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UNITED STATES - CHINA ECONOMIC RELATIONS

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CONTENTS

OPENING STATEMENTS

	Page
Grassley, Hon. Charles E., a U.S. Senator from Iowa, chairman, Committee on Finance	1
Baucus, Hon. Max, a U.S. Senator from Montana	3

CONGRESSIONAL WITNESSES

Collins, Hon. Susan M., a U.S. Senator from Maine	6
Bayh, Hon. Evan, a U.S. Senator from Indiana	8
Graham, Hon. Lindsey O., a U.S. Senator from South Carolina	11
Stabenow, Hon. Debbie A., a U.S. Senator from Michigan	13

ADMINISTRATION WITNESSES

Greenspan, Hon. Alan, Chairman, Board of Governors, The Federal Reserve Board, Washington, DC	15
Snow, Hon. John W., Secretary, U.S. Department of the Treasury, Washington, DC	17

PUBLIC WITNESSES

Rogoff, Dr. Kenneth, Thomas B. Cabot Professor of Public Policy, Department of Economics, Harvard University, Cambridge, MA	38
Bredehoeft, Neal, president, American Soybean Association, Alma, MO	40
Maloney, Sean, executive vice president, Intel Corporation, Santa Clara, CA, on behalf of the U.S. Chamber of Commerce	42
Lubrano, Al, president, Technical Materials, Incorporated, Lincoln, RI, on behalf of the National Association of Manufacturers	44

ALPHABETICAL LISTING AND APPENDIX MATERIAL

Baucus, Hon. Max:	
Opening statement	3
Bayh, Hon. Evan:	
Testimony	8
Bredehoeft, Neal:	
Testimony	40
Prepared statement	53
Bunning, Hon. Jim:	
Prepared statement	56
Collins, Hon. Susan M.:	
Testimony	6
Crapo, Hon. Mike:	
Prepared statement	57
Graham, Hon. Lindsey O.:	
Testimony	11
Grassley, Hon. Charles E.:	
Opening statement	1
Prepared statement	58
Greenspan, Hon. Alan:	
Testimony	15
Prepared statement	62
Responses to questions from Senators Baucus and Kyl	65

Page

Lubrano, Al:
Testimony 44
Prepared statement 70
Maloney, Sean:
Testimony 42
Prepared statement 93
Statement of the U.S. Chamber of Commerce 102
Statements of the Semiconductor Industry Association 120
Rogoff, Dr. Kenneth:
Testimony 38
Prepared statement 137
Santorum, Hon. Rick:
Prepared statement 140
Snow, Hon. John W.:
Testimony 17
Prepared statement 142
Responses to questions from Senators Baucus and Kyl 146
Snowe, Hon. Olympia J.:
Prepared statement 150
Stabenow, Hon. Debbie A.:
Testimony 13
Prepared statement 155

COMMUNICATIONS

Advanced Medical Technology Association (AdvaMed) 161
American Apparel and Footwear Association 166
American Forest and Paper Association 170
American Iron and Steel Institute 177
Masch, Dr. Vladimir A., and Professor Mark Perlman 187
National Retail Federation 197
Stewart, Terence P., Esq., Stewart and Stewart 206
The U.S.-China Business Council 215

UNITED STATES - CHINA ECONOMIC RELATIONS

THURSDAY, JUNE 23, 2005

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:15 a.m., in room G–50, Dirksen Senate Office Building, Hon. Charles E. Grassley (chairman of the committee) presiding.

Present: Senators Kyl, Thomas, Smith, Bunning, Baucus, Kerry, Wyden, and Schumer.

OPENING STATEMENT OF HON. CHARLES E. GRASSLEY, A U.S. SENATOR FROM IOWA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. As you probably know, we had a vote just now. So while we are waiting for members to come, particularly the Senators that are going to testify, Senator Baucus and I will give our opening statements.

Our hearing will explore economic relations between the United States and China. I would like to offer some comments on that relationship.

The fact that we are holding this hearing demonstrates the importance of our trade with China. Ninety-five percent of the people of the world live outside the United States.

The United States is an exporting economy. If we want to prosper, we market to the 95 percent of the people outside the United States, and 20 percent of that 95 percent happens to be Chinese.

The way we approach this developing relationship with China has vast implications for both nations. We must be thoughtful in our actions and get it right. We cannot afford to act rashly and get it wrong.

There are a number of policy prescriptions floating around: some say that China's currency is a problem, so we need to slap 27 percent duties on Chinese imports; some say Chinese subsidies are a problem, so we have to apply our countervailing duty laws to China; some say we should call for more cases to be brought against China in the World Trade Organization. And those are just a few of the ideas floated.

Maybe those folks are right. But before I rush to any conclusions, I think we need to take stock of the problems that exist and the efforts of the administration, and others, to address those problems, and then consider whether additional legislation is appropriate.

This hearing is such a step. Today, Senator Baucus and I are taking another step by requesting that Ambassador Portman appear before the committee after he completes his top-to-bottom review of the administration's trade policy towards China.

The fact is, we have had some important successes in securing China's compliance with its trade obligations. I want to further those efforts, not undermine them. Therefore, I intend to wait to hear from Ambassador Portman before I consider supporting new legislation.

The administration has a responsibility to keep this committee informed about developments in its Chinese trade policy, but we also have a responsibility to ensure that the U.S. Trade Representative has the resources it needs to effectively administer that policy.

Earlier this year, I joined some of my colleagues in trying to get an additional $2-million appropriation to fund 16 new positions at the Trade Representative's office, and to cover unplanned security costs, but I was stymied in that effort. I hope my colleagues will join me to see that those funds are appropriated by the end of the year.

I supported China's World Trade Organization accession because that offered the dual benefits of opening China's market to U.S. exports, and also committing China to respect the rule of law in our international trade relations.

We have reached some benefits, to some extent, from that accession. Exports from my home State of Iowa have almost tripled between the years 2000 and 2004. Pennsylvania and New York saw their exports to China more than double during the same period, and exports from Tennessee to China increased 7-fold.

We cannot be complacent. China's words must be matched by actions that demonstrate full adherence to its obligations. The fact is, China's compliance record has been very spotty. I have been vigilant in monitoring our trade relations with China.

I fought to ensure that Iowa's exporters enjoyed the market access they expected from Chinese accession to the WTO. That is the bottom line, and I will remain vigilant, demanding no less from the Chinese.

I will not stop until our exporters in Iowa and across the United States enjoy the access to China's market that they were promised and, once in the Chinese market, that they enjoy the legal protections that our international agreements require.

Now, today's hearing is primarily meant to explore the macroeconomics of our trade relations with China. The committee will hear from some distinguished witnesses, and their testimony will help inform the development of appropriate policy to improve our trade relations, particularly as this committee is involved with that.

Right now, the United States and China are the engines of global economic growth. We need to ensure that growth occurs in a positive, sustainable manner.

This brings me to our bilateral trade deficit with China. Some argue that our bilateral trade deficit means jobs are migrating from the United States to China. However, the primary factor driving the increase in U.S. imports of goods from China is that manu-

facturers have shifted final assembly of many of their products from other countries in Asia to China. It seems to me that this changing pattern of trade has broad policy implications.

A policy designed to reduce our trade deficits with China could simply have the effect of redistributing a portion of that deficit to other countries in Asia, and that would not reduce any potential instability associated with our overall trade deficit, nor would it help retain and grow jobs here in our country. I want to hear the views of our witnesses on that point.

Another issue to explore is China's fixed exchange rate. I believe a flexible, market-based valuation of China's currency is necessary for China's long-term economic growth, and it is important for America's growth as well. I have stressed that to the Chinese and to our administration.

Without a floating exchange rate policy, China runs the risk of impeding its economic competitiveness and fostering inefficient economic decision making. That could make an eventual currency adjustment that much more painful for China and for China's trading partners.

Finally, this hearing is also intended to provide Senator Collins, Senator Bayh, and other Senators the opportunity to discuss a bill they are co-sponsoring that would extend our countervailing duty laws to non-market economies such as China.

I am still not persuaded of the need for this legislation. Just this week, the Government Accountability Office released a report that raises legal and administrative concerns that need to be addressed if this concept is to be developed legislatively. At a minimum, I would need to feel certain that those concerns are allayed before I consider supporting such legislation.

Senator Baucus?

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA

Senator BAUCUS. Thank you, Mr. Chairman. Thank you for calling this hearing.

It is difficult to overstate the importance of our economic relationship with China. China has been an economic power for 5,000 years. From ancient times, merchants traveled the Silk Road carrying grapes, cotton, and pomegranates from Europe to trade for silk from China. Marco Polo took that road and wrote of a China whose economy dwarfed that of Europe. China literally invented paper money, making modern economies possible.

China has become a main driver of the world economy again. The last century of economic isolation and turmoil, a century of foreign occupation, civil war, the disastrous great leap forward in the Cultural Revolution, now seems to have been a relatively short blip in China's long history.

Some in the United States fear China and seek to close off U.S.-China trade in response. Others see opportunity in China and advocate increasing U.S.-China trade at almost any cost.

I have long believed that we should engage China, engage with our eyes wide open. That is why I led the charge to grant China permanent normal trade relations. It is why I strongly supported Chinese accession to the World Trade Organization. It is why I con-

tinue to support an active and robust economic relationship with China.

Engagement with China has largely been a success. Between 1999 and 2004, a short, 5-year period, the United States' exports to China increased nearly 10 times faster than U.S. exports to the rest of the world.

Montana's exports to China were 15 times greater at the end of that period than they were at the beginning. That is good news. But a rising China poses a competitive challenge. Chinese companies are becoming world players.

Just yesterday, a Chinese state-owned oil company, CNOOC, launched an unsolicited bid to acquire Unocal. CNOOC is challenging Chevron's control for Unocal, a 115-year-old California-based oil and gas company. China is here and now.

China's competitive challenge makes Americans nervous. From Wall Street to Main Street, Americans are nervous about China's effect on the American economy, on American jobs, on the American way of life.

Yet, in the face of this challenge, the administration, it seems to me, has no plan. They have no plan to make sure that China plays by the rules. They have no plan to deal with countries that play around with currency values.

They have no plan to address our gaping trade deficit, and they have no plan to maintain America's role as the most competitive economy on earth. Is it any wonder why America's mood on trade and globalization has soured?

Since the administration has not offered solutions—real solutions, not just words—on how to deal with the rising China, let me give you some of mine.

First, we have to make sure that China lives up to its trade commitments. That should be at the heart of our trade policy. There are many enforcement problems in China. Piracy rates for intellectual property, like movies and software, top 90 percent. That translates into an estimated loss of between $2.5 billion to almost $4 billion to U.S. innovators.

Agricultural trade continues to face opaque and discriminatory barriers that keep out quality products from States like Montana and Iowa.

So, is the administration using all of its resources to tackle these problems? No. It is too busy negotiating economically meaningless free trade agreements with tiny economies.

We need to refocus USTR on enforcement. To do so, I intend to introduce a bill that will create a new trade prosecutor at the USTR. This bill will also give Congress a far greater role in shaping the USTR's trade enforcement priorities with China and other countries.

Second, we must reduce our huge trade and current account deficits. Our 2004 current account deficit was $665 billion, 6.4 percent of our economy, if you can imagine. We are on track to post a $780 billion current account deficit this year.

Why is this important? A current account deficit means that we spend more than we earn. It is that simple: we are spending more than we are earning. Because our deficit is so big, we have to bor-

row $2.1 billion a day—$2.1 billion a day—to cover our shortfall. Until we act, that number just keeps growing.

What is the administration's plan? Again, they have none. They call borrowing $2.1 billion a day a sign of strength. Well, strength is not the first word that comes to my mind. Our current account deficit is a problem, and we must address it.

China is part of the problem. It keeps its currency, the RMB, pegged to the dollar. Their undervalued RMB keeps China's exports cheap, and as a consequence, exacerbates our current account deficit.

An undervalued RMB is bad for our economy and bad for the world economy, but I believe focusing so heavily only on Chinese currency revaluation is a mistake. Revaluation by China alone will not make our trade or current account deficit vanish.

Japan, Korea, and other Asian countries also depress the value of their currencies, and there are deeper domestic problems that fuel our current account deficit than currency valuations.

So what do we do? First, we should get our trading partners to the table to forge a solution that gets China, as well as Japan, Korea, and other Asian countries, to end currency interventions.

Those are big countries now. They have to exercise responsibility. A large, diversified economy like China should not be playing games with currency values. We also need to help foster growth in the sluggish economies of Europe and Japan.

Second, we have to recognize that our economic problems do begin at home. Our problems are not simply that Europe grows too little or that Asians save too much, as the administration likes to claim. In truth, our economy has become less able to handle the challenge posed by rising China. We need to get our national house in order, and we need to do so now.

It is time to stop talking about reducing our trade deficit. We need to take steps to do so now. I am tired of just talking about how we are losing our competitive edge. We need to take steps now to improve basic education, train more scientists and engineers, increase research, and reign in health care costs.

There is not a CEO I meet who does not say that rising health care costs are a top concern. I would be surprised if that is not true of every member of this committee. What is the administration's plan? Again, they have none.

These are things that America must do to confront the challenge of a rising China. These are things that America must do for its own safety. We should continue to deepen our trade relationship with a growing and more competitive China, clearly. We should ensure that China plays by the rules. We should also ensure that America's economy and America's workers are the best that they can be.

I look forward to hearing from the witnesses on these very important issues.

The CHAIRMAN. Thank you very much, Senator Baucus.

We will hear now from Senator Collins, then Senator Bayh, then Senator Graham, then Senator Stabenow. It is my understanding that Senator Graham will go, and come back before this panel completes. Is that right?

Senator GRAHAM. Yes, sir.

The CHAIRMAN. All right.

I would ask my colleagues not to ask questions of our colleagues, because Chairman Greenspan is on a tight time constraint, and we want opportunities to explore in depth with Chairman Greenspan and Secretary Snow before they go.

Senator Collins?

STATEMENT OF HON. SUSAN M. COLLINS, A U.S. SENATOR FROM MAINE

Senator COLLINS. Thank you, Mr. Chairman.

Mr. Chairman, Senator Baucus, members of the committee, I very much appreciate having the opportunity to appear before you today.

All too often, trade issues in this country are seen through the prism of dying industries struggling for survival in an economy that has passed them by. I do not see these issues that way. I strongly believe that American manufacturers can flourish in the global market.

Why, then, do so many very efficient U.S. industries hemorrhage jobs in the face of global competition? The answer, in my judgment, is that they are competing with countries that use illegal and unfair trade practices to get a leg up on their competition. In short, these countries cheat in order to win at the expense of U.S. manufacturers that play by the rules.

No State, Mr. Chairman, understands this more than my home State of Maine. According to a 2003 study by the National Association of Manufacturers, on a percentage basis, Maine has lost more manufacturing jobs in the previous 3 years than any other State in the Nation.

I hear from manufacturers time and again whose efforts to compete successfully in the global economy simply cannot overcome the practices of illegal pricing and subsidies of nations such as China.

Over the past 2 decades, there have been some significant economic changes in China. Beginning in the early 1980s and continuing today, China has undertaken major economic reforms by joining the World Trade Organization and by working towards the establishment of a modern commercial, financial, legal, and regulatory infrastructure.

The problem is not with China's economic liberalization and modernization. Indeed, China holds the promise of offering American businesses significant investment opportunities and a potentially profitable export market.

The problem is this: now that China is a key international economic player, the country has repeatedly refused to comply with standard international trading rules and practices.

China seems not to recognize that the principles of fair trade must apply to both sides of the trading relationship. Consider, for example, that China is currently facing more than twice as many American antidumping investigations than any other country, with tariffs imposed in 17 different cases.

One industry important to my State, the residential furniture industry, has experienced the devastating losses of jobs due to surges of unfairly priced furniture imports from China.

According to the U.S. Bureau of Labor, 28 percent of the workforce has been lost in the American furniture industry since 2000. One furniture manufacturer in Maine, Moosehead Manufacturing, has been forced to eliminate a quarter of its employees due to unfair market conditions.

Unfairly priced and subsidized imports from China are a leading cause for these job losses. China's bedroom furniture exports to the United States, which amounted to just $169 million in 1999, reached an estimated $1.2 billion in 2003.

There are a great many trade issues over which the United States simply must be more assertive in dealing with China. I have focused on one particular problem with my colleague, Senator Bayh. That is China's use of illegal subsidies.

China uses illegal subsidies to provide advantages to many of its exporting industries. It has been known to provide preferential access to loans, for example. A news report last year by the Chinese government news agency states that the Chinese government plans to boost the forest product industry's production by "encouraging investment of $24 billion in the industry over the next 10 years."

Last year, former U.S. Trade Representative Bob Zoellick filed a complaint with the WTO, alleging discriminatory tax policies from China that are disadvantaging our semiconductor industry.

Along with my colleagues Senator Bayh and Senator Grassley, who are here this morning, I have introduced a bill, S. 593, also known as the Stopping Overseas Subsidies Act.

It would revise the current trade remedy laws to ensure that U.S. countervailing duty laws apply to imports from non-market economies such as China, although I would argue that China increasingly has elements of a market economy.

Our Nation's trade remedy laws are intended to give American industries and their employees relief from the effects of illegal trade practices. Under current Commerce Department practice, however, American industries competing with these unfairly advantaged foreign producers can file an anti-subsidy petition against any market economy, such as Canada or Chile, but not against what is considered to be a non-market economy, such as China.

As a result, those countries such as China that subsidize their industries the most heavily and cause the most injury to American companies and workers are exempt from the reach of American anti-subsidy laws. Illegal subsidies distort fair competition, regardless of the economic system in which they are used.

The Collins-Bayh legislation gives U.S. industries the tools to ensure that no country gets a free pass on trade enforcement. Our legislation is a bicameral, bipartisan bill that has a broad range of support. The Senate bill currently has 26 co-sponsors, and is backed by more than 20 organizations and a number of private companies and labor groups.

Of particulate note, the National Association of Manufacturers has listed this bill as one of its top trade agenda items. In addition, the United States Economic and Security Review Commission, a bipartisan organization established by Congress in 2000 to provide recommendations to Congress on the relationship between the United States and China, has formally recommended that Congress

urge the Department of Commerce to make countervailing duty laws applicable to non-market economies.

Mr. Chairman, countries such as China want to have all the benefits of engaging in international trade. They cannot continue to be allowed to cheat on a system with no penalties. It is time that these countries were held to the same standards as other countries around the world.

Thank you, Mr. Chairman, for the opportunity to testify.

I would ask the Chairman and my prime co-sponsor to excuse me, because Secretary Rumsfeld is testifying before the Armed Services Committee. So, if I could be excused, Mr. Chairman.

The CHAIRMAN. You are excused.

Senator COLLINS. Thank you.

The CHAIRMAN. Now, Senator Bayh?

STATEMENT OF HON. EVAN BAYH,
A U.S. SENATOR FROM INDIANA

Senator BAYH. Thank you very much, Mr. Chairman. I want to express my appreciation to you, to Senator Baucus, and the other members of the panel for convening this hearing today.

Our relations with China are profoundly important. Our success in dealing with these relations will go a long way towards shaping the next generation and the future of America.

We want good relations with China, but the issue we are seeming to address today is, what do we do when the Chinese themselves engage in conduct that undermines the process of achieving those good relations, because it is contrary not only to the internationally accepted norms of economic behavior, but to the interests of our country, workers, and businesses in our country?

That is the issue that we address today. As I said, it is profoundly important, and I thank you and other members of the committee for enabling us to air our opinions on this today.

I also wanted to express my appreciation to Senator Collins. Without her leadership and determination, we might not be here today. As you can see, she is an eloquent advocate for these issues, and I am very grateful for our partnership that we have established together.

The issue that we address today, our economic relations with China, is a subset of a broader topic, the topic of globalization. What do we do about it? How do we benefit from it? What do we do when it is not working as it should, for the interests of not only our country, but the global order?

I suggest we must do three things. First, we need a strategy for success. As the economists might say, what is our comparative advantage? What do we need to do in terms of research and development to create new products and services? What do we need to do in terms of education to enable every American to succeed in the new, emerging global economy?

What are the investments that we must make in infrastructure to improve the productivity of our economy? What do we need to do in terms of being more innovative, creative, to be constantly on the cutting edge of growing our economy in a much more competitive environment?

I think Senator Baucus was exactly right: we need to first get our own house in order, have a strategy for success in a globalized world. That, by far and away, is the most important challenge facing America today. That is a subset of what we are talking about here and is perhaps a topic for another occasion, but it is vitally, vitally important.

Second, what do we do when there are dislocations within our country? Many Americans will be winners in the new global marketplace, but some, through no fault of their own, will be dislocated. We owe it to them—we have an obligation—not to say, well, you are on the scrap heap of history, and too bad for you.

We have to create a system where people can work hard, think smart, and get back on the ladder of success. We are not being nearly aggressive enough in doing that today for people who feel the adverse consequences of globalization through no fault of their own.

Finally, the subject that Senator Collins was addressing and that both of us together, with many members of this panel have sought to address, along with Senator Stabenow, what do we do when cheating takes place?

What do we do when American businesses and workers embrace free and open competition, but we have trading partners who do not, who seek an artificial advantage? What do we do? The answer must be something other than nothing.

