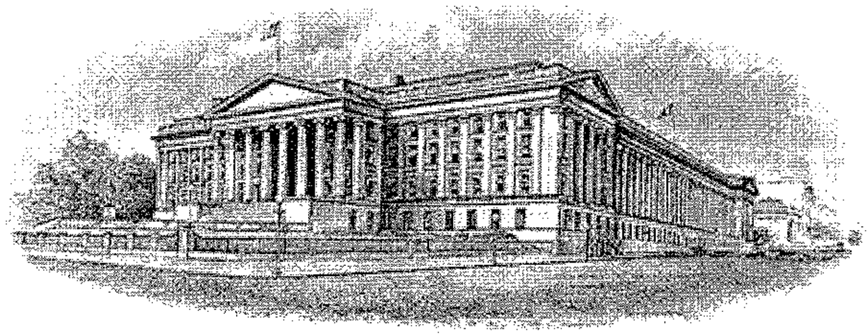

U.S. TREASURY DEPARTMENT OFFICE OF PUBLIC AFFAIRS

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TESTIMONY OF TREASURY DEPUTY ASSISTANT SECRETARY MARK SOBEL BEFORE THE COMMITTEE ON WAYS & MEANS, SUBCOMMITTEE ON TRADE HEARING ON LEGISLATION RELATED TO TRADE WITH CHINA

Washington, D.C.--Chairman Levin, Representative Herger, and members of the Sub-committee on Trade, thank you for the opportunity to appear before the subcommittee to speak to you on our views on legislation related to international currency issues.

The Congress is currently considering legislation to counter perceived unfair currency practices. While the bills are wide-ranging, many focus on the concept of "fundamental misalignment" against the background of very legitimate concerns over China's exchange rate management. Let me share with you our perspectives on these proposals and their implications for U.S. international monetary policy.

Engagement with China

Secretary Paulson is engaging China forcefully through the Strategic Economic Dialogue (SED). He frequently observes that, given China's economic size and importance, ensuring a productive U.S.-Chinese relationship is essential to managing the challenges of the 21st Century.

Last night, Secretary Paulson returned from a trip to China, where he saw President Hu and China's financial officials. He conveyed a strong message about the need for far more vigorous action by China to correct the undervaluation of the renminbi (RMB), take immediate action to lift the RMB's value, and achieve far greater currency flexibility.

Our discussions with China in the SED focus on the imperative for China to rebalance its economy away from exports and investment toward more consumption, to promote better balanced and more sustainable growth and to reduce the country's enormous and excessive external surpluses. A more effective monetary policy, made possible by greater currency flexibility, is also key. It would enable China to better control domestic inflation, dampen swings in the investment cycle, liberalize interest rates and improve credit allocation.

In contrast, heavy foreign exchange market intervention by China's central bank to manage the currency is leading to excess reserve accumulation and rapid increases in domestic liquidity. This heightens the risk of overheating, a build-up of non-performing loans leading to further banking sector stress, and asset bubbles. RMB undervaluation encourages production of exports at the expense of domestic consumption of goods and services. These trends increase the risk of a renewed boom-bust cycle, which would significantly harm first and foremost China, but also the world economy. Chinese currency adjustment is a matter of international responsibility, with significant implications for the smooth functioning of the international monetary and trading systems.

RMB appreciation also would to some extent reduce the U.S. bilateral trade deficit with China. But Chinese and U.S. global imbalances are rooted in the structures of our economies. That is why the SED process is focused not only on increasing currency flexibility but also more broadly on the overall rebalancing of the sources of growth of the Chinese economy.

While we are not satisfied with the pace of change in China, there has been important progress. China's currency is no longer fixed; it has appreciated by nearly 10 percent against the dollar in the last two years and the rate of appreciation has accelerated lately. China also is taking steps to reform its financial sector and to improve market access for U.S. and other foreign firms. Yet, there is still a long way to go.

