 1.6 percent of GDP in the first 6 months of 2003 from 3.0 percent of GDP in the second half of 2002. Gross foreign exchange reserves grew $2.1 billion over the period, reaching $28.8 billion by end-June.

Similarly the new Israeli shekel appreciated 9.8 percent from end-December 2002 to end-June 2003, following a 7.3 percent depreciation in 2002. The current account balance grew to a 1.8 percent of GDP surplus in the period, compared to a 1.0 percent deficit in 2002. Foreign exchange reserves grew 2.0 percent over the period, reaching $24.6 billion by end-June.

East Asia

Asian currencies were generally stable against the dollar in the first half of 2003, although the Indonesian rupiah and Thai baht both appreciated near the end of the period. Currency stability was maintained against the backdrop of a high degree of regional economic uncertainty, stemming from SARS and oil prices. Uncertainties regarding the oil price outlook were reduced after the start of the military campaign in Iraq. Efforts to contain SARS proved successful, and its economic effect, while significant for some countries, was less than anticipated.

Japan

Japan's current account surplus grew to $62 billion (3.0 percent of GDP) in the first half of 2003, up from $54 billion (2.6 percent of GDP) in the second half of 2002. While Japan's merchandise trade surplus declined by 9 percent during the period to $45.2 billion, Japan's services deficit narrowed substantially to $15.4 billion, 35 percent smaller than in the second half of 2002. Japan had a bilateral merchandise trade surplus with the United States of $32.2 billion during 2003H1, down from $36.8 billion in 2002H2, and from $33.1 billion in 2002H1.

The persistent Japanese global current account surplus reflects the high rate of Japanese domestic saving relative to domestic investment. The trend rate of Japanese growth fell after the first oil crisis, and again after the bursting of Japan's asset price bubble at the beginning of the 1990's. Slower growth has meant lower investment, and the share of private investment in GDP has fallen from 26 percent in the 1960's, to 22 percent in the 1980's, to 19 percent in the last 3 years. Excess private saving has been partially absorbed by larger government deficits.

During the first half of 2003, the yen fluctuated in a narrow range against the dollar, depreciating 0.9 percent to ¥119.9 at the end of June 2003 from ¥118.8 at the end of December 2002. But in September and October of this year the yen appreciated against the dollar to around the 108 level or about 7 percent since the beginning of September. Intervention by the Japanese monetary authorities in the exchange markets totaled $59.0 billion in the first half of 2003 and

continued in July and August with an additional $22.7 billion. Japan's foreign exchange reserves grew by 17 percent to $527 billion at the end of June, up from $451 billion at the end of December 2002. Taking the longer view over the past 3 years it has fluctuated between a low of 135 and a high of 108. The Japanese have stated that their "intervention is carried out when excess volatility or over-shooting is observed in the markets." The Treasury is actively engaged with the Japanese on these issues both bilaterally and through the meetings of the G7 finance ministry and central bank officials.

China

China's overall trade surplus narrowed in the first half of 2003 to $13.5 billion (2.2 percent of GDP), compared to $20.7 billion a year earlier (3.8 percent of GDP). The reduced overall trade surplus was accounted for by the strong growth in China's merchandise imports compared to exports. This reflected China's growing deficit with trading partners other than the United States. Other Asian economies that used to export directly to the United States increasingly ship components to China for assembly. China's bilateral surplus on trade in goods with the United States grew to $53.9 billion in 2003H1, up from $43.1 billion a year earlier.

China's current account surplus in 2003H1 was $11.1 billion compared to $13.6 billion in 2002H1. However, net FDI inflows were $26.9 billion, while non-FDI net capital inflows were $17.5 billion, compared to $22.7 billion and -$10.4 billion a year earlier, respectively. Thus, the increase in China' official reserves was due more to capital inflows than to the much smaller current account surplus.

China has pegged its currency since 1994 at 8.28 to the dollar. This policy is not appropriate for a major economy like China and should be changed. The Administration has engaged in direct talks calling on the Chinese to move towards a flexible exchange regime. The Administration has utilized bilateral and multilateral forums to urge China to move toward greater flexibility. At the September 2003 G7 meeting in Dubai, the ministers and central bank governors endorsed flexibility in exchange rates for large economies. Secretary Snow traveled to China for discussions with senior Chinese officials on financial issues including exchange rate policy. President Bush, in his bilateral meeting with President Hu, discussed China's exchange rate policy.

China has maintained its fixed exchange rate despite significant changes – up and down – in the exchange rate of the dollar vis-à-vis other currencies. Recently there has been strong pressure on the yuan, as evidenced by foreign exchange reserves rising to $346 billion in June 2003, up 43 percent from June 2002. The Chinese government has indicated that it will move to a flexible exchange rate regime. It is taking steps to get there and the U.S. is providing technical cooperation. However, it also has stated that doing so immediately would harm the banking system and the overall Chinese economy.