But as Senator Baucus so rightly pointed out, all too often, nothing has been the response that they have received from our government. They have a right to expect something more from us than that, and that is the issue that I would like to address, very briefly, today.

The reason I support the Stopping Overseas Subsidies Act and agree with what Senator Collins was saying? There are three principal reasons. First, is the issue of fairness.

It is simply not right, Mr. Chairman, when American businesses and workers are willing to do their part to think smart, to work hard, to make the investments, to play by the rules of the game to succeed. It is not right when they do those things.

The fruits of those labors, of that ingenuity, of those investments, are taken away from them, not because others are smarter, or work harder, or have more ingenuity than do they, but because of artificial reasons, because of cheating. That is simply not right.

We face the situation a lot like Batesville Tool and Dye in Ripley County in my State, where the products sold by their competitor in our marketplace here in our country are sold for one-half of a penny—one-half of a penny—beyond the cost of just the raw materials, leaving nothing for labor, nothing for transportation, nothing for marketing, nothing for electricity, nothing for rent. This simply is not possible.

I know there are companies in Iowa, Montana, and elsewhere who face a similar situation. But do not take my word for it. Do not take Senator Collins' word for it, or Senator Stabenow's. Talk to the businessmen and women who are out there in the marketplace every day facing this kind of unfair competition. Something must be done, and I hope that something is what we are going to address here today.

Senators Collins, Stabenow, and I have our own suggestions. I think that they are worthy. If there are changes and improvements that can be made, then we should do that, but something must be done. Talk to your businessmen and women. Do not just take our word for it.

The second thing is, it is in our economic and financial interest to enforce the rules and to deal with artificial situations such as currency manipulation and unfair subsidies.

Senator Baucus touched upon this in his opening statement. These current account imbalances are not sustainable. He mentioned the current account imbalance for last year. The current account imbalance for this year will be much, much larger. I believe, for the first quarter, it was about $195 billion, suggesting that we are on our way to about an $800 billion current account imbalance this year alone.

This inevitably—inevitably—will lead to lower currency values, higher interest rates, lower investment and productivity because of that, and a lower standard of living for the American people. That is what is at stake here today. That is what is at stake.

We need to address this in a way that is responsible, otherwise we run an increasing risk of a severe readjustment which could lead to profound adverse consequences for the American economy, the global economy, and our financial situation. We must be prudent and act before that day arrives, and that is why we are here today as well.

Finally, Mr. Chairman, I must say that the American people's support for global trade and a rules-based system is very much at stake here. I speak as someone who has voted for trade agreements, even though they are not always popular. I have supported them.

I believe a majority of the American people understand, as you said and Senator Baucus said, that it is in our interest to trade, to compete, to have open borders for that kind of activity. We benefit, in the aggregate, from that.

But, Mr. Chairman, subsidies are against the rules. Currency manipulation is against the rules. When we do not enforce the rules, when we do not act to do what is already considered to be fair and just under the current system, we undermine the credibility of the system itself.

We undermine the American people's support for trade, for a rule-based system, and you get all sorts of non-helpful behavior. If someone asks why there was not as much support for CAFTA as for previous agreements, therein lies the answer.

If we are not going to enforce the rules, if we are not going to stand for what is right under the current system, then how can we expect the American people to support further agreements? We undermine our credibility. That is at stake here today as well.

Two final things, Mr. Chairman. I noticed today as I was getting dressed, I like to turn on some of the news channels. As a matter of fact, I saw the Chairman. You were very eloquent.

The CHAIRMAN. You dress late in the morning. [Laughter.]

Senator BAYH. Well, you were very eloquent. And I noticed that one of the economists was asking, after you were off the panel—or perhaps it was before—and he said, "How do we address protec-

tionism?" This is the topic before the panel today. How do we address protectionism?

I must say, Mr. Chairman, I am not for protectionism. I found it to be a little Orwellian that, when we stand against cheating, somehow or other it is portrayed as being for cheating.

When we stand for enforcing the rules, it is somehow or other portrayed as seeking an unfair competitive advantage. When we stand against artificial manipulation in mercantile policy, it is somehow warped into saying that we stand for that.

When we stand, Mr. Chairman, for free and open markets, for having marketplaces determine currency values, for standing against artificial subsidies, for letting the hard work, the ingenuity, the creativity of workers here and everywhere else determine who the winners and losers are, when we stand for that, it is portrayed as protectionism. Mr. Chairman, only in Washington, DC could it be interpreted as that. It is not.

So the final thing I would say is this. All over my State today, men and women got up to go to work, businessmen and women, working men and women. It happened in Maine, it happened in South Carolina and Michigan, it happened in Iowa and Montana, and the other States of our country.

And before they got out of bed and got dressed to go to work, many of them started off 20, 25 percent, 30 percent behind the competitive game, not because they are not as smart, not because they are not as hard-working, not because they are not as creative or innovative, but simply because of illegal subsidies and illegal manipulation. It is not right. They have a right to expect more from us than that.

I believe that is why we have gathered here today. We must act to correct the situation. I want to thank you, the Ranking Member, and the other members of this panel for enabling us to do just that. Thank you, Mr. Chairman.

The CHAIRMAN. We cannot give each of the Senators 10 minutes, so would you stay to your 5 minutes, please, the remaining two? I would ask Senator Schumer maybe not to give his opening statement that he has to give, because I want to get Chairman Greenspan up here.

Senator Graham?

STATEMENT OF HON. LINDSEY O. GRAHAM, A U.S. SENATOR FROM SOUTH CAROLINA

Senator GRAHAM. Thank you. I promise you, I will stay within 5 minutes.

Thanks for having the hearing. I can understand why you want to hear from Chairman Greenspan.

I am here, Mr. Chairman, about the currency issue. I mean, you know where I am at. Senator Schumer and I have introduced legislation a couple of years ago to put tariffs on Chinese products, unless they float their currency. The valuation is 15 to 40 percent in terms of how below-market the Chinese currency is. I know the tariff solution is a difficult choice. It is tough. We all admit that.

Senator Bunning has been a co-sponsor. I would like to associate myself with Senator Bayh's comments about, fighting back is not protectionism. But right now, the American economy needs some

protection against unfair trade practices, and that is what we are all trying to provide.

But as to the substance of currency manipulation, President Bush: "There have been some indications that the Chinese government is thinking about an interim step toward floating the currency. We are constantly urging them, if they are going to take that step, to take it as soon as possible and eventually get to a currency which floats. Obviously, we are at a competitive disadvantage to the extent that their currency will not float." I agree with the President.

Secretary Snow: "We feel there is a lot of mischief associated with China's fixed rate system. It is a way to get your currency out of alignment with underlying realities, and thus confer an unfair advantage on your own manufacturers and producers, to the detriment of American manufacturers and producers. The way to deal with that is to let the currency reflect those underlying market forces so nobody can be manipulating the currency." —October 26, 2004.

The China Commission, U.S.-China Economic Security Review Commission chartered by the Congress in a bipartisan fashion, has recommended that the Chinese revalue their currency up to 25 percent because it is out of line with its true value, creating problems for the world, particularly the United States.

I have a list of international organizations. The IMF: "It is in the interest of the Chinese people and the advantage of the Chinese economy to move towards a more flexible exchange rate system. For China, this is a good moment to make that move. If policies do not adapt, do not change to react to these imbalances, we run the risk of an abrupt correction of the markets when confidence, for different reasons, could evaporate or could be reduced. There is a need for Asian countries to be more flexible in their exchange rates."

There are a lot of people who see it this way, that their currency is unfairly valued, the President being at the top of my list. The question is, what are we going to do about it?

I am very open-minded to the idea of working with the Chinese to get their currency in a situation that is fair to their economy and fair to the world. It will create some relief to American manufacturers who have suffered because of the artificial low value of their currency.

We have a bill scheduled for a vote. I think it is very important to note to this committee, and really to the world, that 67 Senators chose to not table our bill. That, to me, is a sea change. I have been here 11 years talking about China, and I was surprised.

They asked Senator Schumer and myself what we wanted, and we said we did not think we would get 67 votes. We do not have a 67-vote strategy. There is something going on here in this Senate that is a fundamental sea change.

I would like to take that "something" and be constructive with it. I would like to engage with the Chinese government to come up with a constructive solution to a variety of problems, because, Mr. Chairman, it is in their best interests and our best interests to do business on a level playing field.

China does not go away, never will, do not expect it to. I do not want to build a wall around my country, but I do believe the Senate has an opportunity, working with the administration, to get movement across the board that would be good for better relations between the United States and China, and one place to start was currency reevaluation in a business-like way. No more saber-rattling. We want results. We are willing to work, but we are not going to ignore the problem.

I appreciate the time you have given me to talk about this matter, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Graham.

Now, Senator Stabenow?

STATEMENT OF HON. DEBBIE A. STABENOW, A U.S. SENATOR FROM MICHIGAN

Senator STABENOW. Thank you, Mr. Chairman. I appreciate your patience and willingness to hear from us all today on this very important topic.

I want to congratulate my colleagues here on the panel, Senators Collins, Bayh and Graham, as well as Senator Schumer. I appreciate the opportunity to work with all of them on this very important issue. I know that, from colleagues speaking who are on this panel who are on the Banking Committee, this same issue has been raised.

I appreciate, also, working with you, Mr. Chairman, on the Agriculture Committee, where we have worked for fair practices and a level playing field.

I cannot think, Mr. Chairman, beyond the issue of health care, of a more ominous issue for my State of Michigan, and so many of our States and our economies, than this whole question of illegal trading practices, particularly with China.

In Michigan, we are experts at a lot of things. We make things and we grow things, and we do it very well, whether it is cars, office furniture, apples or cherries, we lead the way in innovation and efficiency. These jobs are the lifeblood of our communities.

Even today, Michigan forges ahead as the forerunner of micro and nanotechnology development. But, on the other hand, we have one of the highest unemployment rates in the United States right now. Unfortunately, Michigan has added 9,600 people to our unemployment rolls, as there have been jobs added across the country.

Our current economy is moving through a great period of uncertainty, and it would be easy to say that this is just a bad business cycle, a business cycle that will eventually correct itself.

But, unfortunately, I believe that overlooks what is fundamentally happening, as we are now in a global economy and having to address the issues of the rules and how we are going to relate and do business with other countries around the world.

That threat, the lack of a level playing field for American businesses and workers in the global economy, is very, very real, and it is critical that we all address this together.

For example, China currently exports to the United States some $160 billion more than it takes in. Five products come here for every one product that goes to China.

A significant portion of this deficit is driven by consumer demand here, we know that. But a shockingly large portion of it is due to illegal trade practices, namely currency manipulation, and the theft of intellectual property.

Since 1995, China has pegged its currency. We know that. We know it is illegal. It gives a distinct advantage to Chinese companies. In fact, it means that their products cost less, our products cost more.

One example. In China—and I should say also in Japan—a mid-sized American car costs $2,000 more just because of currency manipulation, and their products cost $2,000 less.

Last week, I spoke with employees at one of our large auto parts suppliers who told me that recently they had had the lowest bid against a Chinese company for a parts manufacturing contract, but when they figured in Chinese currency manipulation, the Chinese company won the bid. That is just wrong and it is affecting our jobs and our businesses.

Let me go on to say that we also have another very important issue that I want to briefly address, in addition to currency manipulation. And again, I want to thank Senator Schumer and Senator Graham for their outstanding work, and I am looking forward to that vote in July.

But I would be remiss, Mr. Chairman, if I did not also mention the fact that we have counterfeiting going on with automotive parts and other areas of the economy where essentially patents are being stolen. This has an enormous impact on us.

I would just mention that the Federal Trade Commission estimates that the automobile parts and components industry alone loses an estimated $12 billion annually in automotive parts. It is also a safety issue for us.

This is an issue of jobs. They estimate that, if in fact those sales were brought into legitimate companies in the automotive industry, we could hire 200,000 more workers—200,000 more workers—in the United States.

So, this is a life-and-death issue, I believe, for our way of life, for our economy, for who we are as Americans, and the great middle class that has strengthened and basically moved our country forward in so many very, very positive ways.

I would just show you an example, in closing, Mr. Chairman. Peter Perez, who is the president of Carter Products in Grand Rapids, Michigan, is also the national president of the Wood Machinery Manufacturers of America. He employs 15 people. He has a lot of different patents. One of them is for something called the Carter Stabilizer Guide. What that is, is it supports a band saw blade in such a way as to allow a woodworker to make all kinds of angled cuts.

I raise this only because, shortly after Mr. Perez put this on the market in Grand Rapids, the product, the installation instructions, and the instruction photos were copied by a Chinese company, were re-sold on the American market, and under normal circumstances this would cost $70. They were able, through stealing the information and the hard work of this company, to make it for less than $10, which was far less than the cost of the raw products necessary to create the product.

Carter products can compete, Mr. Chairman, if the rules are fair, we know, whether it is our farmers or our manufacturers. Give us a level playing field and they will compete and they will be successful. We are all here today saying, we have the responsibility, working together, to make sure there is a level playing field and that we are enforcing the law internationally on behalf of American businesses and workers.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

Now, Chairman Greenspan and Secretary Snow will come and testify. We will start out with Chairman Greenspan. Chairman Greenspan is on a tight schedule, so I would ask my colleagues, when you ask questions, to keep within the 5-minute rule that we generally have, and that the Chairman follows.

Chairman Greenspan? And welcome, Secretary Snow. Welcome.

Secretary SNOW. Thank you.

The CHAIRMAN. Secretary Snow, I have asked Chairman Greenspan to start out.

STATEMENT OF HON. ALAN GREENSPAN, CHAIRMAN, BOARD OF GOVERNORS, THE FEDERAL RESERVE BOARD, WASHINGTON, DC

Chairman GREENSPAN. Mr. Chairman, I have somewhat longer remarks than I will read, and ask that the full remarks be included in the record.

The CHAIRMAN. Without objection. That is our practice anyway, that your entire statement will be printed in the record.

Chairman GREENSPAN. Thank you very much.

[The prepared statement of Chairman Greenspan appears in the appendix.]

Chairman GREENSPAN. Mr. Chairman and members of the committee, I am pleased to be here to offer my views on China's trade and exchange rate regime. I would like to emphasize that the views I will express are my own and do not necessarily represent those of the Federal Reserve Board.

Some observers mistakenly believe that a marked increased in the exchange value of the Chinese renminbi, the so-called RMB, relative to the U.S. dollar, would significantly increase manufacturing activity and jobs in the United States. I am aware of no credible evidence that supports such a conclusion.

The enhanced integration of China into the world trading system is having a notable effect on Asia's trade with the rest of the world and on trade within Asia. After having risen rapidly through the 1990s, U.S. imports from Asia, excluding China, have flattened since 2000.

This has occurred as production within Asia has evolved, with the final stages of assembly and exporting to the United States and elsewhere becoming increasingly concentrated in China.

As a consequence, because exports by country are reported on a gross basis rather than as value added, the widening of the United States' bilateral trade deficit with China, measured gross, has largely been in lieu of wider deficits with other Asian economies, including Japan.

Measured by value added, our bilateral deficits with China would have been far less, and our bilateral deficits with other Asian exporters would have been far more.

Accordingly, an increase in the exchange rate of the RMB relative to the dollar would likely redirect trade within Asia, reversing, to some extent, the patterns that have emerged during the past half-decade.

However, a revaluation of the RMB would have limited consequences for overall U.S. imports, as well as for U.S. exports, that compete with Chinese products in third markets.

Such a revaluation would affect Chinese value added, but not the dollar cost of intermediate goods imported into China from the rest of Asia, which represents a significant share of the gross value of Chinese exports to the United States and elsewhere.

To the extent that exporters to China revalued as well, of course, the impact on overall Asian exports would be somewhat greater. The broad tariff on Chinese goods that has recently been proposed, should it be implemented, would significantly lower U.S. imports from China or it would comparably raise U.S. imports from other low-cost sources of supply at only slightly higher prices than prevail at present.

U.S. imports of textiles, light manufacturers, assembled computers, toys, and similar products would, in part, shift from China as the final assembler to other emerging market economies in Asia, and perhaps in Latin America as well. Few, if any, American jobs would be protected.

More generally, any significant elevation of tariffs that substantially reduces our overall imports, by keeping out competitively priced goods, would materially lower our standard of living.

A return to protectionism would threaten the continuation of much of the extraordinary growth in living standards worldwide, but especially in the United States, that is due, importantly, to the post-World War II opening of global markets.

Such an initiative would send the adverse message to our trading partners that the United States, while accepting the benefits of broadened world trade, is not willing to absorb the structural adjustments that are often necessary.

To maintain a rising standard of living, a dynamic economy such as ours requires a continual shifting of resources toward the most up-to-date technologies financed not only by saving, but also, importantly, by the depreciation of increasingly obsolescent facilities.

This highly dynamic process is mirrored in our labor markets, where jobs are constantly being created and destroyed at a rapid pace. New hires in the United States currently average more than a million per week, half resulting from voluntary job change.

At the same time, during a typical recent week, about 150,000 workers are temporarily laid off, and another 225,000 are subject to permanent job loss. Any effect of trade with China on U.S. employment is likely to be very small relative to the scale of job creation and job loss in our economy.

A policy to dismantle the global trading system in a misguided effort to protect jobs from competition would redound to the eventual detriment of all U.S. job-seekers, as well as of millions of American consumers.

Policy should aim to bolster the well-being of job losers through retraining and unemployment insurance, not to stave off job loss through counterproductive efforts to impede the process of income-enhancing international trade and globalization.

While the presumption that a reevaluation of the RMB would notably increase jobs in the United States by constraining imports or expanding exports is without statistical or analytical support, it is nonetheless the case that a more flexible RMB would be helpful to China's economic stability, and hence to world and U.S. economic growth.

Rapid accumulation of foreign, largely dollar, reserve holdings by the People's Bank of China, China's Central Bank, as a consequence of support for the RMB, would boost the growth of the money stock, with the accompanying risk of triggering upward pressure on inflation and a general overheating of the Chinese economy.

The Chinese Central Bank's issuance of liquidity management bonds to lessen potential increases in the money supply created by foreign asset accumulation has accelerated since regular issuance began in April of 2003, posing threats to China's financial stability.

Hence, the sooner the Chinese, in their own self-interests, move to a more flexible currency regime, perhaps leading other Asian currencies to become more flexible as well, the better for all participants in the global trading system.

In the decades ahead, Mr. Chairman, it is in our interest, and that of the global economy, that China continue to progress towards becoming a more market-based, productive, and dynamic economy in which individual initiative, not government decision-making, is the fundamental strength behind economic activity.

For our part, it is essential that we not put that outcome or our future at risk with a step back into protectionism. Thank you very much.

The CHAIRMAN. Yes. Thank you, Chairman Greenspan.

Now, Secretary Snow, please?

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

Secretary SNOW. Thank you, Mr. Chairman, members of the committee. It is always a pleasure to join you.

I am delighted to be here and have a chance to renew our conversation on the important subject of China, the U.S.-China economic relationships, and in particular the currency issues that are receiving so much attention these days.

Recently, Mr. Chairman, you know the Treasury Department released its semi-annual currency, so-called foreign exchange, report, pursuant to the Trade Act of 1988.

The report this year was a little different as it relates to China than in prior periods, in that we indicated clearly that China is now ready to move to a more flexible system, and, therefore, since it is ready to move, it should do so now in a manner and a magnitude that reflects the underlying market conditions.

In other words, it is time for China to move to greater flexibility to get its currency better-aligned with underlying, real market conditions.

We concluded that the current policies on the currency are highly distortionary and that they pose a risk to China's economy, to its trading partners, and to the growth and stability of the global trading system.

It is in China's best interest to move, and to move quickly. The Chinese have acknowledged their objective of moving to a flexible regime—I think in large part because of the work of Treasury over the course of the last 2 years.

We now have built a consensus among the global institutions of the world—the World Bank, the IMF, the G–7, APEC—and any number of individual countries that China should move to a flexible exchange rate regime.

In addition, working with China—and I have tried to keep this committee and the Banking Committee advised—China has made a number of steps to make its banking and financial system better able to accommodate flexibility.

We are now at the point, Mr. Chairman, as I indicated, if China fails to move and if current trends continue without substantial alteration, China's policies on the currency will likely meet the statute's technical requirements for a designation.

China's 10-year-long pegged currency regime may at times in the past have contributed to global stability, particularly at the time of the Asian crisis, but that time has passed.

So, we are going to continue to engage the Chinese vigorously on this issue and we will keep this committee well-advised of our efforts.

Let me say, I fully appreciate the sentiments, the frustration, that lies behind some of the pending legislation before this committee, a subject that I have engaged on with virtually every member of this committee. China needs to play by the rules.

We want to have China part of the global trading system, but it is a 2-way street. They have to deal with the intellectual property rights issues. They have to deal with the counterfeiting issues, the knock-offs issues. They have to enforce their laws. They have to open up their markets. And they need to move to a flexible exchange rate. No one should interpret, Mr. Chairman, our failure to designate China as acquiescence in China's currency regime.

I thank you for the opportunity to be here.

[The prepared statement of Secretary Snow appears in the appendix.]

The CHAIRMAN. Thank you very much, Secretary Snow.