We must continue to work hard for greater progress in our engagement. We appreciate the frustrations of Congress with the slow pace of Chinese reform. Indeed, we strongly share those frustrations. Yet, we continue to believe that direct, robust engagement with China is the best means of achieving progress. We do not believe that legislation would strengthen the United States' hand in achieving the goal, which the Administration and Congress share, of promoting faster Chinese economic reform. Indeed, we believe legislation would be counterproductive and could lead to unintended adverse consequences.

Multilateral Engagement

While strong bilateral engagement is a vital part of U.S. financial diplomacy, experience has taught us that multilateralism is essential to accomplish our objectives. Experience also teaches us that China responds defensively to bilateral pressure and is more open to multilateral engagement. Through multilateralism, the United States can win the high ground. But perceived unilateral actions would run the risk of weakening our effectiveness and fostering unwarranted perceptions that we are an isolationist nation.

That is precisely why we have worked through both diplomacy and multilateral fora to enhance global understanding of the adverse impact of China's currency practices and build a multilateral consensus to persuade China to alter its exchange rate regime. The G7 has repeatedly called for greater currency flexibility in China. The President of the European Central Bank recently reaffirmed this position. French President Sarkozy, soon after assuming office, spoke out about Chinese currency practices. Brazil's Finance Minister also recently made similar comments, as have many in Southeast Asia.

The United States has also worked hard to strengthen the IMF's focus on currency surveillance. Last month, the IMF – the only multilateral institution with a mandate for exchange rate surveillance – modernized its thirty-year old operational rules for carrying out this responsibility. Under the new Executive Board decision, the IMF will scrutinize much more closely countries' currency policies and their impact on the stability of the country and the world economy. This decision was adopted by an overwhelming consensus of the IMF's membership. Twenty-two of the twenty-four IMF Board chairs, accounting for 94 percent of the IMF's voting power, supported the decision. Only China and the Iranian-led chair opposed.

Critically, the new decision sends a strong and welcome message that the IMF is putting exchange rate surveillance back at the core of its duties.

U.S. Economy

The performance of the global economy in recent years has been the strongest in three decades. Much of this owes to the soundness of our economy. But China's unparalleled growth has also been a hugely positive factor. The United States and China together account for over 40 percent of global growth over the past five years.

The global economic landscape is changing rapidly. Technological innovation, trade and globalization are potent drivers of change. The United States benefits enormously from openness. Change, however, creates uncomfortable dislocations and angst, and we have sympathy for American workers affected by these powerful forces. China has become the face on the poster of rapid global economic change, and the RMB its symbol. China needs to play by the rules of the game. But neither RMB appreciation nor currency legislation will alter the underlying forces of globalization and technological change.

If the United States adopts currency legislation that is perceived abroad as unilateralist, investors' confidence in the openness of our economy could be dampened, diminishing capital inflows into the United States, and potentially putting upward pressure on interest rates and prices. Further, if we adopt legislation targeted at one country, we must be mindful of the risk that we will create a retaliatory precedent that others might use, including against the United States. This could have serious adverse effects for the smooth functioning of the international monetary system.

Currency Misalignment

Many of the proposals under consideration mandate determination of whether currencies are in "fundamental misalignment" as a basis for remedial measures. Fundamental misalignment is a useful concept. Indeed, the IMF included "fundamental misalignment" as a foundation of its new currency surveillance decision, stressing that it must be thoroughly analyzed and reviewed in IMF surveillance work.

In assessing currency misalignment, economists typically rely on models first to compute "real equilibrium exchange rates" and then to compute misalignment -- or the over- or under-valuation -- as deviations from these computed real equilibrium exchange rates. There are many approaches to these calculations – some rely on a "macroeconomic balance" approach, others on "behavioral equilibrium exchange rate models", and others simply on "purchasing power parity" calculations, to name a few.

The models make various assumptions. Among others, should a sustainable external position mean a country has a balanced trade account, or is a deficit of a given size consistent with external sustainability? What is the underlying saving and investment balance in a country? Should one assume trading partners are growing at potential, and if so, what is that potential? How do trade balances respond to exchange rate changes? What price index should be used in deflating nominal prices? What is the proper goods basket for measuring purchasing power? What are the key variables influencing the behavior of exchange rates and their proper weights?