In his discussions, Secretary Snow stressed the desirability of China's moving to a flexible market-based exchange rate regime and reducing controls on capital flows. The Chinese economy is now one of the largest in the world, and China is a major player in world trade. The

Chinese capital account is expected to become increasingly open, and policies of maintaining a currency peg in the face of an increasingly open capital account increases risk. Greater exchange rate flexibility would also allow China greater scope to maintain a low-inflation, pro-growth monetary policy. It would improve the allocation of resources and the quality of financial intermediation in the Chinese economy. Moreover, such a change would be consistent with our view that the international trading system works best with free trade, the free flow of capital and with market-based exchange rates.

Serious engagement with China on these issues will continue. A new Technical Cooperation Program is being implemented under the leadership of the Secretary of the Treasury and the Governor of the central bank of China. This program can help create the market mechanisms needed to make the transition to a flexible exchange rate regime. Moreover, the Chinese deputy finance minister and deputy central bank governor have begun to have regular meetings with the G7 finance deputies, with the first meeting held in Dubai in September and the next one scheduled for Paris in November.

Korea

Korea entered its first recession in five years during the first half of 2003. Real GDP contracted 2.9 percent in the second quarter of 2003, continuing the 1.6 percent drop in the first quarter. The slowdown was due to contracting domestic demand combined with slowing external sales. In response, both fiscal policy and monetary policy have been eased. In July the overnight call rate was cut a quarter-point to 3.75 percent.

Korea's current account surplus for the first half of 2003 was $1.2 billion, down from $3.9 billion for the same period last year. The balance on capital and financial account transactions recorded an almost $3.0 billion increase as the result of portfolio and other investment inflows. Official foreign reserves increased by $10.2 billion to $131.7 billion. The U.S. bilateral trade deficit with Korea in the first half of 2003 was $5.4 billion.

The won depreciated a net 0.8 percent in the first half of 2003 but has been on a rising path for several months. JP Morgan's real trade-weighted index of the won fell 2.3 percent during the period. While Korea has officially adopted a flexible exchange rate policy, in practice the won is quite closely linked to the Japanese yen. Since 2000 the monthly nominal won/yen exchange rate has averaged 1031, and the rate has deviated no more than 6 percent from this average.

Taiwan

After decreasing 2.4 percent in the first quarter of 2003, Taiwan's real GDP declined by a sharp 9.9 percent in the second quarter of 2003, reflecting the drag of SARS on the economy. Deflation remained entrenched, with consumer prices falling 2.2 percent in 2002 and 0.9 percent in the first half of 2003. Taiwan recorded a current account surplus of about 10.6 percent of GDP or $14.7 billion during the first half of 2003. The current account surplus was due mainly to a

large, $13.4 billion, trade surplus with China and growing foreign investment earnings. The United States ran a $7.3 billion bilateral trade deficit with Taiwan in the first half of 2003.

Net portfolio investment recorded an extraordinary deficit of 20 percent of GDP during the first half of 2003, as residents' portfolio investment abroad increased 160 percent compared with the same period in 2002. These portfolio outflows were largely offset by other investment inflows, and the financial account recorded a more moderate deficit of 5 percent of GDP in the first half of 2003. In the first half of 2003, the new Taiwan dollar appreciated slightly (0.3 percent) against the U.S. dollar and also depreciated 4.3 percent on a real trade weighted basis, as measured by the JP Morgan index. Reserves increased by $15 billion during the first half of 2003. Taiwan's $177 billion in reserves are equivalent to almost 10 times its short-term external debt and almost twice the country's total foreign liabilities.

Taiwan is in the process of liberalizing its capital account regime; this liberalization has already resulted in a significant increase of flows in the financial account. The increase in outward portfolio investment over the last 18 months has eased appreciation pressures and reserve accumulation.

Malaysia

After a strong rebound in 2002, Malaysia's economy slowed in the first half of 2003. Real GDP grew 3.0 percent in the first quarter and 6.1 percent in the second quarter. The current account surplus increased to 12.3 percent of GDP in the first half of 2002 from 7.2 percent a year earlier, reflecting slowing domestic demand growth. Malaysia's bilateral trade surplus with the United States increased to $6.6 billion in 2003H1 from $6.0 billion in 2002H1.

Malaysia has maintained a fixed peg to the dollar since September 1998, when it also imposed capital controls. Controls on capital flows have since been relaxed, but offshore trading of the ringgit remains prohibited and foreign portfolio investment by residents continues to be restricted. The ringgit depreciated 2.7 percent over the period on a real trade-weighted basis, according to the JP Morgan index. At the end of June, reserves stood at $36.8 billion, up from $34.2 billion at end-2002.

-end-