Now we will take 5-minute rounds. That would be, in the order of coming: Grassley, Baucus, Bunning, Wyden, Kyl, Thomas, and Schumer.

I am going to start with Chairman Greenspan, so 5 minutes would apply to me as well.

The argument is made that trade deficits are evidence of job losses in the United States. I would like to have your response.

Chairman GREENSPAN. Mr. Chairman, there is no evidence of which I am aware that indicates that trade deficits have a significant impact on the level of jobs in an economy.

Indeed, if you go back over the record of the United States, we have had periods of trade deficits, trade surpluses, intermixing

with various levels of an unemployment rate, and it is very difficult to find any significant relationship.

Trade changes the structure of jobs within our country among industries and skills, et cetera. But we tend, because we have a flexible economy, to gradually move towards full employment, irrespective of the level of our trade deficits.

The CHAIRMAN. Another point, Chairman Greenspan. It seems to me that the trade deficit is best understood as the funding of our consumption with foreign capital, so our trade deficit is really a function of our low rate of saving and investment relative to our consumption.

Do you think policies designed to increase our national savings rate would be more effective in tackling our trade deficit than measures in restricting trade flows?

Chairman GREENSPAN. It is a very complex issue, but there is no question that, in general, policies which would enhance our national saving are generally good, and the evidence is certainly in the direction that the higher the national savings rate, other things equal, the lower the size of the current account deficit.

Indeed, we do find evidence, for example, that if the Federal budget deficit were brought down, about 20 cents on the dollar of the reduction also reduces the current account balance.

So, I do agree that we ought to be moving in that direction, and it is certainly a major policy initiative which the Congress should move in the direction of.

The CHAIRMAN. Again, Chairman Greenspan, could you describe some of the pitfalls the Chinese face the longer they avoid moving towards a freely floating currency, particularly in terms of inefficient economic decision-making?

Chairman GREENSPAN. In the short run, they are confronted with the problem of sterilizing, as economists put it, the accumulation of foreign assets to support their exchange rate, obviously, U.S. Treasury bills. They do this by selling RMB-denominated debt to sop up the domestic reserve increase that occurs as a consequence of the intervention.

This grosses up the Central Bank's balance sheet. There is a tendency, as we are observing, to impact the structure of finance within China, but because they have only sterilized about half, the rest, as I indicated in my prepared remarks, shows up as increased money supply. Eventually, they get a highly unstable, inflationary environment, which will create very severe difficulties for them.

In addition, fixing the exchange rate where they are tends to misallocate capital to their most efficient uses, to the detriment of the long-term growth of the Chinese economy.

So far as I can see, as they observe the problem emerging and as they watch the underlying inflationary forces begin to expand, this will induce them, sooner rather than later, to move their exchange rate to a more sustainable level.

The CHAIRMAN. Again, Chairman, in your view, is there an optimal way in which the Chinese should move to a market-based valuation of their currency?

Chairman GREENSPAN. There are numbers of ways of doing it, and they are far better at understanding various implications of the move than we. Remember, they are still, to a very large extent,

a command-and-control economy. As a result, they do not get the same responses that we do as a market economy. So, as they move towards a market economy, they have to recognize that the adjustments they make should not be destabilizing.

So they have a little more difficult problem in how one moves, and therefore, I think, since there are so many different ways to create a degree of flexibility which solves the problem that we are confronted with, that they are far more able than we, for example, at the Federal Reserve, to devise what would be the most effective way to do that.

The CHAIRMAN. Thank you. Now my time is up, so I will turn to Senator Baucus if he is ready now, or I will go to Senator Bunning.

Senator BAUCUS. I appreciate it, Mr. Chairman.

The CHAIRMAN. All right. Go ahead, then.

Senator BAUCUS. Mr. Chairman, it has often been stated, and by the Federal Reserve, that the increased flexibility of the American economy will likely facilitate any adjustment without significant consequences.

You know better than I of the huge current account deficit we are projected to face into the year. The figure I get is $780 billion, which would need about $3 billion daily to finance.

At the same time, our economy appears increasingly dependent on cheap credit to fund consumer spending. There are certain segments of our housing sector that have bubble-like appearances. My question really is, should we not do more than just let the "free market" take care of it?

By definition, market flexibility will correct. By definition. The trouble is, there are very significant adverse consequences for a lot of Americans when that happens. If I might, Mr. Chairman.

For example, people dislocated from jobs. They are put out of work. There are some who can adapt to market flexibility a lot more easily than can others. So, do you not really think that we need stronger policy options to minimize the adverse consequences of free market flexibility, which, by definition, will correct some of this?

Chairman GREENSPAN. Senator, let me just preface my remarks by suggesting that what we are confronted with is the consequences of an extraordinary change in globalization in recent years, which has augmented trade and current account balances throughout the world. At the same time, that process has created an increasing rate of growth in economic activity virtually worldwide, and has redounded very specifically to the benefit of the United States' economy.

We are looking at the extension of what went on in this economy, our economy, when we moved from local markets to national markets. What we are observing now, and it is very specifically in the last decade or so, is the emergence of national economies, the trade in national economies which had been restricted to national economies, spilling over sovereign borders and in the process creating a much broader global market system. The statistics will begin to show very significant increases in the dispersion of current account balances and trade balances, in the same way that, had we in the United States been measuring trade imbalances among the 50

States, we would have found a very large increase in the dispersion of trade surplus and trade deficit within the United States.

So, this is a process, really, which reflects a broadening of globalization, which is, in my judgment—and I presume almost all economists'—some significant positive force for world economic growth and prosperity.

Senator BAUCUS. But if I might, Mr. Chairman, again, because our time is so limited here.

Chairman GREENSPAN. I was going to get to your question.

Senator BAUCUS. All right. Thank you. Hopefully now, because we have so little time here.

Chairman GREENSPAN. I was just about to get to that. In the process, you create a very significant number of winners and losers. The basic problem that we confront is, given that the advantages are so much greater than the deficits, how do we take care of those who are on the wrong side of this process?

I do emphasize that what our international trade policy should be focusing on is finding how we put resources, basically among the resources that we gain from globalization, to assist those who are on the wrong side of the adjustment, to retrain, come back, and if necessary, to at least get a means of redress which recognizes that there are very significant problems in any competitive advance in economic activity.

Indeed, you cannot have an advance in economic activity unless you have obsolescent industries' cash flow moving to finance cutting-edge types of capital investments which we are engaged in in the United States.

It would be nice if it were different, but the world only gives us the choice of stagnation or advance. If we choose advance, it occurs only in the context of moving capital from older industries to newer industries, with the consequences that that clearly has. It is that problem which I think we should direct our efforts to adjust.

Senator BAUCUS. Well, you are very good in using my time. You have been around.

Mr. Chairman, the slight problem is this, though. I do not see a plan. I do not see a plan in the United States. I think, frankly, too much of a burden is on your shoulders. Too many people in this country think, well, the Federal Reserve will take care of it.

It is all monetary policy, and that the administration, the Congress, because we are in a free market era, do not have to do anything. Apparently, I think that philosophy is controlling too much in this country. Our country is great because of free markets. It is the strongest country in the world because of the free market system in our country.

But at the same time, there are huge dislocations. Increasingly, fewer and fewer people are able to adapt to those dislocations. You, yourself, said we need some kind of a readjustment, a plan of some kind in this country, an education. I do not see one. I do not see one. I do not see the administration proposing any plan that addresses that, and I do not see the Congress coming up with anything significant that addresses that.

I also do believe, and will give you a chance to respond, if you think this country should or should not spend comparatively more time on legislative policy and fiscal policy to take some of the bur-

den away from the Federal Reserve, which is trying to correct for some of this with monetary policy.

Chairman GREENSPAN. I think the critical problem, as you point out, Senator, is the issue of education. The problem, as I have emphasized—and I do not want to go over it in detail right at the moment—where the real adjustment process is going to be required, where the retraining and the like rests, is in the problems that are associated with our inability to move our children sufficiently through primary and secondary education into college and beyond, to create an adequate level of skilled workers to staff the ever-increasing and complex——

Senator BAUCUS. Do you see that in this country? Do you see the United States sufficiently addressing that?

Chairman GREENSPAN. I do not.

Senator BAUCUS. Thank you. I do not, either. I think that is a huge problem.

Chairman GREENSPAN. If we do not, whatever else we do is not going to be helpful.

Senator BAUCUS. I agree with you. Thank you very much.

Chairman GREENSPAN. If we do, nothing else will be necessary.

Senator BAUCUS. Thank you very much.

Thank you.

The CHAIRMAN. Senator Bunning?

Senator BUNNING. Yes. Thank you, Mr. Chairman.

In 1994, our trade deficit with China was $18 billion; in 2004, $162 billion. Since China joined the WTO, to say what its record is on living up to its obligations, is a joke.

For starters, they have been violating the WTO prohibition on export subsidies and the IMF rules against currency manipulation by systematically devaluing their currency. They have kept their currency at artificially low numbers. All in all, it is an effort to keep their goods cheaper on the market than our goods when we go the other way.

Furthermore, the record of the Chinese on protection of intellectual property is also a joke. Other countries that we trade with that we have allowed in the World Trade Organization are trying, at least, to clean up their act. China has ignored us and ignored the administration's trying to get them to shape up.

So, Mr. Greenspan, no matter how much we all love free trade, it has got to be fair trade also. So, it is a 2-way street. All of the nice things that you say occur when we trade are only good if it is fair. So, we would like your suggestion on how we can have fair trade with China, not only free.

Chairman GREENSPAN. Senator, let me first start off by saying, the distinction between "free" and "fair" is a difficult one to make. The problem is that most economists would presume that free trade is fair trade, so that our job is essentially to make it free.

We do have mechanisms in the international arena to resolve disputes, and indeed——

Senator BUNNING. What happens when nobody pays attention to them?

Chairman GREENSPAN. Well, if you begin to find that those systems break down, what will tend to occur is the free trading system

in the world will begin to break down, to the detriment of everybody, especially the United States.

Let me just say this, to make sure that we understand something important here. If China had never developed from its fully command-and-control economy, never entered into the marketplace as it has, never engaged in opening up its administrative system, its central planning and market forces——

Senator BUNNING. Mr. Chairman? Mr. Chairman, I am sorry, but China, out of necessity, could not feed their people, so they opened their markets.

Chairman GREENSPAN. Senator, I do not care what the reason was. The fact that they have has been of advantage to the world at large, and especially to the United States.

Senator BUNNING. Everybody is entitled to their own opinion.

Chairman GREENSPAN. Indeed.

Senator BUNNING. Secretary Snow, in the Banking Committee last month you said, "China does not yet meet the technical requirements needed to be considered a currency manipulator." Can you tell us why they failed to meet that technical definition?

Secretary SNOW. Yes, Senator. It is only recently that we concluded that the progress in China with respect to the banking system, financial institutions, modernization of the way their financial infrastructure works, achieved a sufficient robustness that it could accommodate flexibility. Flexibility in the currency puts some pressures on the underlying financial infrastructure.

Senator BUNNING. Are you telling me that they do not fix their currency to a given rate with the dollar?

Secretary SNOW. Oh, no. They definitely do.

Senator BUNNING. They do?

Secretary SNOW. They definitely peg it. They now are at a point, though, that their system would accommodate movement to flexibility. We have urged them to move to flexibility. We have technical teams over in Beijing working with them. They come here.

Senator BUNNING. Mr. Secretary, they have kind of told us to take a hike. They have not followed through very well, the Chinese.

Secretary SNOW. Senator, we are not satisfied. I want you to know that. It is time for them to move. We have made that clear to them in no uncertain terms, it is time to move.

Senator BUNNING. I hope that the Congress of the United States does not have to force you to make that move, because there are a lot of us who are sitting up at this table that feel that we are not moving fast enough.

Thank you.

Senator BAUCUS. Thank you, Senator.

Senator Wyden?

Senator WYDEN. Thank you, Mr. Chairman.

I think both of you know that I consider myself a free trader, voted for CAFTA last week, against slapping these tariffs on China. I think that would boomerang on our companies. But I do not think being a free trader is synonymous with being a sucker and being a patsy.

I have one question for each of you this morning. Mr. Secretary, as you know, the headline all across this country today was: "Chinese Oil Giant in Takeover Bid for U.S. Company."

Now, under the 1988 Omnibus Trade Act, there is an Exxon-Florio amendment that requires that a Treasury-led committee, a committee that you chair, review foreign bids to acquire U.S. assets that may have a national security impact.

My question to you is, do you intend to review the Chinese bid to buy Unocal, and what is your initial read of this particular bid?

Secretary SNOW. Well, Senator, of course, the Exxon-Florio process provides for the national security review that you alluded to, where a foreign company seeks to acquire a U.S. company.

It is hypothetical at this point, though, because we do not have a transaction. I would fully contemplate that the parties to a transaction would want to avail themselves of that process.

That is normally what happens on a voluntary basis: the parties to a transaction involving a foreign purchase of a U.S. company that could have security implications file for the review.

Senator WYDEN. I would only tell you, Mr. Secretary, if you do not review this one, that law is meaningless. I am telling you, and you and I have talked about this, those of us that consider ourselves free traders have got to be aggressive in terms of using the existing tools on the books. I am telling you, I do not see the arguments for not doing a review there.

Secretary SNOW. Senator, I would just say, under the CFIUS process chaired by Treasury, we do consider all threats to national security in that process. Of course, the composition of the board includes the major parts of the government: Homeland Security, Defense, USTR, Treasury, and Commerce.

Senator WYDEN. But you chair the committee under the statute. I think I have made my case.

Secretary SNOW. Yes.

Senator WYDEN. Chairman Greenspan, I thank you for the discussions we have had about free trade in the past as well. I think you know that I am concerned that a significant portion of China's economic growth simply is due to a conscious policy of stealing our technology.

China is the world's number-two purchaser of computer hardware, but ranks only 25th in purchases of computer software. Ten percent of China's software purchases are thought to be legal.

Now, there is a step that I believe that could be taken that would not require any legislation at all. I would like to ask you, and perhaps you as well, Secretary Snow, what your thoughts would be to the idea that the Treasury Department would publish, on a regular basis—it could be available online, offline—a list of products made in China with stolen U.S. intellectual property that are sold in the United States.

That way, if we had that kind of list, every time a U.S. consumer walked into a major store in this country they would know who in China was ripping them off, and people could vote with their wallets.

I would be interested in the reaction of you, Chairman Greenspan, and you, Secretary Snow, each to that idea, because it could be done immediately and could be done without any legislation.

Mr. Chairman? Chairman Greenspan?

Chairman GREENSPAN. Well, if you put the word "verified" in so it is just not an allegation, I think it is not a bad idea. The reason,

essentially, is that all trade implies that the seller has a property right to what is being sold. Indeed, if you do not have property rights, trade—domestic or international—cannot exist.

To the extent that an ever-increasing proportion of world trade is intellectual property, our inability to enforce rights under such laws is an extraordinarily important detriment to the movement of goods and services, specifically intellectual property.

I think, in addition to what you are suggesting, which I think is a very interesting idea, it is important that we convene a much broader international forum to make certain that efforts to protect intellectual property rights advance, because, if we get to the point that a very large part of the trade is what our globalization is all about, but rights are not protected, it must ultimately fail, to the detriment of all parties.

Senator WYDEN. My time is up. But Secretary Snow, could you just respond to this idea? Again, this is something that you all could do in Treasury. You could do it now, with no legislation. I think it would send a real message.

Secretary SNOW. What we are talking about here is theft, plain and simple. As the Chairman said, open, free trade cannot work unless property rights are respected and theft is dealt with. I think it is a very interesting idea. Let me think about it and talk to Ambassador Portman, and see if we cannot come back to you with some suggestions on it. Thank you very much.

Senator WYDEN. Thank you, both. I look forward to working with both of you.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator Kyl?

Senator KYL. Thank you, Mr. Chairman.

I appreciate both of you testifying. You have obviously experienced the bit of frustration that we have here, much of it based upon what we hear back home. You both have expressed frustration with a system that must comply with a set of rules in order to work.

The question I have, very specifically, for both of you, is this. It is more a matter of education here. I am asking to be educated, not for interesting, innovative policy suggestions, like Senator Wyden's, which I agree is a very intriguing thought. Transparency in commerce is critical, and abiding by the laws, as well.

Review for us, if you would—since you have rejected the idea of tariffs by the United States to enforce compliance with both intellectual property, with the U.S. law, as well as WTO requirements, all of which China is violating—the U.S. legal means, and WTO and any other mechanisms, by which we could, as a practical matter, begin quickly putting pressure on China to begin playing by the rules that they have signed up to play by, or that they should abide by.

First, Mr. Greenspan, then perhaps Secretary Snow.

Chairman GREENSPAN. Any set of rules has built into them, either explicitly or implicitly, a set of enforcement capabilities. To the extent that there is violation of agreements, there are mechanisms to be employed to redress that particular problem.

Indeed, to the extent that there are violations, you cannot maintain a system in which contracts are violated, because that, in the context of property rights, is the firm, unequivocal base of a trading system. So, you have to have a mechanism for redress where there are, in fact, violations of a contract. You need a form of adjudication.

The question is, can you do it bilaterally? The answer is, not properly, in an international system. What we need to do, if we are not getting contractual relationships and rules of international commerce lived up to, we have to find out why that is, and how to redress that. But I do not believe that you can effectively do it with bilateral tariffs. First of all——

Senator KYL. Excuse me, Mr. Greenspan. We know we agreed with China's accession to WTO status with a commitment to meet certain milestones, which they are not meeting, apparently not even trying to meet a lot of them. WTO is an international arrangement which has enforcement mechanisms. Which of the mechanisms involved in WTO do you think we could reasonably employ under these circumstances?

Chairman GREENSPAN. Senator, may I answer that for the record? There are a number of detailed issues within the statutes which I would like to address.

Senator KYL. That would be very helpful, because we are searching for the right way to enforce international law with respect to trade with China. To the extent we are told, well, you should not do it this way, you cannot do it that way, we are looking for how we could do it. So, an answer for the record, utilizing WTO provisions, would be very, very helpful.

[The information appears in the appendix.]

Senator KYL. Is there anything else during this time that you would recommend?

Chairman GREENSPAN. I would think that that should be sufficient.

Senator KYL. All right.

Secretary Snow?

Secretary SNOW. As you know, Senator, we are trying to encourage the global community—IMF, World Bank, G–7, Asia Development Bank, and others—to convey to the Chinese their displeasure with the Chinese peg. They have done that. I think creating a consensus in the global community about the right behavior is a positive thing. I think it will help foster the right outcome.

In terms of the U.S. Government, I know that Ambassador Portman and Secretary Gutierrez, who have principal responsibility for this, are conducting a thorough review of the options we have, and how to make them fully effective.

One of the areas we have, of course, is the safeguards. The textile safeguards now are much in evidence. Other possible actions are being reviewed. Conveying to the Chinese our firm commitment, they have got to live up to the rules, is a starting place.

In Ambassador Portman and Secretary Gutierrez, I think we have seen new, forceful people, bringing a strong message to the Chinese about the importance of living up to, and actually accelerating, those WTO commitments. We are engaged.

Senator KYL. Since the red light is now on, let me ask you to submit for the record as well, if you would, please, the specific steps we can take.

Secretary SNOW. I would be pleased to.

Senator KYL. Since both of you have suggested that some of the ideas emanating from Congress would not be helpful, in your view, what specifically can be done, other than expressing our displeasure? That is a wonderful start.

It has been going on now for about 5 years. And I am not talking about the currency. In my case, I am not talking about the currency. Others are talking about that as well. I am talking about the violations of rules, whether it be from intellectual property, to WTO requirements.

I must say this. I am just a little bit disappointed that, in 5 minutes, it is not possible to identify a couple of specific things that we can do, and should do, within the framework of our laws and international laws, to gain compliance with what everybody recognizes are violations by the Chinese.

However, I am very happy to receive the commitment to get on the record some specific suggestions from both of you about how we might do that in ways that do not run afoul of some principles that you have articulated here, and I certainly agree with some of those principles.

Secretary SNOW. Senator, obviously one thing we can do, and have to continuously do, is look at violations and WTO legal enforcement actions.

The CHAIRMAN. Now, Senator Schumer.

Senator SCHUMER. I want to thank you, Mr. Chairman. First, I was going to be here for a brief opening statement, given that our bill has been one of the focuses of this hearing, and then I will ask a couple of questions. I will try to stay within my time limit.

The CHAIRMAN. Secretary Snow has to go at noon.

Senator BAUCUS. Mr. Chairman, I have got a lot more questions. That is going to cause a problem.

The CHAIRMAN. Secretary Snow, can you stay longer for Senator Schumer?

Senator SCHUMER. No, I will be fine. He does not have to stay longer for me. All right.

First, Mr. Chairman, I want to talk a little bit about our bill. First, one of the biggest misconceptions of our bill is that it is protectionist. We want to make one thing clear. When it comes to the issue of China currency manipulation, it is the opponents of our bill who are the protectionists.

They are protecting China from joining the community of free trade. Pressuring China to reform itself is the free trade position, because free traders believe in floating currencies. We all know the theory: when currencies float, the free market self-corrects the trade imbalances.

The currency of a country with the trade deficit falls in value, and that causes that country's imports to shrink and its exports to rise, correcting the deficit.