Depending on the answers to these questions, a wide range of results is yielded. One study on China, collating academic research, found an extremely large range of estimates, from as little as zero to as much as 50 percent undervaluation of the renminbi. The GAO echoed this finding in an April 2005 report.

It is difficult for models to describe fully and accurately all the features of a modern economy relevant to exchange rate determination. In particular, most models do not take into account the world's enormous private financial markets and their impact on currency valuations. Yet, the volume of global foreign exchange transactions in one week exceeds all trade transactions that take place over an entire year. Currencies can be substantially "under-valued" as defined by a model, yet this undervaluation may result from purely market phenomena. This is especially the case for Japan and Switzerland, countries with floating currencies integrated into the global financial system, yet experiencing large capital outflows in view of very low domestic interest rates. Failure to take financial market effects into account could result in currencies whose exchange rates are wholly market determined being assessed as fundamentally misaligned.

Most approaches focus on **multilateral** real exchange rates – or indexes of a country's currency valuation against its trading partners adjusted for relative price differences and trade shares of each partner. Economists view **bilateral** equilibrium exchange rates as a less robust concept. Practically speaking, computing a bilateral equilibrium exchange rate implies that one knows the appropriate amounts of bilateral trade, investment, and other financial activity with another country. To be sure, many financial institutions compute such bilateral rates, but they are interested in assessing the direction in which a currency may move for the purpose of maximizing trading profits.

Equilibrium exchange rate analysis is a worthwhile undertaking. If many multilateral exchange rate models yield similar directional conclusions and project a broadly similar range of misalignment, that is valuable information. But while exchange rate models yield valuable insights, there is no reliable or precise method for estimating the proper value of an economy's foreign exchange rate or measuring accurately a currency's undervaluation. As Sam Cross, one of the distinguished architects of U.S. post-Bretton Woods financial diplomacy put it: "Most of the approaches to exchange rate determination tell only part of the story – like the several blindfolded men touching different parts of the elephant's body."

Using the concept of fundamental misalignment to drive a bilateral exchange rate calculation for the purpose of imposing trade penalties goes well beyond the IMF approach to fundamental misalignment. On matters pertaining to the WTO, the Treasury defers to colleagues at USTR and Commerce. But using currency calculations that admittedly lack precision and reliability to determine trade remedies, which appear to raise serious concerns with respect to U.S. compliance with WTO rules, underscores the weakness of some of the legislative approaches.

Other Issues

Some of the bills include provisions requiring the Treasury to oppose any change in International Financial Institution governance arrangements if a country with a currency designated for action were to receive a higher voting share. Such provisions are detrimental to U.S. interests. The IMF's current voting structure is out of touch with today's global economy and the growing weight of many emerging market economies. IMF members are currently discussing governance reforms aimed at shifting voting power from over-represented countries to under-represented, dynamic emerging market economies. The United States has led this modernization process, seeking to keep emerging market economies from drifting away from the multilateral system from which we strongly benefit.

Such legislative provisions could prevent many emerging markets from increasing their weight in the IMF, presumably in order to keep China from seeing an increase in its share. Yet even if China's voting share will rise as a result of governance reform, given the current state of discussions, it will likely still be at a level far less than China's true weight in the world economy. China already has its own Board seat in the IMF. On balance, this provision would likely be ineffective in influencing Chinese behavior, but harm U.S. relations with many fast-growing emerging market countries around the world and thwart highly necessary modernization of the IMF.

Proposals to consider "remedial intervention" in the foreign exchange markets as a counter-weight to currency misalignment are ill-advised. It would be enormously difficult to intervene in a currency that is not traded internationally, as in the case of the RMB, which is traded only in China. Even if we could intervene in the Chinese market by buying RMB, China at the same time might be in its own market selling RMB. In the final analysis, the proposal could detract from our efforts to work with China to correct the RMB's undervaluation, immediately raise the RMB's value and achieve far greater flexibility in the currency regime.

Thank you.

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