We can tolerate it when it comes to little countries, but if a major country's currency is artificially pegged, it causes distortions in that country's economy, in the country whose currency it is pegged

to, and in the world economy. That is why the EU and Japan agree with us, and with both of you, frankly, that China's currency should be allowed to float.

Getting China to play by the rules of the game is the free trade position. If we do not, if we dither, the fragile, but very important, support for free trade around the globe is going to wither away.

After years of inaction, we are frustrated. Everyone knows the history of our bill. We introduced the bill 2 years ago, not yesterday, not 2 days ago, and we were asked by your predecessor, Mr. Secretary, by you, Mr. Chairman, and by many others: delay, and we'll get something done. Just give the Chinese some time. Nothing has happened.

In fact, the only real focus, heated focus, occurred after our bill passed. My belief is, there are some in China who believe in free trade. They tend to be in the economic departments: Central Bank, the Finance Ministry.

I do not believe that the Communist leadership of China believes in free trade. I believe they are mercantilists. They are of the view that China should accumulate as much money as possible, and when free trade helps them do that, they support free trade, and when free trade does not help them do that, they do not. So, they need some prodding. It is not an accident.

It is not just currency, it is intellectual property, and even abjectly, I know company after company in New York are just not allowed to trade in China. You cannot send your products there. They find one reason or another.

How about the recent merger? It has been reported today that one of China's largest oil companies is trying to take over Unocal. The problem, once again, is fairness and reciprocity, not the attempt to take over. Would the Chinese freely allow an American company to take over a Chinese company?

Well, we know countless instances where that has not been allowed; well, you have to find the right Chinese partner; you have to be 49 percent and let us be 51 percent; or you even have to get the permission of the Chinese government.

So we go on and on and on. Maybe you gentlemen do not have to do what we have to do, which is sit down with the workers who have lost their jobs. I know company after company. I will tell you of two just in Syracuse—that is what got me into this—Crucible Steel and Stickley Furniture.

Both of them said they could compete against China and do well, even with China having lower wage costs and lower other costs, but they said that the 27.5 percent advantage knocks them out of the box. That would be true of most companies. Capitalism works pretty well. You do not have a 27.5 percent margin of error, if that is what the currency is.

So our goal is not protectionist. It is to get China to play fair. You know our bill is careful. We have talked to the administration. We allow a 180-day negotiation period after it becomes law. The President can certify at the end of the negotiation period that China is making progress. That is another 180 days. That is a year.

Even after that, if the President determines China is implementing an actual plan to revalue the currency, there is another

12-month delay. That is 2 years. And China is moving along. No one is going to force anything to happen. All we have gotten is words, and that is it. Nothing else.

What everyone agrees they should do, everyone who has testified and everyone on this side, is they should revalue their currency. We are not demanding they do it all at once, but we need two things, Senator Graham and I, anyway. One, some real change, and two, a timetable—it does not have to be adhered to minute-by-minute—of when they will finally get to full revaluation. So, yes, I am frustrated.

The CHAIRMAN. Thank you, Senator.

Senator SCHUMER. Wait. I have a question.

The CHAIRMAN. All right. Your time is up. Why do you not ask one question?

Senator SCHUMER. One question.

The CHAIRMAN. Then hopefully they will give a short answer. Because Senator Baucus needs to ask a question of Secretary Snow.

Senator SCHUMER. All right.

My question is very simple. Let us say that the Chinese continue to do nothing on currency revaluation. Let us say there are no actual changes. How much longer should we wait before we take stronger action? It is not rhetorical. Should we wait another 2 years, with no action? I am not talking about some change.

Chairman GREENSPAN. Senator, I think you will find that the Secretary and I agree with your general philosophy of coming at this problem, that they should do something, and that we ought to be taking action to bring them into compliance with many of the areas where they are not in compliance.

A big problem is that, if you put a tariff of 27.5 percent out as the end of the process, the question is, if that ever gets implemented, the consequences, in my judgment, are extraordinary and negative.

I think that if you can find a way to do precisely what you are trying to do, which I happen to think is a very sensible overall approach, with another, less destructive procedure——

Senator SCHUMER. Do you have a recommendation, other than talking?

Chairman GREENSPAN. Well, basically, Senator Kyl raised an issue which we will have to respond to.

All I can tell you is that you are dealing with a very complex question, because we have China trying to move from essentially a centrally planned economy, which views market forces as a positive direction.

You are getting a system which is still politically a Communist system, recognizing that market capitalism is where they want to be, which is an extraordinary change.

They have done it, frankly, far more rapidly and much more in depth than I had anticipated, but there are certainly the problems that you have correctly identified, and that they should be changing in ways which will, in my judgment, enhance their move effectively towards an effective market economy.

My basic concern is that, if we are forced to implement a very significant unilateral tariff, the dangers to the overall international financial system, in my judgment, are very large, and I merely stip-

ulate that I agree with you in principle, but it is your particular tactic which I find——

Senator SCHUMER. Mr. Chairman, that is why we give 2 years after this should become law. Lots can happen in that 2 years.

The CHAIRMAN. Senator Baucus?

Senator BAUCUS. Thank you, Mr. Chairman.

Following along the general question to Secretary Snow, although I think we are all in the right direction, it is a little more complicated. There are all kinds of areas where it is more complicated. But the one I am focusing on is this: it is not just China, it is other Asian countries which also peg their currencies.

The real question is—and I am sure this is a problem facing China, too, as well as facing the United States—if China revalues, what effect is that going to have, honestly, on the U.S. current account deficit?

Then, secondly, what will other Asian countries do? Will they continue to peg? Will they not continue to peg? Because they are going to be competitive with China, as well as the rest of the world.

So does it not make more sense, is it not time for another Plaza Accord? I can remember, it was not too long ago, early 1980s, whenever it was, the dollar was high, and Japan, then, was the issue. I remember Secretary Baker was very involved then. The countries met at the Plaza Hotel in New York. They got together to figure out a way to jointly intervene or coordinate a response.

Now it is more complicated. There are more countries. I do not know that the United States has quite the same leverage, frankly, now that it had back then. But Europe certainly has a role here.

Isn't it time for something like that? Because China has grown up. China is not a developing country any more. There are other countries in Asia, they used to be called tigers. Well, that was a long time ago, that we called them tigers. They are more powerful now than they were then.

Doesn't it all make more sense to get a coordinated response here, because there are ramifications and ripples which have not yet been brought out in this hearing?

Secretary SNOW. Senator, I think, in answer to your explicit question, that there would be competitive adjustments throughout the Pacific Rim that would also play out through the larger global economy.

One reason we are so intent on seeing China move to a flexible exchange rate is not just China, but the global economy and the effect on a whole series of countries who view themselves as competitive with China.

I think their movement to greater flexibility would lay the foundation for a broad movement to greater flexibility, which would, in and of itself, start a process that would be very beneficial to address the issue I know you opened with, and that is the current account deficit.

Senator BAUCUS. Why can the administration not, or should the administration not, call for a Plaza-like get-together, sit-down, maybe just the region, Asia? It just seems to me that it is time to get some kind of order here.

Mr. Chairman?

Chairman GREENSPAN. The world is different from the days of the Plaza.

Senator BAUCUS. Oh, much different.

Chairman GREENSPAN. I would merely indicate to you that the huge changes that have occurred which I alluded to earlier with respect to the broadening of current account balances—vast movements of capital, the newer technologies—would make it extraordinarily difficult to fix any set of exchange rates in that global market, which is essentially what the Plaza was endeavoring to do.

I do not think it is technically possible, even if it were somehow conceptually desirable. I am not sure that it is. In other words, there are major changes that occurred as a consequence of the international financial crisis, especially in Asia.

The 1998 crisis induced them, being caught very short of reserves, to become inordinately attracted to building reserves, to the point where they are beginning to distort, in many cases, their financial systems, and specifically their central banks.

I do not think they can proceed very far along that way. If capital controls are removed generally from a lot of these countries, you begin to get differing types of flows. But I do think that the issue you are addressing is being focused on within the IMF, the WTO, and indeed in the G–7 and G–8 meetings.

Senator BAUCUS. If I might, Mr. Chairman, because the light is flashing here: there may be some general sorts of discussions, but I do not know if there is much action. It seems to me that part of the problem back in the late 1990s was there was massive intervention with the banks.

You were part of it, Secretary Rubin was part of it, Larry Summers was part of it. I mean, there was a coordinated response to deal with the Asian currency crisis, very coordinated and very aggressive, and it worked pretty well.

Part of the problem, too, in a lot of those Asian countries, is a capital flow problem. I mean, they opened up perhaps too quickly, so capital flowed in when things were going well. The trouble is, capital left when things were not going too well. It seems to me we have two choices here: we try or do nothing. Let me ask if that question is the answer.

I understand all the technical problems, but there has got to be some attempt here, some way to sit down with the relevant countries and get some order here. We all know that, by and large, we are all better off the more there is some stability in the currency markets, if we are all pretty much working off the same game plan, rather than if not.

Chairman GREENSPAN. Well, actually, Senator, I think the very fact that there is this major set of discussions in the international financial arena is leading us in that direction. Because, remember, we all are groping as to what the appropriate balances are, because we are dealing with something we have never seen before. We have never seen the extent of the dispersion of current account balances worldwide with the implicit, very large capital flows that we are observing.

We have never experienced this before. We are learning how it is working, and I think, as a consequence of that, we are gradually

approaching the point of addressing the types of issues, as you placed them. There is no crisis at this particular stage.

Senator BAUCUS. No. We are trying to avoid one. We are trying to avoid one.

Chairman GREENSPAN. There are problems. If there is a crisis, we will all get together and solve it, or hopefully solve it. But that is what we are trying to avoid. One of the ways you avoid it is not introducing actions based on frustration, which do not address the real serious problem.

Senator BAUCUS. If I might, Mr. Chairman, though, it just seems to me that you run the risk of too many of these decision-makers trying to address some of these subjects in private.

It is legislation, whether it is Senator Schumer's, or whoever it is; it is proposals by the administration; it is getting this a lot more out in the open. I firmly believe, the more it is in the open, the more we are going to have a better solution.

I firmly believe that the administration is not doing enough yet out in the open to bring more people in, bringing the Congress in on an honest basis, because we risk real peril here if we do not.

Secretary SNOW. Senator, let me just respond, briefly, here. The United States is playing a crucial role in bringing the global community together on this fundamental issue of the global adjustment process.

It was the United States that led the G–7, as the Chairman was suggesting, to lay out a framework to deal with it, a framework that calls on us to do some things, falls on Europe and Japan to do some things, and calls on China to do some things. That framework, Senator, is the framework that is now widely accepted at the IMF, at the World Bank, at the Asia Development Bank, at APEC, at the Euro-Zone. I was in Europe last week talking with European leaders. That is their framework, it is our framework. I agree with the Chairman. There is a conceptual framework we are all working with here now, and it is working.

The IMF is taking a lead, in its macroeconomic surveillance capacity for the global economy, to look at Asia and the adjustment processes that are required in Asia, and carrying on continuing dialogue with leaders in Asia—Finance ministers, Central Bank governors, and country leaders. So, Senator, there is an awful lot going on here to stitch the world together.

Senator BAUCUS. I do not believe it. Mr. Secretary, that is words. I am sorry. The IMF is more of a monitoring agency. It does not really do much. I do not see much. Look at how much China is intervening, buying our securities; current account deficits are getting larger.

I mean, there is just so much going on, they are just really, really risky. I do not sense that the administration senses the gravity of the situation. The administration does not show that it senses the gravity of the situation here. There is a lot of words, a lot of talk. I just urge you and the others to step up.

Secretary SNOW. Well, then you would not be surprised if I disagree with your assessment.

The CHAIRMAN. Senator Kerry?

Senator KERRY. Thank you, Mr. Chairman. I apologize for being late. We had the Iraqi Prime Minister. But I am glad I am here, and I want to pick up on where Senator Baucus just left off.

You disagree, Mr. Secretary, but the record, since we have become engaged in a very significant way with China and other countries, and a number of us have been part of that journey here in the Congress the whole time in the early 1990s, is one of this problem getting worse, and worse, and worse.

Just yesterday, there was an article about how the United States presented the Chinese, in May, with a list of modest proposals to curtail intellectual property violations. The Chinese rejected the proposal outright. The administration responded, not by pressing the Chinese, but by telling U.S. companies to go file lawsuits in Chinese courts to defend their rights.

So the question is, are we powerless to stand up for American companies that are losing $24 to $25 billion a year? You can walk around the embassy in China, one block away, and you can go buy counterfeit disks, right around from our embassy.

I mean, it is a joke, except that it has got serious consequences. We have been talking about currency manipulation for several years here. Intellectual property has gotten worse, and worse, and worse in terms of the stealing from American companies, and the disrespect for the law which they said they would agree to.

So are we powerless, or are you oblivious, or is it a combination of the two?

Secretary SNOW. Senator, you missed the earlier discussion on a variety of these issues.

Senator KERRY. Well, I heard, Secretary, that the Chairman said that we could use the WTO, and you said that the JCCT and other things are working. I am confronting that. I do not think it is working.

Secretary SNOW. Well, they are not working to our satisfaction.

Senator KERRY. So how do we get satisfaction?

Secretary SNOW. Well, I think by continuing to take the message to the Chinese on what U.S. policy is, and what we expect of them. That is a starting place.

Senator KERRY. What is U.S. policy?

Secretary SNOW. Well, U.S. policy is that our trading partners live by the rules.

Senator KERRY. But they are not. So what is our policy?

Secretary SNOW. Well, that is a matter of enforcement, Senator.

Senator KERRY. What is the enforcement? Where is it?

Secretary SNOW. The enforcement is both in private and public sector activities.

Senator KERRY. What is the public sector enforcement?

Secretary SNOW. Well, the new Trade Representative of the United States, former Congressman Portman, has indicated he is doing a bottom-to-top and top-to-bottom review of just what options are available to us. He has been forceful——

Senator KERRY. You mean, over the last 4 years you have not looked at those options?

Secretary SNOW. Well, he is doing a new review of the options.

Senator KERRY. I see. So a new review is our enforcement.

Secretary SNOW. A new review hardly qualifies as enforcement. A new review is the basis for determining what enforcement actions to take.

Senator KERRY. And you do not know, over the last 4½ years, what they are?

Secretary SNOW. I do not know what the new actions will be.

Senator KERRY. What are the actions we have taken?

Secretary SNOW. Well, look at the textile actions that were taken here just a few days ago. Look at the safeguards in other areas.

Senator, the question here is what course we want to stay on. Do we want to stay on a course that basically embraces rule-based trade, or do we want to impose protectionism? I do not think we want to impose protectionism.

Senator KERRY. Of course we do not. Nobody here has suggested protectionism. We suggested standing up for the rules. The WTO, with respect to currency manipulation. How long have we talked about currency manipulation? Do you believe it is taking place?

Secretary SNOW. Senator, we believe that the currency is pegged. It should move to flexibility. Yes.

Senator KERRY. Well, I know you have gone over this somewhat so far, but I must say to you, I reemphasize what the Ranking Member has said, that I think there is just a deep frustration, and our companies are turning to us. We have got a lot of them in Massachusetts. We have them all over the country, in California and elsewhere. They are falling behind because we are not standing up and enforcing, and a lot of people are asking why.

Mr. Chairman, in your testimony you said, "To maintain a rising standard of living, a dynamic economy such as ours requires a continual shifting of resources toward the most up-to-date technologies, financed not only by savings, but also, importantly, by the depreciation of increasingly obsolete facilities." Obviously, I think we would all agree with that.

But does it not also depend on sound fiscal decisions? I know you mentioned education. You said, if education is not where it ought to be, nothing is. We are $28 billion below the promise of No Child Left Behind, of investment in education in this country.

The Chinese are investing in transportation. They are investing in infrastructure. We are not. We are billions of dollars below where we were last year in our transportation bill, and it is all of these investments, the lack of them. Pell grants are more expensive, so it is harder for our kids to go to college.

China is turning out 300,000 engineers; India is turning out 300,000. We are not. The president of the Massachusetts Institute of Technology came to me the other day lamenting the lack of American kids going into science, the lack of commitment in our country to this.

Now, here we are, committed to a tax cut we have not yet passed, that we cannot afford, that is going to drive the deficit larger, require us to sell more, have Chinese invest more in America and carry our debt.

So my question to you is, are we making the right fiscal decisions with respect to the long-term investment and infrastructure capacities of our country so that we can compete with China through this century?

The CHAIRMAN. Can you give a short answer, Mr. Chairman? Because Senator Smith is waiting for questions.

Chairman GREENSPAN. Senator, I cannot distinguish between fiscal actions on education and other actions. What we do know is that the Boston College survey, which is done periodically, indicates that fourth grade children are above-average in math and science in an international comparison.

By the time they get to twelfth grade, they are way below any median, and indeed are pretty much at the bottom of the listings. We do something there. Whether it is the lack of fiscal resources or something else, I am not in a position to know.

All I can say to you is, the basic problem that we have, which is showing up in very many aspects of our economy, is a very severe bifurcation of our labor markets, in which we have too few skilled people where the demand for skills are very high, and therefore their wages are rising very rapidly and we have left too many people in the lesser skilled areas where they are in excess relative to demand, inducing very weak growth. Now, that is an educational issue. How one resolves it, whether it is by fiscal means or other means, I do not know.

The CHAIRMAN. Senator Smith?

Senator SMITH. Thank you, gentlemen. Mr. Chairman, thank you.

As we contemplate trade with China and the way it has grown, I wonder if you can speak to the wisdom of reaching out with trade agreements to less-developed countries, in Sri Lanka, and others affected by the tsunami, as a way to foster competition with China.

Is that an advisable thing, in the opinion of you gentlemen, as opposed to just giving aid, as we have done very generously as a country? Should we not be looking to help them in a more long-term way by giving them a trade agreement, and also fostering competition with China?

Chairman GREENSPAN. I would certainly favor such a direction, Senator.

Secretary SNOW. Sure. Sure, Senator. We should do it, as well, through the WTO, the Doha Round, on a multilateral basis.

Senator SMITH. Senator Feinstein and I have introduced such a bill, and I appreciate your response.

Thank you, Mr. Chairman.

The CHAIRMAN. I would like to call the next panel. Can you maybe make your questions short? I have got another panel, and you guys will go eat while I am conducting the meeting. [Laughter.]

Senator Wyden?

Senator WYDEN. Thank you. I will be very short.

Chairman Greenspan, I think you made the case for our trade adjustment assistance amendment, which we are trying to make part of CAFTA and part of trade agreements in the future, so that when workers are dislocated as a result of changes in global markets, we could have some help, a safety net for them.

Could you give us your thoughts on trade adjustment assistance? Because we are trying to get that as part of CAFTA in these upcoming agreements.

Chairman GREENSPAN. I am certainly in favor of it, in principle. The real problem you have is that it is very difficult to determine whether a job has been destroyed because of domestic technology or international trade. But the principle of endeavoring to address the problem of adjustment, to me, is where our focus ought to be firmly put.

Senator WYDEN. Thank you, Mr. Chairman.

Senator SCHUMER. Mr. Chairman, I have one question as well.

The CHAIRMAN. Go ahead.

Senator SCHUMER. Thank you, Mr. Chairman.

I just would like to ask Secretary Snow the question I asked Chairman Greenspan. I appreciate Chairman Greenspan being sympathetic to where we want to go.

So far, we have just heard about two solutions; one, our bill; and two, talking, continuing to talk to the Chinese, which we have done for a long time.

Is there a third alternative that you see? If not, how long do we continue to talk if no action occurs?

Secretary SNOW. Senator, as I indicated earlier, we are not satisfied with this situation at all. China has made sufficient progress in modernizing their financial infrastructure. They are not the U.S. yet, but they are capable of adjusting to flexibility.

It is time for them to move. We said that in the clearest way possible. I share your frustration totally. You and I have talked about this in your office, and in the halls of the Congress, and in hearing rooms many times.

I think they are going to move. If they do not, then when we do the report next time, if conditions continue as they are unaltered, then I think we will be left little option but to do the designation.

Senator SCHUMER. I would just say, Mr. Chairman, I thank both witnesses, and thank you for your patience. We have heard a lot, but so far I have not heard anyone present an alternative to trying, begging the Chinese to change verbally, and the kinds of solutions that Senator Graham and I have put forward. Thank you.

Senator KERRY. Mr. Chairman? Just one quick question.

The CHAIRMAN. All right.

Senator KERRY. Chairman Greenspan, do you believe, just to follow up on the other question, that the fiscal and debt situation we face now is having some impact on other choices, such as basic scientific research, technology development, et cetera? I mean, those are zero-sum choices, are they not?

Chairman GREENSPAN. I cannot see how it could be otherwise.

Senator KERRY. All right. Thank you.

The CHAIRMAN. Thank you both.

Senator BAUCUS. If I might, Mr. Chairman. Just one little question. It is not long at all. It is kind of a technical issue. That is, the various components of the current account deficit. We have the trade account, the income account, and the transfer account. Of course, the trade account is the largest of the three.

But I have seen data that indicates that the income account, although it is slightly positive now, is going to be negative, and very much negative, in the next several years.

For example, in 2003, it is positive, but by 2005, this year, it is a $40 billion deficit. By 2008, the figure I have is about $270 bil-

lion. That is on top of the trade account deficit. It just seems to me, this is starting to escalate here a little bit and it is going to cause problems.

Either of you can comment on that, briefly.

Secretary SNOW. Senator, I fully agree with you. The current account needs to be addressed. It is a shared responsibility. It is why we put in place this framework through the G–7, the IMF, the World Bank, and other multilateral institutions.

It is why we are calling on the Chinese to adjust. I agree with the Chairman and his observations on that. But it would set in motion a broader and wider global adjustment process.

Senator BAUCUS. I am addressing the income account portion of the current account.

Secretary SNOW. Unfortunately, the trend line, as you said—what we could expect to see in the future—suggests that will be the case.

Senator BAUCUS. And does that exacerbate the problem?

Secretary SNOW. Well, it is another source of a negative on the current account, certainly.

Senator BAUCUS. Also, with all the investment that is coming into the United States, it does not go into plants, machinery and equipment. It is going into our securities. That is with China, anyway.

That is not productive. People talk about direct investment. That is not direct investment. At least, it is not direct investment in matters that count. It enables them to consume and spend, but not invest, say, in education. Is that not true? Is that not the practical effect?

Chairman GREENSPAN. Well, remember, the financial system is a whole set of intermediaries. If you invest in securities, ultimately it affects the investment in hard assets. But you are quite correct. There is an issue here as to what extent those investments in securities finance consumption rather than investment.

Senator BAUCUS. Exactly.

Chairman GREENSPAN. But, in general, the mere fact——

Senator BAUCUS. That is right. Per se, it is not necessarily the case. But that is the trend.

Secretary SNOW. But it becomes part of the supply of loanable funds, which are available for capital generally.

Senator BAUCUS. I thank the Chairman.

The CHAIRMAN. All right. Thank you, both, very much.

Our next panel is Kenneth Rogoff, Thomas D. Cabot Professor of Public Policy, Department of Economics, Harvard University; Neal Bredehoeft, president of the American Soybean Association; Sean Maloney, executive vice president of Intel Corporation; and Al Lubrano, president of Technical Materials, Incorporated, on behalf of the National Association of Manufacturers.

We will start off with Dr. Rogoff. Dr. Rogoff, would you start with your testimony, please?

STATEMENT OF DR. KENNETH ROGOFF, THOMAS D. CABOT PROFESSOR OF PUBLIC POLICY, DEPARTMENT OF ECONOMICS, HARVARD UNIVERSITY, CAMBRIDGE, MA

Dr. ROGOFF. Yes. Thank you. Thank you, Mr. Chairman and Senator Baucus, for the privilege of addressing the committee and adding my remarks to those of the Senators, as well as Chairman Greenspan and Secretary Snow, and the other panelists.

There has been a lot very sensible said here. I have submitted written remarks, and I will just try to abstract them.

[The prepared statement of Dr. Rogoff appears in the appendix.]

Dr. ROGOFF. The first thing to say is, we are talking about this trade balance problem in the context of a global problem. The stunning fact is not simply that the United States is borrowing over 6 percent of GDP last year, looking on track to do it the next year. The stunning fact is, if you add up all of the current account surpluses—that is an extended measure of the trade balance—of Japan, Germany, the OPEC oil producers—and they are, by the way, much larger than China in their current account surpluses—take all the surplus countries in the world, we are soaking up 75 percent of it. It is utterly unprecedented.

Chairman Greenspan referred to a dispersion of current account deficits. Well, yes, I mean, in the sense that it is very lopsided dispersion, that the United States is absorbing such a large amount.

Senator BAUCUS. Say it again. The United States is absorbing 75 percent?

Dr. ROGOFF. Seventy-five percent of all the world's current account surpluses are being eaten up by the United States. I will note that when Britain sort of ruled the roost in the 1800s, it was running surpluses up towards 10 percent. It is a highly unusual situation.

Now, maybe it will all unwind in a very benign way. I think the most likely way that that would happen is if it ended slowly and gradually went away over 15 or 20 years, and that is possible.

But I think there is also a possibility, because markets have a way of behaving in an unpredictable fashion, that it could be worse and we could see a very sharp drop in the dollar of 20 percent or more. Even that might be benign, but maybe it will not be. We look around, and Europe, Japan, and Latin America have very inflexible economies.

This could boomerang on the United States. It could lead to a sharp rise in our borrowing costs. Senator Baucus mentioned earlier the interest we pay on our loans.

Charles DeGaulle once described the United States as having an "exorbitant privilege," that it got to borrow at a much lower interest rate than anybody else, or to be precise, people will hold a lot of our debt, and we get to buy equities, plants, equipment, and risky things.

Well, we could lose that exorbitant privilege some day, or at least have to share it with the rest of the world. It would cost a lot. We have more than $10 trillion in debt, $11 trillion. If our borrowing costs were just to go up to what we get on bonds to the rest of the world, that would add $150 billion a year to our deficit. It is a significant problem.

There is no painless way to defuse this at this point. There is no magical solution. Certainly a mix of factors have been discussed. One would be more saving in the United States.

I do not know how you are going to persuade people to save more when their housing prices are going up at 15 percent a year, but more saving would be a good thing. The Federal Government, the State and local governments, clearly play a role. If they were to save more or to save less, it would be a factor.

I do not think anybody has a good number for how that would translate into the current account, although I think the 20 percent on the dollar that Chairman Greenspan cited, I would sort of say, is on the low side. I think it would make a bigger contribution than that under most plausible scenarios. But in the context of closing up the current account, these global imbalances, it is true that having more flexible exchange rates in Asia would help.

Now, I want to be clear that if they were fixing their exchange rates through, say, expanding domestic demand or lowering interest rates, if they were holding down their exchange rates that way, I mean, in terms of the way the global system works, we would have no beef. That is what these surplus countries are supposed to do, expand domestic demand. Some of it spills onto our goods, and that helps balance things.

But it is true that that, in large part, has not been what is going on. They have been accumulating reserves. I want to remind everyone—we heard it earlier—that we told them to accumulate reserves after the Asian crisis.

The IMF, the U.S. administration said, you should save for a rainy day. You need to build up your reserves. Well, of course, now China has $660 billion in reserves; Japan, $900 billion; Korea and Taiwan, over $200 billion. Even India has over $100 billion.

I think at this point we are not talking about saving for a rainy day, we are talking about building Noah's Ark in these regions. It is clearly an issue that needs to be addressed. It is not something that can go on.

I want to make two final points. One, is that I do think China should move to a more flexible exchange rate, but I do not think we should pretend that this is an easy step, that this is painless, that this is riskless.

Nobody quite knows how it is going to work. My experience in watching other countries over the years is the leaders tend to be terrified of floating, and, when they try it, they find out it is not so bad. But there are huge risks.

China is a very diverse economy. There are 450 million people who live on the coast, who live in this vibrant, dynamic economy, but there are 850 million people who live in the 18th century. They are much poorer. For them, their needs are different. Of course, just as Europe is having a hard time finding one system to balance its needs with the euro, it is not an easy problem for China.

Although I think within the G–7, within the IMF and other agencies, we need to press for Asian currencies to be more flexible, or at least to make their domestic demand more responsive. We have to acknowledge our role in this.

We cannot just say we are doing a good job, we are doing our share, you do ours, because that is patently not true. We are run-

ning significant fiscal deficits in a situation where our economy is growing in a healthy fashion, our private savings rates are very low. I do not think we can just say to this other great nation that we are doing our job, you do your job. I do not know if it calls for another Plaza agreement.

I agree with Chairman Greenspan, it is very hard to fix exchange rates. But it is a global problem, it needs a global solution. We need also to do our share. We cannot just tell the Asians, and the Chinese in particular, that they need to absorb and they need to take risks if we are not doing anything ourselves.

I think that the responsibility for the U.S. trade deficit is a shared global responsibility, but it has a large U.S. component, that the U.S. trade balance deficit is one thing that is still largely made in America.

The CHAIRMAN. Mr. Bredehoeft?

STATEMENT OF NEAL BREDEHOEFT, PRESIDENT, AMERICAN SOYBEAN ASSOCIATION, ALMA, MO

Mr. BREDEHOEFT. Good afternoon, Mr. Chairman and Senator Baucus. I am Neal Bredehoeft, a soybean and corn farmer from Alma, Missouri. I am currently serving as president of the American Soybean Association.

ASA represents 26,000 producer members across the country on national issues important to all U.S. soybean farmers. It is an honor to be here this afternoon to appear before you today on the vitally important subject of U.S.-China economic relations.

It is really impossible to overstate the importance of China as a market for U.S. soybeans. In 1996, the U.S. sold $414 million worth of soybeans to China, really a significant market at that time.

This year, the value of our soybean exports is expected to reach a record $2.96 billion. This represents a 7-fold increase in a decade which has seen China emerge as the largest foreign buyer of U.S. soybeans.

The 440 million bushels we expect to export to China in 2005 represent 40 percent of our total U.S. soybean exports, and 18 percent of last year's U.S. soybean harvest. In other words, today, nearly 2 out of every 10 rows of soybeans grown in the United States are destined to be exported to China.

Prospects for continued rapid growth in Chinese imports are excellent. China's population continues to expand and is becoming increasingly urban. As a result of dynamic economic growth, more Chinese consumers can afford, and are seeking, a higher standard of living, including more protein and vegetable oil in their diet.

China's ability to supply these needs through increased production of soybeans and other feeds and all seeds is limited, so most of the increased demand will be filled by imports.

Development of Chinese demand for soybeans has not been driven only by demographics and economic growth. Twenty years ago, the American Soybean Association established a presence in Beijing to develop what was then a very small market for U.S. soybeans.

Working with the Foreign Agricultural Service of USDA and the Soybean Check-Off, we have undertaken a variety of programs to

educate the Chinese on economic, nutritional, and other benefits of utilizing U.S. soybean meal for animal feed and soybean oil for human consumption. These efforts have clearly paid off.

We have also worked very closely with this and previous administrations to increase access to the Chinese market through trade negotiations.

ASA provided specific objectives to U.S. negotiators during talks on China's accession to the World Trade Organization and strongly supported approval of this agreement. We look to the current negotiations under the Doha development agenda to further improve the rules governing market access.

Our industry's trade relations with China have not been without difficulties. In 2002, Chinese government agencies began to require import permits and safety certificates for import of U.S. soybeans derived through biotechnology. These requirements went through a number of revisions and deadlines, resulting in disruption of deliveries and increasing risk and cost to U.S. exporters.

The situation was resolved only through the personal intervention of President Bush with the Chinese leadership, which U.S. soybean producers deeply appreciate.

We have also seen China act to restrict or quarantine imports of soybeans, both from the U.S. and other regions, due to the reported presence of diseases such as white mold, or of unapproved fungicide products. Additionally, we have seen China use its import inspection procedures as a de facto import licensing scheme to slow or limit imports.

Imposition of these restrictions and the resulting increase in soybeans processed in the domestic Chinese market have tended to coincide with anticipated harvests of China's soybean crop in the fall. While we have not experienced similar disruptions in the past year, they remain a serious and ongoing concern for the future.

Despite these difficulties, Mr. Chairman, we are hopeful that China is coming to accept greater access to its market for imported soybeans, and the imposition of illegal non-tariff barriers will become less frequent.

We believe improved behavior results from the constant application of even-handed pressure to respect trade agreements through discussion and negotiations. ASA and other U.S. agricultural organizations actively support this approach.

We certainly do not support measures that would try to force China to revalue its currency through imposition of punitive tariffs on imports of Chinese products. Such punitive, rather than constructive, measures are not likely to have the desired effect of changing China's policies, and could trigger retaliation by China.

The Chairman and others will recall another occasion when the United States used trade sanctions in an attempt to punish or correct international behavior. When we cut off grain exports to the Soviet Union in 1980, it sent a shock wave through world agricultural markets.

Not only were the Soviets able to source wheat and soybeans from alternative suppliers, but other major U.S. customers decided we were an unreliable supplier. The Japanese, in particular, invested heavily in development of soybean production in southern Brazil.

Today, Brazil has become our largest competitor for soybean exports and is rapidly emerging as an aggressive seller of cotton, sugar, rice, and bio-fields products. Twenty-five years ago, U.S. policymakers convinced themselves we could control agricultural trade.

Today, with the emergence of Brazil and other South American exporters, there can be no mistake. In response to trade sanctions, China could easily replace U.S. soybeans and other agricultural products from other sources. The result would be the loss of a growing $3-billion soybean market for U.S. soybean farmers that has taken us 20 years to develop.

China is a vital and growing market for U.S. agriculture sales. It is one of the strongest arguments for supporting efforts to open world markets through the Doha trade negotiations.

Any action to force changes in China's economic policies by imposing punitive tariffs would have the most negative consequences, not only for U.S. soybean exports, but also for efforts to liberalize the global trading system.

Thank you again for this opportunity to be here today.

The CHAIRMAN. Thank you, Mr. Bredehoeft.

[The prepared statement of Mr. Bredehoeft appears in the appendix.]

The CHAIRMAN. Now, Mr. Maloney?

STATEMENT OF SEAN MALONEY, EXECUTIVE VICE PRESIDENT, INTEL CORPORATION, SANTA CLARA, CA, ON BEHALF OF THE U.S. CHAMBER OF COMMERCE

Mr. MALONEY. Mr. Chairman and members of the committee, thank you for the opportunity to appear before you today at this important hearing. My name is Sean Maloney. I am executive vice president at Intel Corporation, and I am pleased to testify today on behalf of Intel and the U.S. Chamber of Commerce.

Our industry is a strong supporter of expanding free trade. Our ability to sell products in foreign markets is a critical part of what made us successful. On average, 3 out of every 5 dollars of revenue in the U.S. high-tech industry comes from outside the U.S.

China specifically represents a remarkable opportunity. Semiconductors were the second-largest export to China in 2004, with a healthy trade surplus. In China, 4 of the 10 most successful semiconductor companies are American. This market is worth $35 billion for our industry today, and is expected to be one-third of the world demand by 2006.

Since 1995, when we opened our first office in Beijing, we have grown to a workforce of 5,000 people across China, and have invested $1.3 billion in research and development assembly facilities, as well as sales and marketing operations.

Supply chain economics, brand building, the access, and recognition that comes from being part of the local community mandate that we must live near our customers. This strategy has paid off. Today, China is adopting the Intel Pentium 4 processor more quickly than any other country in the world.

As we celebrated our twentieth anniversary in China, we have become the world's largest semiconductor exporter to China. Intel

sales to China were nearly $5 billion in 2004, representing over 10 percent of our worldwide sales.

While our industry has grown strongly overseas, we remain committed to the USA. Although 75 percent of our annual revenues come from outside of the U.S., we employ 60 percent of our workforce here; 50,000 employees in Massachusetts, New Jersey, North Carolina, Arizona, Texas, Utah, New Mexico, California, Oregon, Colorado, Washington State, and others.

Since 1999, we have added over 15,000 jobs at our U.S. locations, and invested over $40 billion in factories, R&D, training and education. Over the last 10 years, we have also paid $20 billion in corporate income taxes.

Our commitment to the United States is manifest and enduring, in spite of our need to do business globally. China is a critical part of our global business and critical to our future growth. Considering its importance, it is not surprising that, when problems occur, they can have significant commercial and political ramifications.

Since China's accession to the WTO, however, there has been remarkable progress. Tariffs on most high-tech products immediately went to zero, contributing to the 200 percent increase in U.S. semiconductor exports. Our industry has also benefitted from the Chinese government's efforts to improve transparency in the promulgation of laws and regulations.

Despite these positive changes, we must continue to work together to address the problems that remain. Strong enforcement of intellectual property rules, commitment to global standards, as well as open and transparent government procurement policies must be the top priorities.

We have provided more details on these policy challenges in our written submission for the record. Although there has been good progress, there is still work to be done.

When a specific problem arises that needs immediate government attention, we believe that constructive dialogue and negotiations between both governments are the best path. In some cases, negotiations can help avoid lengthy litigation and prevent extended periods of uncertainty. We have seen this strategy succeed.

In July of 2004, the U.S. and Chinese governments announced that they had successfully negotiated an agreement to resolve disputes over value-added taxes in China. In doing so, both governments avoided a formal and lengthy WTO dispute, and healthy trade is allowed to continue.

In legal or policy areas where problems may arise in the future, the U.S. Government, industry, and other stakeholders should work together to implement capacity-building programs and share best practices with the Chinese government to avoid escalating disputes.

The U.S. and China must remain committed to resolving issues at hand without resorting to measures that will negatively impact workers and industries on either side of the Pacific. Our economic relationship needs to remain healthy for both countries and the global high-tech industry to prosper.

The CHAIRMAN. Thank you, Mr. Maloney.

[The prepared statement of Mr. Maloney appears in the appendix.]

The CHAIRMAN. Now, Mr. Lubrano?

STATEMENT OF AL LUBRANO, PRESIDENT, TECHNICAL MATERIALS, INCORPORATED, LINCOLN, RI, ON BEHALF OF THE NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. LUBRANO. Good afternoon, Mr. Chairman and Senator. My name is Al Lubrano. I am president of Technical Materials, Incorporated, a small manufacturer of engineered material systems primarily used in the electronics industry.

In addition to that market, we are also part of the automobile industry supply chain and sell to many of the major auto manufacturers' biggest suppliers. We have approximately 200 employees and are located in Lincoln, RI. That is a State, by the way.

I am also chairman of the Rhode Island Manufacturers Association, and am pleased to testify today on behalf of the National Association of Manufacturers.

As a member of the NAM's China Policy Subcommittee, I participated in the development of our 2005 China Trade Agenda that included vigorous participation and resulted in a consensus from both large and small NAM member companies.

The NAM seeks a positive and balanced trading relationship with China that reflects market forces as closely as possible. We want to get government interference out of Chinese exports.

That means an end to interference with currency values, subsidies, and an end to the theft of our intellectual property. China has emerged as a leading world economy, and this has meant significant opportunities for many NAM members.

My company has participated in these opportunities. Right now, we are selling high-technology plating material systems to companies in China that are not able to get this high-quality product they need from any Asian supplier.

In this case, we have overcome China's low-wage advantage through innovation and the use of technology. This situation is not sustainable long-term. As we explore possibilities for manufacturing in China, we have a grave concern for our intellectual property.

Additionally, as a result of fierce Chinese competition, I have seen many of our customers lose their business because their customers have sought refuge in one of two strategies, either an outright movement of production to China, or forcing purchasing from lower-cost Chinese manufacturers.

Some of our customers tell us that their customers will pay only the Chinese price. This has become a favorite ploy of auto industry purchasing managers.

Competing against low wages is one thing. We can do that with technology and innovation. But we should not have to put up with an artificially low exchange rate and subsidized production. It is particularly important that the Chinese end the significant undervaluation of their currency.

Would a considerably stronger Chinese Yuan have beneficial effects? Absolutely. Attached to my testimony is an analysis done by NAM staff that refutes a number of the common arguments that

a revaluation of the Chinese currency would not help American manufacturing.

I know from my own experience, and from talking to other companies, that currency revaluation is not a silver bullet—there is not a silver bullet—but it would certainly help. We are not just talking about the return of jobs to the U.S. Some will, but many will not because they were in sectors that left a long time ago.

We can, however, stem the loss of future production. Not what would go as a result of normal market forces, but I am talking about the production that is leaving because of the artificial advantages China gets from its managed exchange rate and from trade practices that are not consistent with international commitments.

We are pleased that the Treasury Department says China should make a significant move now, and that, absent a move by October, Treasury will cite them for currency manipulation, resulting in formal negotiations with China under the IMF.

This sends an important signal to the Chinese government and to American business that October is a date-certain for change in China's currency practice or Treasury will take firmer action.

The NAM supports the legislation to address this problem that was introduced by Senators Collins and Bayh. The report just issued by GAO on this subject states that it would be prudent for Congress to legislate in this area, and we agree.

China has also become the world's epicenter of counterfeiting, costing U.S. companies billions of dollars, thousands of jobs, and threatening consumer health and safety.

Earlier this year, NAM recommended to the USTR that the administration develop a WTO case to deal with what NAM president John Engler calls China's "grand larceny on a massive scale."

The NAM predicts that the trade deficit with China could reach $220 billion this year. At the present rate, it will grow to almost $500 billion in 5 years, larger than our entire manufactured goods deficit last year. There is no question that eliminating the severe Yuan under-valuation is an essential step in creating more balanced and sustainable trade flows.

Mr. Chairman, the issues I have outlined today are having a serious and negative effect on manufacturing in this country. We have an obligation to see that America's manufacturing base stays strong.

We can do that within the rules of the international trading system, but we must not be timid in the insistence that those rules be enforced, and we must act now.

Thank you very much.

The CHAIRMAN. Thank you, Mr. Lubrano.

[The prepared statement of Mr. Lubrano appears in the appendix.]

The CHAIRMAN. We will have 5-minute rounds.

Mr. Bredehoeft, you have heard reports, I am sure, that U.S. farmers are becoming increasingly skeptical about the benefits of trade. But it is clear that our agricultural sector, including even soybean growers, are heavily dependent upon export markets.

Do you believe that members of your organization are aware of the importance of foreign markets, including the Chinese market, for profitability in farming?

Mr. BREDEHOEFT. Yes, Mr. Chairman. In our industry alone, we export close to 50 percent of our crop every year. So, the members are very aware of the importance of export markets for our own bottom line.

That is something that we in ASA have spent the last 50 years-plus on, international marketing into different countries around the world. So, we are very supportive of markets that we can promote our soybeans into, and sell our soybeans into.

The CHAIRMAN. In your testimony, Mr. Bredehoeft, you note that the Soybean Association provided specific objectives to U.S. negotiators during talks on China's accession to the World Trade Organization.

What were some of those objectives? Were they met? If so, have U.S. soybean farmers benefitted from the fulfillment of those objectives?

Mr. BREDEHOEFT. Well, there were two areas that we were pretty persistent on. One of them was the quota on soybean imports. China, of course, wanted a certain quota, and we got that included, through talks with the trade negotiators, that there would be no quota on soybean imports.

Number two is what they call a growing tariff rate quota, in which they wanted to set the level of the tariff very high on imported beans and soybean oil especially.

But we were able to put that in as a growing tariff rate over years, which means that you can raise the amount of oil or beans into China starting out at a basis, and increasing on a yearly basis. Both of those areas were implemented and both of those areas are still working.

The CHAIRMAN. Mr. Lubrano, why do we need to apply countervailing duties to China? In other words, can you identify any specific cases that cannot be addressed using the Commerce Department's non-market economy methodology for calculating antidumping duties?

Mr. LUBRANO. Well, I think that the reason for the countervailing duties would come in where specific industries felt that there was harm being done because of subsidies. These cases would then be taken up to the administration, and then the countervailing duty rules would apply. I think there are many cases where that happens.

Some of our customers, in particular, when they have gone to compete, have actually come and told us that they cannot get the order if all they include in their pricing is the cost of materials alone. Clearly, there is some artificial phenomenon taking place here, and I would see that as a case where you would need these countervailing duties.

The CHAIRMAN. The Government Accountability Office report states that it is unclear whether applying countervailing duties to a non-market economy like China would result in levels of protection for our producers that are higher than those already applied in the form of antidumping duties. How would you respond to that?

Mr. LUBRANO. Well, the way I would respond to that is that what happens in the trenches and what happens in theory are two different things. I think there are two separate issues here relative to antidumping and subsidies.

I think the countervailing duty would prevail in the case of what would be considered subsidies. Antidumping is a different matter, and I would defer part of the answer to that to the NAM staff, but that would be my opinion on that. I am in the process of trying to determine how best to address the China market. I was just over there 2 weeks ago.

I would say to you that there are cases where firms are actually getting subsidies and are competing on a basis that is not realistic. In those cases, I would say the countervailing duties should be prevalent.

The CHAIRMAN. All right.

Mr. Maloney, what lessons are there to be learned from cases in which we have successfully resolved disputes with China, such as respect for China's wireless encryption standards and China's tax refund policy for semiconductor chips?

Mr. MALONEY. Often in China there is not a single point of decision making. So, a broad engagement with a number of people—it is a continent rather than a country—and detailed technical and commercial discussions and arguments are necessary.

So, I think a mixture of patience, but determination, and then broad engagement across the Chinese government and authorities is necessary.

The CHAIRMAN. All right.

Senator Baucus?

Senator BAUCUS. Just following up, Mr. Maloney, I think it was—correct me if I am wrong—Andy Grove who said that "only the paranoid survive." What is Intel's current paranoia?

Mr. MALONEY. Well, we have a number of them, for sure.

Senator BAUCUS. I am sure of that. The couple or three that pop on this general subject.

Mr. MALONEY. In the context of this discussion, the last 10 years, as was discussed earlier, have seen 3 billion people entering the global labor market, and 1.2 billion of those are in China. Those people are both consumers, and obviously, downstream, potentially competitors. You do not get one without the other.

So I think our paranoia, in the case of China, is we want to be in there enough so that we take our share of that market and sustain the jobs that are here in the U.S., manufacturing those products to go to China.

Senator BAUCUS. What is another one?

Mr. MALONEY. That will do for now.

Senator BAUCUS. All right.

Mr. MALONEY. The point here today is, there is no other opportunity on the table for the global high-tech industry that is anything as large as China. India is some distance behind that. The rest of the emerging markets are some distance behind that. So, constructing the balance of trade so that it carries on in a smooth, uneventful manner is very important.

The other point here is, the global high-tech industry is now heavily dependent upon China as a manufacturing base. A large proportion of the world's high-tech equipment, whether it is phones or computers, is manufactured in Guangdong province and the coastal regions of China. So, continuity of trade, without pushing the issues under the table, I think, is critical.

Senator BAUCUS. What is your sense as to how much value added is there now, and will there be in China, and how long will that take? We have autos being produced now in China. It is not just textiles and so forth, but it is technology, equipment, automobiles. As you look at China, are there any limits or not?

Mr. MALONEY. No. There is no theoretical limit. Looking at China as a competitor, you would have to take the same view, or Intel would, that we took of Korea and Japan, that if you stand still you are going to lose.

We slogged our way through the 1980s to get to the top of the world's list of semiconductor companies, overtaking the Japanese on the way. We have had strong battles with the Korean companies over the last 10 years.

I daresay, somewhere out there in the future there will be a Chinese equivalent. There is no substitute for staying paranoid and investing in staying ahead. There is no other way.

Senator BAUCUS. Dr. Rogoff, could you just help us understand a little better the role of other Asian countries and their currencies in conjunction with China? I think you wrote somewhere, if the U.S. current account deficit with China were cut in half, there would be about an 18-percent re-valuation in other Asian countries, and China would have to be around there, too. What is the role of other countries? I understand you think it is not just China.

Dr. ROGOFF. Asia, altogether now, is about a third of the global economy. China, depending on how you measure it, is between a sixth and a third of Asia. So, China's role, really, is it has become the leader in Asia. I think when people are hoping China will have a more flexible currency, that that will be leadership from China.

But the point about value added: the typical Chinese good exported to the United States only has 20 percent Chinese content. So, it is a tremendous illusion, the bilateral deficit with the United States. Several people have used the phrase that China is the "global assembler," that things get assembled somewhere else.

So just having flexibility in China is not really what this is about. It is really about Asia and, I might add, increasingly emerging markets in Latin America and elsewhere, because we are running this giant current account deficit and it is a lot of downward pressure on the dollar.

That is why everybody is desperately buying up reserves to try to keep their currencies low against the dollar. It is a losing battle, eventually. But it is a global phenomenon, and China is just representative.

Senator BAUCUS. Tom Friedman wrote this book, *The Earth is Flat,* and how, with telecommunications and new technologies, anything can be produced anywhere. Is that relevant to this discussion at all? I am just trying to understand the degree to which you agree with that phenomenon that he is talking about in his book.

Second, the degree to which that is relevant to this issue. And it is an Asian problem, it is a developing country issue as well. I guess maybe, Mr. Maloney, or any of you if you have any thoughts about that.

Dr. ROGOFF. Well, certainly the paranoia that China is going to produce everything that people have is just nonsense. These people

are entering the global economy and it is going to take a long, long time. Their income, per capita, is still only $1,100 per person.

Senator BAUCUS. But all those people on the east coast, though.

Dr. ROGOFF. They have the people on the coast who are at $4,000 per person. They are coming and they are very significant. It is a great benefit. But right now, it is something of an illusion, the high-tech goods that we see coming from China. Yes, they are going to do things in the future, but now it is mostly being imported into China and assembled in China.

Senator BAUCUS. Mr. Maloney?

Mr. MALONEY. From the context of competitiveness, by far the biggest issue is the education issue and the necessity of the U.S. to up the game on scientific and engineering education.

The amount of investment that China is putting into its universities and in the production of increasingly world-class engineering talent is something we should pay very close attention to, and there is absolutely no room for complacency there.

Senator BAUCUS. I totally agree. You heard Chairman Greenspan mention that we do all right in competing worldwide at the fourth grade level, but up toward twelfth grade, something goes haywire. First, do you agree with that assessment? If you do, what is to be done?

Mr. MALONEY. Well, I think it is difficult to argue with the assessment. It is a factual assessment. The encouragement of interest in U.S. children in engineering and in science is absolutely essential, and it is a task in which industry and government have a major role to play.

Mr. LUBRANO. If I could add on a more positive note, I think there are a lot of good things going on to address that. I know the Rhode Island Manufacturers Association is working in conjunction with educators to try to get children re-interested in manufacturing, re-interested in math and science.

I think the issue, in my mind, and the manufacturing company I run and the customers I interface with, is not protectionism, it is not having trade practices that do not make sense, it is really having a level playing field. We talked about that and heard about that a lot this morning.

Senator BAUCUS. Right.

Mr. LUBRANO. I think American manufacturers can still compete. They can still interest children in math, sciences, and manufacturing. If the playing field is level, we will take technology and innovation, as Intel has done, and other companies have done, and we will compete successfully on a global basis.

Senator BAUCUS. Do you not think it is 2-fold? One is a level playing field, that is true. But do you not think also, gleaning from what Mr. Maloney said, things are going on worldwide, and even if there is a level playing field, we have got to get our act together?

Mr. LUBRANO. I absolutely agree.

Senator BAUCUS. All right.

Mr. LUBRANO. I absolutely agree with that. But it is not any single thing.

Senator BAUCUS. I agree.

Mr. LUBRANO. Education, without a level playing field, is not going to work either.

Senator BAUCUS. Right. Right. Exactly.

Dr. Rogoff, you were going to say something?

Dr. ROGOFF. Yes. Thank you. Just on a positive note, you compared fourth grade and twelfth grade. I am a university professor. American universities just dominate the world in virtually every field. To some extent we do it by skimming the cream off the rest of the world with foreign students and foreign professors, but we have this incredibly competitive, vibrant system.

Senator BAUCUS. That is true. But that has been the case for quite a while now, and a lot of those things are kind of getting a little shaky, even though that has been the case for decades.

That is great, but I am just a little concerned about, (a) the K through 12 quality of education, and (b) the numbers are large numbers. India is a bigger country than the United States. China is a lot bigger country, has a lot more people, and is graduating a lot more engineers, and they are hungry. That is my concern.

Do you want to add anything, Mr. Maloney? I see you are nodding. I do not know if that means anything.

Mr. MALONEY. Well, yes. I agree with you. There is no question that the U.S. universities, in science and education, are still leading the world. There is no question about it. But every U.S. worker has 3 billion potential new customers and 3 billion potential competitors, so obviously we have to raise our game.

Senator BAUCUS. All right.

So what else do we do about education here in this country? We agree on the level playing field. We have got to be much more aggressive in leveling the playing field, that is true.

But what else can be done to get more science and engineers, kids in math? We are going to make the best products, we are going to be the most creative, software development.

Mr. LUBRANO. We had a discussion about this the other day. Again, the Rhode Island Manufacturers has Train RI, which is the educational arm of that organization.

One of the things we decided was that we are missing the boat in that we are not getting into the middle schools and really talking to children about manufacturing, science, math, engineering careers.

I think that is one of the very positive things that can be done, the manufacturing community getting back in, the math and sciences being stressed at the middle school, and these are the kinds of careers you can have. I think the global economy helps that.

Senator BAUCUS. One other program I saw—and I will wrap up here, Mr. Chairman—I do not know what university it is. I have forgotten the name of which university it is. We will say William & Mary.

They have a program where they will poll the graduating senior class and ask those graduating, who was your most inspirational, the best high school teacher? They worked at that pretty hard. They would find maybe the 20, 30, 40, 50 best high school teachers that that college graduating class had.

Then they go back and they bring those teachers, all expenses paid, back to campus during graduation week and really showcase

them and give them a big stipend, and they go back to their community, and so forth.

To me, that is a small thing, but it is important. It puts good teachers at a higher status. Most teachers go home and say, guess what happened to me? That kind of inspires other teachers and inspires other kids.

I do not know about you, but I think for most of us, we are really somewhat motivated by the best teachers we had, either in high school, college, or whatnot. That has kind of got us going. The more we can get motivators, it seems to me, that might, in a small way, be part of the solution here.

Anyway, thank you, Mr. Chairman. It has been a good hearing.

The CHAIRMAN. Thank you. Thank you all very much.

Hearing adjourned.

[Whereupon, at 1:08 p.m., the hearing was concluded.]

APPENDIX

Additional Material Submitted for the Record

Statement by Neal Bredehoeft, President
American Soybean Association

Good morning, Mr. Chairman and Members of the Committee. I am Neal Bredehoeft, a soybean and corn farmer from Alma, Missouri. I currently serve as President of the American Soybean Association. ASA represents 26,000 producer members on national issues important to all U.S. soybean farmers. We are honored to have the opportunity to appear before you today on the vitally important subject of U.S.-China economic relations.

It is impossible to overstate the importance of China as a market for U.S. soybeans. In 1996, the U.S. sold $414 million worth of soybeans to China – a significant market at that time. This year, the value of our soybean exports is expected to reach a record $2.96 billion. This represents a seven fold increase in a decade which has seen China emerge as the largest foreign buyer of U.S. soybeans. The 440 million bushels we expect to export to China in 2005 represent 40 percent of total U.S. soybean exports, and 18 percent of last year's U.S. soybean harvest. In other words, today, nearly two out of every ten rows of soybeans grown in the United States are destined to be exported to China.

Prospects for continued rapid growth in Chinese soybean imports are excellent. China's population continues to expand and is becoming increasingly urban. As a result of dynamic economic growth, more Chinese consumers can afford and are seeking a higher standard of living, including more protein and vegetable oil in their diet. China's ability to supply these needs through increased production of soybeans and other feeds and oilseeds is limited, so most of the increase in demand will be filled by imports.

Development of Chinese demand for soybeans has not been driven only by demographics and economic growth. Twenty years ago, ASA established a presence in Beijing to develop what was then a small market for U.S. soybeans. Working with the Foreign Agricultural Service of USDA and the soybean checkoff, we have undertaken a variety of programs to educate the Chinese on the economic, nutritional, and other benefits of utilizing U.S. soybean meal for animal feed and soybean oil for human consumption. These efforts have clearly paid off.

We have also worked very closely with this and previous Administrations to increase access to the Chinese market through trade negotiations. ASA provided specific objectives to U.S. negotiators during talks on China's accession to the World Trade Organization, and strongly supported approval of this agreement. We look to the current negotiations under the Doha Development Agenda to further improve the rules governing market access.

Our industry's trade relations with China have not been without difficulties. In 2002, Chinese government agencies began to require import permits and safety certificates for imports of U.S. soybeans derived through biotechnology. These requirements went through a number of revisions and deadlines, resulting in disruption of deliveries and increasing risk and cost to U.S. exporters. This situation was resolved only through the personal intervention of President Bush with the Chinese leadership, which U.S. soybean producers deeply appreciate.

We have also seen China act to restrict or quarantine imports of soybeans, both from the U.S. and other origins, due to the reported presence of diseases, such as white mold, or of unapproved fungicide products. Additionally, we have seen China use its import inspection procedures as a de-facto import licensing scheme to slow or limit imports. Imposition of these restrictions and the resulting increase in soybean prices in the domestic Chinese market have tended to coincide with the anticipated harvest of China's soybean crop in the Fall. While we have not experienced similar disruptions in the past year, they remain a serious and ongoing concern for the future.

Despite these difficulties, Mr. Chairman, we are hopeful that China is coming to accept greater access to its market for imported soybeans, and that imposition of illegal non-tariff barriers will become less frequent. We believe improved behavior results from the constant application of even-handed pressure to respect trade agreements through discussions and negotiations. ASA and other U.S. agricultural organizations actively support this approach.

We certainly do not support measures that would try to force China to revalue its currency through imposition of punitive tariffs on imports of Chinese products. Such punitive rather than constructive measures are not likely to have the desired effect of changing China's policies and could trigger retaliation by China. The Chairman and others will recall another occasion when the United States used trade sanctions in an attempt to punish or correct international behavior. When we cut off grain exports to the Soviet Union in 1980, it sent a shock wave through world agricultural markets. Not only were the Soviets able to source wheat and soybeans from alternative suppliers, but other major U.S. customers decided we were an unreliable supplier. The Japanese, in particular, invested heavily in development of soybean production in southern Brazil. Today, Brazil has become our largest competitor for soybean exports and is rapidly emerging as an aggressive seller of cotton, sugar, livestock, and biofuels products.

Twenty-five years ago, U.S. policymakers convinced themselves that we could control global agricultural trade. Today, with the emergence of Brazil and other South American exporters, there can be no such mistake. In response to trade sanctions, China could easily replace U.S. soybeans and other agricultural products from other sources. The result would be the loss of a growing $3.0 billion soybean market for U.S. soybean farmers that has taken us 20 years to develop.

China is a vital and growing market for U.S. agricultural sales. It is one of the strongest arguments for supporting efforts to open world markets through the Doha trade negotiations. Any action to force changes in China's economic policies by imposing punitive tariffs would have the most negative consequences, not only for U.S. soybean exports, but for efforts to further liberalize the global trading system.

Thank you again for the opportunity to appear today. I will be happy to answer any questions.

Prepared Statement of Senator Bunning

Thank you, Mr. Chairman.

I would like to welcome our guests to the committee.

This issue of American-Chinese trade relations is one that has troubled me for a long time.

In 1993, I stood on the floor of the U.S. House of Representatives arguing against the granting of most favored nation status to China.

Our trade deficit with China at that time was $18 billion dollars. In 2004, it was $162 billion.

Since China joined the WTO, to say that its record on living up to its obligations is "mixed" is being generous.

For starters, they have been violating the WTO prohibition on export subsidies and the IMF rules against currency manipulation by systematically devaluing their currency.

They keep their currency at an artificially low number level--all in a concerted effort to keep their goods cheaper than U.S. goods.

Furthermore, the record of the Chinese on the protection of intellectual property rights is a joke.

At the same time as other countries, notably Taiwan, are taking steps toward cracking down on folks who steal the creativity and innovation of others, the Chinese are making little if any progress.

In fact, they are acting as a haven for crooks that are being driven out of other countries by tougher law enforcement.

The Chinese are acting to frustrate the transitional review mechanism which is the annual review of its compliance with its WTO obligations--a requirement of its WTO accession.

They are refusing to open up their government procurement procedures.

They are putting up non-tariff barriers, such as putting in place unique technology standards, right and left.

I could go on reciting examples of the lack of good faith on the part of the Chinese government for hours.

I'm sure we will hear many more examples during the hearing today.

This dismal list of living up to the commitments it has made should come as no surprise to anyone who has followed how the Chinese have behaved over the years.

I have a number of questions, and I am looking forward to hearing your responses.

Thank you.

Statement of Senator Mike Crapo

Thank you, Mr. Chairman. Mr. Secretary, Mr. Chairman, and other distinguished guests, I welcome you here today for this important hearing.

Mr. Chairman, I would like to express my appreciation for your willingness to take on this difficult subject. In my short time on this Committee, I have been impressed by your eagerness to tackle many controversial matters pending in Congress, and today's hearing further demonstrates that fact.

Others Senators have already raised a number of the problems facing the United States in its trade relations with China. I also want to associate myself with the comments of others who have illustrated the importance of ensuring we have the right trade and monetary policies with China. Earlier this year, I supported the initiative of my colleague from New York to concentrate our attention on the currency exchange situation caused by the pegging of the Chinese yuan to the U.S. dollar. Since then, in meetings with experts, including with the Treasury Secretary, and in forums such as this, it has become apparent that currency manipulation cannot be the sole focus of our attention.

The scope of the problem requires a larger and more holistic approach. Our country has to develop a broad, overall policy of how we are going to deal with the current trade gap and Chinese monetary policies that confront us. China's GDP continues to grow at an impressive rate and we must be agile and industrious to meet the challenge of the new circumstances.

I appreciate the Administration's recent report identifying a series of interconnected approaches to resolving the complex problems caused by the exchange rate situation and the persistent trade deficit. I did note that, in reference to the currency, it does include a call on the Chinese to allow for a more flexible valuation of the yuan versus the dollar. This recognition is to be applauded. While this is an important point, it is only one step in a larger response. U.S. policy should address the entire panorama of how we interact with China and utilize our trade policies and the World Trade Organization's tools to encourage Beijing to establish the right policies. China is an important and growing trade partner and our policies must be as dynamic and thoughtful as the situation requires.

Mr. Chairman, I appreciate your calling this hearing and look forward to a healthy discussion with our witnesses. Thank you, Mr. Chairman.

Senate Finance Committee Hearing on U.S.-China Economic Relations
Opening Statement (Unabridged for Hearing Record) of Senator Chuck Grassley
Thursday, June 23, 2005

Today's hearing will explore economic relations between the United States and China. Before we turn to witness statements, I want to offer some comments on that relationship. After that I'll turn to Senator Baucus for his comments, and then we'll hear from our first panel. The fact that we're holding this hearing today demonstrates the importance of our trade with China. Consider where we were just 20 years ago. In 1985, we had $3.8 billion in exports to China, and we imported the same amount from China. Our two-way trade of $7.6 billion was equivalent to less than two-tenths of 1 percent of U.S. gross domestic product (GDP) that year.

In contrast, last year we had $34.7 billion in exports to China, and $196.6 billion in imports from China. Our two-way trade of $231.3 billion was equivalent to about 2 percent of U.S. GDP last year. And this growth in bilateral trade is only projected to continue. Some say that by 2010, China will surpass Canada as our largest single trading partner. The way we approach this developing relationship with China has vast implications for both our futures. We must be thoughtful in our actions and get it right. We cannot afford to act rashly, and get it wrong.

Now, there are a number of policy prescriptions floating around. Some say China's currency is a problem, so we need to slap 27 percent duties on Chinese imports as soon as possible. Some say Chinese subsidies are a problem, so we have to apply our countervailing duty laws to China as soon as possible. Some say we should call for more cases to be brought against China in the World Trade Organization as soon as possible. And those are just a few of the ideas out there. Maybe those folks are right. But before I rush to any conclusions, I think we need to take stock of the problems that exist and the efforts of the Administration to address those problems, and then consider whether there are any appropriate legislative measures to complement those efforts. This hearing is a step in that direction.

Senator Baucus and I are taking another step by requesting that Ambassador Portman appear before the committee after he completes his top-to-bottom review of the Administration's trade policy toward China. Our letter requesting that meeting is being sent to Ambassador Portman today. The fact is, we've had some important successes in securing China's compliance with its trade obligations. I want to further those efforts, not undermine them. Therefore, I intend to wait to hear from Ambassador Portman before I consider supporting any new legislation.

The Administration has a responsibility to keep this committee informed about developments in its trade policy toward China. And we also have a responsibility to ensure that USTR has the resources it needs to effectively administer that policy. Earlier this year, I joined some of my colleagues in trying to get an additional $2 million appropriation to fund 16 new positions at USTR and to cover unplanned security costs. But I was stymied in that effort. I hope my colleagues will join me to see that those funds are in fact appropriated by the end of the year.

China's economic integration and commitment to the rule of law was formalized with its accession to the World Trade Organization in December 2001. Since then, our bilateral trade has almost doubled. I supported China's accession to the WTO because that offered the dual benefits of opening China's market to U.S. exports and also committing China to respect the rule of law in our international trade relations. And we've reaped those benefits to some extent. Exports from my

home state of Iowa almost tripled from 2000 to 2004. Pennsylvania and New York saw their exports to China more than double over the same period. And exports from Tennessee to China increased more than seven-fold.

But that doesn't mean we can be complacent. China's commitments on paper must be matched by actions that demonstrate full adherence to its obligations. And the fact is, China's compliance record has been spotty. I've been vigilant in monitoring our trade relations with China. I've fought to ensure that Iowa's exporters enjoy the market access they expect from China's accession to the WTO. In September 2003, I wrote an article highlighting concerns about China's use of non-tariff barriers to trade and China's failure to adhere fully to its WTO commitments. In October 2003, I followed up with a lengthy letter to China's Minister of Commerce, in which I pressed for action on a number of deficiencies in China's implementation of its WTO obligations. I encouraged the Administration to address these issues with China as well. One of the issues I raised was how China failed to provide the full market access for our soybean exports that was promised in China's accession agreement. Today, U.S. soybean exports to China are expected to reach a record of almost $3 billion for the full year, and China is our number one export destination for U.S. soybeans. I look forward to hearing more on this from Neal Bredehoeft, President of the American Soybean Association, later today.

In November 2004, I joined Senator Baucus in writing to the Chinese Ambassador and China's Minister of Industry and Information regarding draft regulations on government procurement of software that would shut U.S. companies out of the Chinese market. As China prepares its final regulations, we must insist that discriminatory regulations that distort trade are simply not acceptable. I note that China has yet to sign the WTO Government Procurement Agreement. China should do so without delay. More recently, in April I joined every other member of this committee in writing to President Bush to express our concerns over China's deficient enforcement of laws to protect intellectual property rights. We stressed that China must fully live up to its commitments in joining the WTO. That's the bottom line, and I will remain vigilant in demanding no less from the Chinese. I will not stop until our exporters in Iowa and across the United States enjoy the access to China's market that they were promised – and, once in the Chinese market, that they enjoy the legal protections that our international agreements require.

Now, the bilateral trade issues I've discussed are all vitally important. But they are not primary purpose of today's hearing. Today's hearing is primarily meant to explore the macroeconomics of our trade relations with China. The Committee will hear from some distinguished witnesses, and it's my hope that their testimony will help inform the development of appropriate policy to improve our trade relations. Right now the United States and China are the engines of global economic growth. We need to ensure that growth occurs in a positive, sustainable manner.

Which brings me to our bilateral trade deficit with China. Some argue that our bilateral trade deficit means jobs are migrating from the United States to China. But I understand that according to the Congressional Budget Office, the primary factor driving the increase in U.S. imports of goods from China is that manufacturers have shifted the final assembly of many of their products from other countries in Asia to China. Much of the value of Chinese exports consists of parts made elsewhere in Asia. The U.S. bilateral trade deficit with China reflects the net balance of trade in goods with many Asian countries that are channeled through China.

For example, between 2000 and 2002, the U.S. trade deficit with China grew 33 percent from $84.3 billion to $104.2 billion. But while U.S. imports from China increased by $25.2 billion over this period, imports from other East Asian countries decreased by $48.8 billion. The net result was an overall $23 billion decrease in imports into the United States from all East Asian countries in the period of 2000-2002.

It seems to me that this changing pattern of trade has broad policy implications. A policy designed to reduce our trade deficit with China could simply have the effect of redistributing a portion of that deficit to other countries in Asia. And that would not help reduce any potential instability associated with our overall trade deficit. Nor would it help retain and grow jobs here in the United States. I look forward to hearing the views of our witnesses on this issue.

Another issue to be explored today is China's currency valuation policy. China has maintained a fixed exchange rate for its currency of about 8.3 to the dollar since 1995. I believe a flexible, market-based valuation of China's currency is necessary for China's long-term economic growth and prosperity. And it's important for ours, too. I've stressed that to the Chinese, and to our Administration as well. Without a floating exchange rate policy, China runs the risk of impeding its economic competitiveness and fostering inefficient economic decision-making. That could make an eventual currency adjustment that much more painful, for China and for China's trading partners. Those risks only loom larger as China becomes a more important participant in the global economy.

Finally, this hearing is also intended to provide Senator Collins and Senator Bayh the opportunity to discuss a bill they are cosponsoring that would extend our countervailing duty law to non-market economies such as China. I'm still not persuaded of the need for this legislation. Just this week, GAO released a report that raises legal and administrative concerns that need to be addressed if this concept is to be developed legislatively. At a minimum, I would need to feel certain that those concerns are allayed before I could consider supporting such legislation. With that framework in mind, I will now turn to Senator Baucus for his opening remarks.

CHARLES E. GRASSLEY, IOWA, CHAIRMAN

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United States Senate
COMMITTEE ON FINANCE
WASHINGTON, DC 20510–6200

June 23, 2005

The Honorable Robert J. Portman
United States Trade Representative
Winder Building, 600 17th Street, N.W.
Washington, D.C. 20508

Dear Ambassador Portman:

We are writing with respect to your review of the Administration's trade policy toward China. During your confirmation hearing in April, you indicated that you would conduct a top-to-bottom review of our ongoing trade issues with China. We understand that you have since visited China, and that key personnel responsible for the China portfolio in your office are in China right now working on our outstanding issues. We applaud your prompt attention to this very important matter. Serious challenges remain with respect to China's compliance record, and many U.S. businesses are still not able to maximize their opportunities in the Chinese market. Five areas remain of particular concern, *i.e.* intellectual property rights, agriculture, services, industrial policies, and procurement.

China must significantly improve its enforcement of intellectual property rights protections. Similarly, China must improve the transparency of trade in agricultural goods and trade in services. In particular, China must implement outstanding services commitments, such as those distribution services commitments which came due in December 2004. In addition, China must not resort to industrial policies that limit market access for non-Chinese origin goods and services, or that aim to extract technology and intellectual property from foreign rights-holders. And finally, given troubling signs in the direction of China's procurement policies, China must begin the process of joining the WTO Government Procurement Agreement.

We expect that you will raise these and other outstanding issues with China during the next meeting of the Joint Commission on Commerce and Trade. In addition, we request that you appear before the Finance Committee after you complete your review. The Committee expects to be kept informed of developments in the Administration's trade policy toward China.

Again, we appreciate the seriousness with which you are approaching this very important matter. We look forward to working with you to ensure that U.S. farmers, ranchers, manufacturers, and service providers, fully realize the benefits of China's membership in the World Trade Organization and integration into the global economy.

Sincerely,

Chuck Grassley
Charles E. Grassley
Chairman

Max Baucus
Max Baucus
Ranking Member

Prepared Statement of Alan Greenspan
Chairman
Board of Governors of the Federal Reserve System

Mr. Chairman and members of the Committee, I am pleased to be here today to offer my views on China's trade and exchange rate regime. I would emphasize that the views I will express are my own and do not necessarily represent those of the Federal Reserve Board.

Some observers mistakenly believe that a marked increase in the exchange value of the Chinese renminbi (RMB) relative to the U.S. dollar would significantly increase manufacturing activity and jobs in the United States. I am aware of no credible evidence that supports such a conclusion.

The enhanced integration of China into the world trading system is having a notable effect on Asia's trade with the rest of the world and on trade within Asia. After having risen rapidly through the 1990s, U.S. imports from Asia excluding China have flattened since 2000. This has occurred as production within Asia has evolved, with the final stages of assembly and exporting to the United States and elsewhere becoming increasingly concentrated in China. As a consequence, because exports by country are recorded on a gross basis rather than as value added, the widening of the United States' bilateral trade deficit with China, measured gross, has largely been in lieu of wider deficits with other Asian economies, including Japan. Measured by value added, our bilateral deficits with China would have been far less, and our bilateral deficits with other Asian exporters would have been far more.

Accordingly, an increase in the exchange rate of the RMB, relative to the dollar, would likely redirect trade within Asia, reversing to some extent the patterns that have emerged during the past half decade. However, a revaluation of the RMB would have limited consequences for overall U.S. imports as well as for U.S. exports that compete with Chinese products in third markets. Such a revaluation would affect Chinese value added but not the dollar cost of intermediate goods imported into China from the rest of Asia, which represents a significant share of the gross value of Chinese exports to the United States and elsewhere. (To the extent that exporters to China revalued as well, of course, the impact on overall Asian exports would be somewhat greater.)

The broad tariff on Chinese goods that has recently been proposed, should it be implemented, would significantly lower U.S. imports from China but would comparably raise U.S. imports from other low-cost sources of supply. At only slightly higher prices than prevail at present, U.S. imports of textiles, light manufactures, assembled computers, toys, and similar products would in part shift from China as the final assembler to other emerging-market economies in Asia and, perhaps, in Latin America as well. Few, if any, American jobs would be protected.

More generally, any significant elevation of tariffs that substantially reduces our overall imports, by keeping out competitively priced goods, would materially lower our standard of living. A return to protectionism would threaten the continuation of much of the extraordinary growth in living standards worldwide, but especially in the United States, that is due importantly to the post-World War II opening of global markets. Such an initiative would send the adverse message to our trading partners that the United States, while accepting the benefits of broadened world trade, is not willing to absorb the structural adjustments that are often necessary.

To maintain a rising standard of living, a dynamic economy such as ours requires a continual shifting of resources toward the most up-to-date technologies, financed not only by savings but also importantly by the depreciation of increasingly obsolescent facilities.

This highly dynamic process is mirrored in our labor markets, where jobs are constantly being created and destroyed at a rapid pace. New hires in the United States currently average more than a million per week, half resulting from voluntary job change. At the same time, during a typical recent week, about 150,000 workers are temporarily laid off and another 225,000 are subject to permanent job loss. Any effect of trade with China on U.S. employment is likely to be very small relative to the scale of job creation and job loss in our economy.

A policy to dismantle the global trading system in a misguided effort to protect jobs from competition would redound to the eventual detriment of all U.S. job seekers, as well as of millions of American consumers. Policy should aim to bolster the well-being of job losers through retraining and unemployment insurance, not to stave off job loss through counterproductive efforts to impede the process of income-enhancing international trade and globalization.

While the presumption that a revaluation of the RMB will notably increase jobs in the United States by constraining imports or expanding exports is without statistical or analytical support, it is nonetheless the case that a more flexible RMB would be helpful to China's economic stability and, hence, to world and U.S. economic growth. Rapid accumulation of foreign, largely dollar, reserve holdings by the People's Bank of China, China's central bank, as a consequence of support for the RMB could boost the growth of the money stock, with the accompanying risk of triggering upward pressure on inflation and a general overheating of the Chinese economy.

The Chinese central bank's issuance of liquidity management bonds to lessen potential increases in the money supply created by foreign asset accumulation has accelerated since regular issuance began in April 2003. Nonetheless, only about one-half of the increase in reserves over the past two years has been offset, with the remainder showing through as money growth.

Because the Chinese financial system has considerable distance to go before achieving a satisfactory degree of soundness and flexibility, sterilization of continuing inflows of speculative funds will presumably become more difficult as the scale of these operations, already large, increases over time. In spite of its recent improvements, the financial system of China is still inordinately governed by administrative command and control. Market pricing of financial instruments is still accorded only a minor role.

Financial markets, if left free to continuously reprice interest rates and asset values, will identify and respond to imbalances far sooner than a system based on administrative edict. In market-based financial pricing systems, automatic adjustments are inherent. But in a highly administered system, supervisors can identify emerging imbalances only when these imbalances become visibly large and are already troublesome. Adjustment in a system requiring human intervention is accordingly far less flexible than in a system based on the automaticity of markets. Given this vulnerability to emerging imbalances, the buildup of ever-larger holdings of bonds resulting from sterilization of foreign exchange purchases poses threats to China's financial stability. Hence, the sooner the Chinese, in their own self-interest, move to a more flexible currency regime, perhaps leading other Asian currencies to become more flexible as well, the better for all participants in the global trading system.

In the decades ahead, it is in our interest and that of the global economy that China continue to progress toward becoming a more market-based, productive, and dynamic economy in which individual initiative, not government decisionmaking, is the fundamental strength behind economic activity. For our part, it is essential that we not put that outcome, or our future, at risk with a step back into protectionism.

Chairman Greenspan subsequently submitted the following in response to written questions received from Senator Max Baucus in connection with the hearing on June 23, 2005, before the Senate Committee on Finance:

1. Mr. Chairman, in February of this year you stated that Asian central bank purchases in support of their currencies "may be supporting the dollar and U.S. Treasury bond prices." Since February, Asian central banks have continued their massive purchases of dollar assets.

Can you today say with greater certainty that Asian central banks are propping up the dollar and U.S. asset prices? If so, can you estimate the impact on the dollar if Asian central bank intervention would taper or cease?

If so, how does this affect our competitiveness of our export industries? Is there a way to measure this impact?

How do we get them to cease their intervention?

It is difficult to explain or predict exchange rates under most circumstances, and this is true as well for the dollar's exchange rate against most Asian currencies. Japan's monetary authorities have not intervened in currency markets in more than a year. Although intervention by some emerging-Asian central banks has continued in the first six months of this year, the overall pace of central bank intervention has declined somewhat from that of last year. Despite the lower pace of intervention, the dollar has appreciated considerably so far this year against most other currencies, including most Asian currencies.

The U.S. assets purchased by Asian central banks are primarily Treasury, agency, and corporate bonds. Given the depth of the U.S. bond markets, the effect of these purchases on U.S. bond yields is likely to be modest.

The exchange value of the dollar is one factor that affects U.S. export industries. But there are many other factors that also affect the competitiveness of our exporters, such as U.S. productivity growth, materials costs, trade barriers, and the pace of economic activity abroad.

I would also note that in a flexible and competitive economy such as that of the United States, market forces direct resources and activity to their most productive uses. What matters is not the size of any particular sector, but rather the size and productivity of the economy as a whole.

Asian governments are unlikely to continue to intervene at recent rates. At some point, they are likely to find that large-scale intervention to hold down the exchange value of their currencies creates domestic economic problems, such as rising inflation. Attempts to limit inflationary effects through sterilization of foreign exchange purchases may lead to other problems in still-developing financial systems. In the long run, greater flexibility of exchange rates is in the interest of most countries, including the Asian countries.

2. Mr. Chairman, one consequence of Asian central bank purchases of dollar assets is lower interest rates. This encourages investment in interest sensitive sectors, like housing. In addition to soaring housing prices, there has been significant growth in home equity loan advances and cash-out refinancings.

You yourself have noted that growing home mortgage debt correlates with our growing current account deficit. In your opinion, as more Americans take on mortgage debt, will our current account deficit continue to grow?

Further, what does overinvestment in the housing sector mean for investment in those industries that can boost our exports?

How does this diversion away from the tradable goods sector into the non-tradable goods sector affect our long-term competitiveness?

It is difficult to gauge the impact of Asian central bank purchases on U.S. interest rates, but as I have noted, this impact is likely to have been modest, given the depth of U.S. bond markets. Moreover, although low interest rates certainly have contributed to rising housing prices and associated increases in mortgage debt, other factors likely have been important as well, including solid income growth, innovations in financing techniques that have improved the availability and lowered the costs of home mortgages, and demographic and productivity trends leading to a long-term uptrend in housing prices.

The change in U.S. home mortgage debt has, indeed, been correlated with our current account balance over the past half century. However, it is not clear that, going forward, the pace of growth of mortgage indebtedness will continue undiminished. Additionally, the correlation between mortgage debt and the current account balance likely does not reflect a line of causality running exclusively from the former to the latter. Both mortgage debt and the current account are the product of dynamic and complex interactions among asset prices, spending, and production decisions in the American economy.

Heavy investment in residential construction does not, by itself, imply under-investment in our export sector. In fact, all else equal, the low interest rates that have supported the housing sector have made investment in other sectors attractive as well. During the late 1990s and early part of this decade, the relatively elevated level of the

dollar likely restrained exports and, in consequence, may have posed some disincentive to investment in the export industry. More recently, however, the dollar has fallen, foreign growth has picked up, and exports have accelerated. There are no indications of important capacity constraints in the export sector at present, and in our flexible and competitive economy, market forces will channel investment toward those sectors with the greatest potential for profitability and growth.

3. Mr. Chairman, much has been made of borrowing from abroad and the availability of cheap credit in our economy. I am concerned that this borrowing is adding up. Our foreign debt to GDP ratio has now reached 25 percent, a level not seen since 1893. According to conservative estimates, we are set to hit a foreign debt level equal to 40 percent of GDP by 2007.

To me, this growing indebtedness hurts the long-term competitiveness of our industries, as more of our nation's production goes to paying off our loans instead of investing in our future. Do you agree with this assessment? What fiscal and monetary policy steps must we take to reverse this disturbing trend?

What are the primary factors driving the deterioration in the income account of the current account? According to your estimates, how much will the income account deteriorate over the next ten years?

At its most fundamental level, the growth of the negative net international investment position of the United States represents an excess of domestic investment over domestic savings. That is, net financial inflows from the rest of the world have allowed the United States to increase its domestic capital stock at a rate faster than would have been possible had we relied solely on domestic savings. The resulting larger capital stock has increased the competitiveness of the U.S. economy.

It is true that in the future some share of our domestic product will be devoted to servicing our international borrowing; and if our borrowing continues at its current pace, that share will likely grow. Nonetheless, to the extent that we invest wisely and the rates of return on our incremental investments exceed the rates of return on our borrowing, the net impact on U.S. income and competitiveness will be positive.

This does not imply that the current paths of our external balances are optimal. In particular, paths with a higher rate of domestic saving combined with a macro environment that remains conducive to investment and growth would lead to higher future income. Fiscal policy can play a useful role toward this end in that a reduction in the fiscal deficit directly raises total domestic savings. Monetary policy can also play a role by fostering full employment with low inflation.

The primary factor determining the evolution of the net investment income balance in the current account is the growing net international liability position. However, the investment income balance also depends on the composition of the various investments and their rates of return. At present, the rate of return that U.S. residents receive on their investments abroad exceeds the rate of return that foreigners receive on their investments in the United States. As a result, the U.S. balance on investment income is near zero despite a large net liability position. There is no guarantee that future investments will enjoy such large rate-of-return differentials, and it is reasonable to expect the investment income balance will turn negative if our net international indebtedness continues to increase. Another factor that has kept net investment income contained is the low level of dollar interest rates.

4. What is the impact of the federal budget deficit on the current account? What is the impact on the current account (in percentage terms), for each dollar by which the budget deficit is reduced? Are these estimates broadly supported in economic literature?

While considerable attention has been devoted to assessing how fiscal deficits affect the current account balance, substantial uncertainty remains about their quantitative impact.

There are two basic approaches to estimating the impact of a fiscal deficit on the current account balance. The first approach utilizes large-scale econometric models of the global economy. A fairly typical result from the large-scale models used by the staff at the Federal Reserve is that a government deficit of 1 percent of GDP--or roughly $120 billion--causes the trade deficit to expand by less than 0.2 percentage point of GDP, or roughly $25 billion (the effects on the current account are a bit larger than on the trade balance given that the United States is a debtor country, and that interest rates rise). These effects are not very sensitive to whether the fiscal deficit is induced by a cut in tax rates or a rise in government spending.

Some alternative large-scale econometric models imply that fiscal deficits have somewhat larger effects on the trade balance than our models, though usually not exceeding double the 0.2 percentage point of GDP response mentioned above. Even so, the higher estimates from these alternative models typically depend on certain features that Federal Reserve staff regard as somewhat implausible, including a strong responsiveness of the exchange rate to fiscal policy changes, and a very high sensitivity of imports and exports to exchange rate movements.

An alternative approach uses small-scale statistical models to attempt to uncover a systematic relationship between fiscal policy and the trade balance in historical data. These statistical models have yielded a much wider range of estimates of the effects of fiscal deficits on the trade balance than the large-scale econometric models. For example, one researcher reported that a $1 increase in the U.S. fiscal deficit resulted in an expansion of the U.S. trade deficit ranging between $0.22 and $0.98. By contrast, another reported the surprising finding that U.S. fiscal deficits appear to improve the trade balance!

Chairman Greenspan subsequently submitted the following in response to a written question received from Senator Jon Kyl in connection with the hearing on June 23, 2005, before the Senate Committee on Finance:

1. What U.S., WTO, and other legal means does the United States have to require China to abide by its global trade obligations (meaning, intellectual property protections, WTO accession commitments, transparency, etc.)?

When China acceded to the World Trade Organization (WTO) in 2001, it committed to abide by a number of policies agreed to in pre-accession negotiations with other WTO members. Monitoring its progress on achieving these commitments occurs through a number of mechanisms. First, the WTO itself monitors China's performance. As part of the accession process, a "transitional review mechanism" provides for annual reviews of China's policies for the first eight years of membership and a final review (likely in year ten). Second, the United States Trade Representative (USTR) reports annually to Congress on China's compliance with its commitments. Finally, as part of the Special 301 process, the USTR reviews the intellectual property rights (IPR) protection of foreign countries, including China, annually, and may place them in Priority Foreign Country, Priority Watch List, or Watch List categories, depending on the extent of their shortcomings. (In the most recent report, China was elevated to the Priority Watch List.)

There are also a number of mechanisms in place to resolve concerns that the United States has with China's policies. First, through the U.S.-China Joint Commission on Commerce and Trade (JCCT), the United States meets with China to work through problems on a bilateral basis. In addition, the United States is able to bring complaints about specific Chinese policies to the WTO Dispute Settlement Body. Moreover, in cases where the United States finds evidence that Chinese companies are "dumping" their products in the U.S. market or are being subsidized by the Chinese government, the United States may impose duties on China's exports to the United States, subject to review by the WTO.

At the recent G8 summit held in Gleneagles, the leaders issued a statement on reducing IPR piracy and counterfeiting. They pledged to promote and uphold laws and procedures to strengthen IPR enforcement, to improve coordination of IPR-crime fighting strategies, and to work with developing countries to strengthen their legislation and to enhance their enforcement capacities. A group of experts, slated to meet in the fall, will lay out a plan for achieving these goals.

Statement of Al Lubrano
President, Technical Materials, Inc.
and
Chairman, Rhode Island Manufacturers Association

On Behalf of
The National Association of Manufacturers

Before
The Senate Finance Committee

"U.S.- China Economic Relationship"

June 23, 2005

Mr. Chairman and members of the Committee:

I appreciate the opportunity to participate in this very important hearing. My name is Al Lubrano, and I am president of Technical Materials Inc., a small manufacturer of engineered materials systems primarily for the electronics industries. In addition to other markets we serve, we are also part of the auto industry supply chain and sell to many of the major auto manufacturers' biggest suppliers. We are located in Lincoln, Rhode Island. I am also the Chairman of the Rhode Island Manufacturers Association which represents 200 companies in our state.

I am pleased to testify today on behalf of the National Association of Manufacturers (NAM) at this hearing regarding our trading relationship with China. The National Association of Manufacturers is the nation's largest industry trade association, representing small and large manufacturers in every industrial sector and in all 50 states.

No other trade subject comes close to commanding the attention that China is getting from NAM companies. China is simultaneously the greatest concern of many of our import-competing members and the fastest-growing global market for many companies that operate internationally. China has emerged within a short span of two decades as a strong international competitor in a wide range of manufactured products and a key market for U.S manufactured exports.

As a member of the NAM's China Policy Subcommittee, I participated in the development of our 2005 China Trade Agenda, a process that included vigorous participation from both small and large NAM member companies. The fact that we developed a separate China policy is an indication of its importance to NAM members.

The entire agenda is available at www.nam.org/trade. It is a realistic agenda that seeks a trade relationship that is fully within the rules-based trading system, and is one in which market forces determine trade to the fullest degree with minimal governmental intervention – particularly by ending currency intervention, enforcing intellectual property rights, and countering subsidies.

Let me make it plain that the NAM is seeking a positive and productive trading relationship with China. China is one of most important factors in world trade and will only become more important. The NAM worked hard to support China's membership in the World Trade Organization (WTO), and we remain fully supportive of that membership. Bringing China into the WTO required it to begin following the same trade rules as the rest of the world and to open its markets more fully. We now need to see that China implements its obligations fully – particularly in areas such as protecting intellectual property.

China is the largest single bilateral trade factor affecting manufacturing. In 2004, we had a global trade deficit in manufactured goods of $490 billion. Two-thirds of that total is with Asia and over one-third is with China. China's exports are not only having a significant direct effect on many U.S. producers, but also are exerting downward pressure on prices at a time when domestic costs are rising. A large number of U.S. manufacturers cannot pass on their production costs because of the so-called "China price." Notwithstanding the recovery in manufacturing, a number of sectors that have borne the brunt of China's emergence as an industrial power have continued to lose revenue and jobs.

Despite the significance of this, it is incorrect to view China as the principal cause of the loss of 3 million U.S. jobs in manufacturing, as some have alleged. It certainly has been a factor in that job loss, but it is not the most significant factor. The bulk of the job loss has stemmed from the general undervaluation of many currencies against the dollar – a factor which only recently has begun to be corrected, the domestic manufacturing recession that only recently ended, and domestic cost factors that are making it more expensive to produce in America at the same time that companies lack pricing power. Above-trend productivity growth has also been a factor.

Illustrating the problem, since 1994 prices in the rest of the economy have risen 20 percent, but prices of manufactured goods as a whole have fallen steadily and now stand nearly 7 percent below their 1994 level, in part because of the "China price" problem. Cost pressures, though, have continued for U.S. producers, including those from regulatory policy, excessive litigation, a tax system that disadvantages U.S. producers globally, increasing health care costs and energy prices. The NAM estimates that these domestically imposed costs account for a 22% cost disadvantage.

The largest trade factor affecting jobs was the dramatic drop in U.S. exports from 2000-2003 due to the overvalued dollar, which began its 25% run-up in 1997, peaked in 2002 and is still about 10 percent higher than when it started its run-up. It is true that the U.S. trade deficit in manufactured goods worsened by about $90 billion during the time manufacturing lost 3 million jobs, but about 80 percent of the increase in the deficit came from the collapse in U.S. manufactured goods exports.

Imports have also been a factor. Import penetration (the import share of the U.S. market for manufactured goods) has been increasing, raising imports higher than they would have been. Since 2001, for example, total import penetration of the U.S. manufactured goods' market grew 2.2 percent. China's import penetration grew 1.6 percent during this period, three quarters of the total increase. At the same time, import penetration from the rest of Asia fell only slightly – 0.2 percent. Thus it is obvious that increased Chinese import penetration has not been offset by decreased import penetration on the part of other Asian countries.

China Trade Deficit

Last year U.S. merchandise imports from China were $197 billion , while exports to China were $35 billion, resulting in a trade deficit of $162 billion – the largest with any country in the world (See Exhibit 1). U.S. imports from China are now almost six times as large than our exports to China. Much has been said about China being our fastest growing export market, but looking at Exhibit 2, it is plain that U.S. exports to China have been on a plateau since the third quarter of 2003, and U.S. exports are losing market share in China. This is a serious problem that demands more attention than it is receiving.

Imports, however, have continued to surge, and in the first quarter of 2005 were 30 percent above the same period of a year ago. Rapidly rising imports of textiles were part of the reason, but there were also significant increases in machine tools, electric machinery and plastics. Based on first quarter numbers, we are on track to have a $220 billion trade deficit with China for 2005 – up nearly $60 billion from last year.

As Exhibit 3 shows, if the recent rates of export and import percent growth continue, the U.S. bilateral trade deficit with China would be nearly $500 billion in five years – larger than our manufactured goods trade deficit with the whole world last year. The mathematics of a deficit when imports are nearly six times as large as exports are quite compelling.

The problem is still manageable, if it is addressed now, within world trade rules, to address the factors that are pushing such a growing trade imbalance, including China's undervalued currency that confers an artificial advantage to its products and distorts trade flows. The NAM rejects protectionism. We must avoid damage to the entire global trading system because we have failed to address problems in our trading relationship with China in a positive way. We must act to see that China follows global rules – particularly those set by the World Trade Organization and the International Monetary Fund.

Effect of China on Many U.S. Companies

As I said earlier, China's emergence as a leading world economy has meant significant new opportunities for many NAM members, including increased export and investment, and these should be nurtured. Other companies, however, see prices of Chinese products so low that it is difficult for them to see how they can compete. Yet others see their customers moving to China and cannot find new ones to replace them.

I have seen this in my own company. As I said, we are a small manufacturer of engineered materials systems with about 200 employees in Lincoln, Rhode Island. As a result of fierce Chinese competition, fueled partially by the undervalued yuan and possible other unfair trade practices, I have seen many of our customers lose their business because their customers have sought refuge in one of two strategies: either simply moving production to China or forcing purchasing from lower-cost Chinese manufacturers. It is common for our customers to tell us that their customers will only pay the "Chinese price." And I am afraid we are just at the beginning of the process, with matters threatening to get much worse.

On the other hand, we are not without distinct advantages in U.S. production. Right now, my company is selling high technology precious metal plated material systems to stamping companies in China that are unable to procure the high quality product they need from a Chinese or other regional local supplier and therefore are buying from us. Our technology and innovation have kept us ahead of the curve with some of our customers, but it is not going to be enough if we don't address the problems in our trade with China.

Revaluation of the Chinese Yuan to Reflect Economic Fundamentals

No other factor can distort trade as much as currencies that are manipulated to establish artificial advantages in trade. China devalued its currency by about 30 percent in 1994 and has maintained that value for the last ten years -- despite a huge increase in production capability, productivity, quality, production range, foreign direct investment inflows, and other factors that would normally be expected to cause a currency to appreciate.

When NAM first raised this issue with regard to China more than two years ago, many didn't agree the currency was undervalued, but today the undervaluation is virtually universally recognized. Appended to my statement is an NAM staff listing of a partial compilation of officials and institutions that express this view. (Appendix I)

Economists estimate that the yuan is undervalued by as much as 40 percent. This undervaluation effectively taxes U.S. exports and subsidizes imports from China, feeding the growing bilateral trade deficit. This undervaluation exacerbates our trade deficit with China and makes U.S. goods less competitive in third country markets. Furthermore, the undervalued yuan makes foreign investment in productive capacity in China cheaper and more attractive, thus artificially distorting investment in China – including domestic Chinese investment.

The best measure of the amount of upward pressure on the yuan is the value of the foreign currencies – mostly dollars – the Chinese government has to buy in order to suppress the yuan's value. In 1994, when China began to hold its currency down, its global currency reserves were only $30 billion. In 10 years they have spent over $660 billion to keep the yuan from rising. Reserves grew a phenomenal $230 billion in the last twelve months – to a total accumulation of $691 billion, or an amount approaching half of China's entire annual output of goods and services (See Exhibit 4).

The $200 billion that China added to its reserves in 2004 significantly exceeded China's entire increase in GDP that year. Yet China has no choice but to continue this huge reserve buildup so long as it insists on maintaining a sharply undervalued currency.

It should be noted that, while a currency peg *per se* does not contravene International Monetary Fund (IMF) requirements, IMF Article IV proscribes "manipulation of exchange rates to gain unfair competitive advantage over other members" - and this includes "protracted large-scale intervention in one direction in the exchange market." With foreign currency reserves of $691 billion, China's action is clearly incompatible with the intent of IMF Article IV. It is also inconsistent with its obligations in the WTO to avoid frustrating trade liberalization through exchange rate action and to avoid impairment of trade benefits.

Administration Response

The NAM has been working with the Administration for two years to find the most effective way to obtain a change in China's currency practices. During this period, the Administration has gradually – but significantly -- raised the visibility of the issue. There is no question that the Administration has realized the central importance of a revaluation and more flexible structure for the yuan. As noted in the appendix, other governments concur.

Just this Monday, at a press conference with European leaders around the U.S.-EU Summit in Washington, President Bush said that they had agreed that:

> "China should work to do something with her currency so that the trade between our respective countries is fair. That's all we want. We just want there to be a level playing field. The people in Europe can compete, and the people in the United States can compete if we have fair rules and fair trade."

We agree. We are pleased at the leadership evident in the Administration's message to the Chinese government on their currency practices. The Treasury Department's semiannual report delivered to Congress in May 2005, stated that "China is now ready and should move without delay in a manner and magnitude that is sufficiently reflective of underlying market conditions." Secretary Snow's remarks and the report put China on notice that "If current trends continue without substantial alteration, China's policies will likely meet the statute's technical requirements for designation." We welcome this indication that, absent a significant move on the part of China by October, Treasury will cite them for currency manipulation in its semiannual report to Congress. This sends an important signal to the Chinese government and to American business that October is a date certain for a change in China's currency practice or Treasury will take firmer action.

In this regard, we would also like to recognize an additional important point made by Secretary Snow, one that the NAM has been making for some time: that any step taken by China in this regard must be a significant one, in Secretary Snow's words "this has to be significant, it has to be material, it has to be real, it has to be a step that gets the yuan into a close alignment with underlying market realities."

Will A Revalued Yuan Have Any Effect?

As I said earlier, Mr. Chairman, there is virtually universal agreement that the Chinese currency is undervalued, yet recently it has become popular to say that a revaluation will have no effect and may even be harmful to the United States. These arguments, however, do not match either the actual experience of U.S. industry losing business to China or economic analysis. There are six common arguments, and these are discussed in the NAM staff analysis appended to my statement. (Appendix II)

The analysis shows that a yuan revaluation, depending of course on its size, would lessen or remove China's artificial price advantage in the U.S. market, would reduce the rate of growth of U.S. imports from China by market mechanisms, and would tend to boost U.S. exports to China – while also benefiting the Chinese economy and doing no harm to U.S. capital markets.

The NAM has not been pressing for currency reform in China because we believe it is a silver bullet – there are no silver bullets. But we believe that it is an essential component of addressing our deficit with China. It would slow import growth, boost exports, and result in a trade balance that is moving to a more sustainable level. We don't need to have a trade surplus with every country. With some we have surpluses, others deficits, but our deficit with China is one that needs to be reigned in, without protectionism, bringing it into better balance, to a more sustainable level.

Mr. Chairman, we understand that any change in exchange rates is a complex process that will allow some sectors to be more competitive and remain producing in the United States while for others it will have little or no effect. We agree with Prof. Rogoff, who is also testifying on this panel, that "while having more flexible exchange rates in Asia won't turn around America's deficit overnight, they will provide a more flexible global environment for imbalances to unwind."[1]

Strengthening and Enforcement of Intellectual Property Laws

Next to the exchange rate, the most serious problem NAM members have with China is its failure to curb intellectual property theft – particularly copyright piracy and product counterfeiting. I have a personal experience with this problem. A company with whom we do business, a leader in the production of very highly technical products, whose president is a colleague of mine, told me a couple of years ago that they were urged to move a portion of their production to China by a colleague of his. He was told that he "had to be there." However, they chose not to make the move to China. When I talked with him further about this, he relayed that while his colleague's company was finishing construction on their plant in China, an identical plant was put up only one-half mile away producing his product. The comment to my colleague was, "Thank God you didn't go there." His company had been robbed blind.

[1] Rogoff, Kenneth. "America's current account: a deficit of judgment," Global Agenda, 2005.

China has become the world's epicenter of counterfeiting, costing U.S. companies billions of dollars and thousands of legitimate jobs, and threatening consumer health and safety. Because of this, our members have pressed us to do more, and the NAM, with the U.S. Chamber is currently co-secretariat of the Coalition Against Counterfeiting and Piracy (CACP).

Despite bilateral and multilateral agreements with China to protect intellectual property rights, China's record of enforcement has been inadequate and seriously flawed. China has been taking positive steps; the laws are better, and there is at least a higher degree of official attention to the enforcement of those laws at the central government level. But it is enforcement that counts and China seriously fails in that regard. It is each WTO member's obligation to provide effective protection for intellectual property.

In spite of these official efforts, it is the general view that product counterfeiting and copyright piracy is not getting better, but worse. An inability or unwillingness to protect intellectual property strikes at the core of American competitiveness. If the products of our innovation and research and development are stolen, there will be little we can do to maintain our industrial base.

As a result, the NAM, in its submission to the USTR on the Special 301 out-of-cycle review of China, recommended that the Administration designate China a Priority Foreign Country and commence development of a WTO case, ideally in conjunction with the EU, Canada, Japan and other countries whose companies are also suffering from what NAM President John Engler calls China's "grand larceny on a massive scale." We need to see the law enforced, with counterfeiters thrown in jail and the volume of counterfeiting significantly reduced.

Application of Countervailing Duty Laws to China

As President of the Rhode Island Manufacturers Association (RIMA), I hear from a number of Rhode Island companies that when they try to bid for a contract against Chinese manufacturers of the same product, the Chinese price is below their cost of raw materials. This raises concerns that China's industries may benefit from a wide array of government policies that, in effect, result in subsidies. These include: government bank lending to enterprises without creditworthiness, export-based tax incentives, and the discriminatory application of tax rates and rebates.

In Beijing in September 2003, former Commerce Secretary Evans said, "There is simply no valid economic justification for many of the loans currently being extended to unprofitable businesses in China. Non-performing loans to state-run companies are a form of government subsidy." However, since 1984, the Commerce Department has not applied the countervailing duty statutes against imports from non-market economy countries such as China.

The WTO Subsidies and Countervailing Measures (SCM) agreement allows countervailing import duties to offset such subsidies. In fact, China's WTO accession agreement specifically outlines the process for assessing subsidies in China. A good deal of time was spent by former USTR Barshefsky negotiating this language.

In developing NAM's 2005 Trade and China Agendas, what emerged as very important to many of our members, especially small companies, is the need for greater focus on trade enforcement. Many companies said that, while they supported trade liberalization and recognized the general benefits, they did not see the follow-up in enforcing agreements that were negotiated. The Commerce Department policy that does not permit the application of countervailing duties to non-market economies, an action that is entirely consistent within the WTO generally and with regard to China's WTO accession agreement specifically, is a glaring example of this lack of enforcement.

The NAM supports reversal of the Commerce Department's 1984 decision in light of the SCM Agreement and the terms of China's accession to the WTO, and supports legislation that was introduced in the House by Congressmen English and Davis (H.R.1216) and in the Senate by Senators Collins and Bayh (S.593). We hope that members of the Senate Finance Committee will look favorably on this legislation.

The report just issued by the Government Accountability Office (GAO) on this subject reinforces the need for this legislation. The GAO states in its report that it would be prudent for Congress to legislate in this area, and we agree with that.

Development of Significant Export Promotion Effort Targeting China

In looking for positive ways to alleviate our trade imbalance with China, promoting the more rapid growth of U.S. exports to China certainly should be emphasized. The NAM believes there is substantial potential for Chinese economic growth to lead to a corresponding growth in the U.S. manufacturing economy. But that potential is far from realization. Of the $560 billion of goods China imported in 2004, only 8 percent were from the United States, including agricultural products. In contrast, the European Union (EU) and Japan have been significantly more successful selling into the Chinese market.

Many manufacturers are taking advantage of China's rapid economic growth to sell more of their products there. In fact, for some member companies, China is their most important foreign market for increasing export sales or local production. However, China remains a difficult place to do business and small and medium-sized companies, even those successful in other foreign markets, often have difficulty entering the Chinese market and developing profitable business relationships.

To help U.S. manufacturers reach their export potential in China, a new and greatly expanded export promotion initiative is needed. Current U.S. Government export promotion programs offer useful assistance but are not on the scale needed to make a sufficient difference in overall export trends.

The U.S. Government and the private sector must work together to launch a more ambitious program that provides more on-the-ground assistance in China and more trade outreach to potential U.S. exporters. A complete outline of NAM recommendations for this program can be found in the 2005 NAM China Trade Agenda. Our goal should be to achieve at least one-third growth in our exports to China each year. This would triple our exports in four years and quadruple them in five.

Conclusion

Mr. Chairman, I want to reiterate that the NAM wants a healthy, vibrant trade relationship with China that provides mutual benefits. But when manufacturers are telling us they are close to laying off their entire workforce and shutting their doors because of competition from China, we have to pay attention. Protectionism must be avoided. We must not take any steps that would risk reversing the open trading system that has been such a source of growth for the United States and the rest of the world, and risk a downward cycle of global trade deterioration. We must pursue approaches relying on market mechanisms and take actions consistent with the rules-based trade system.

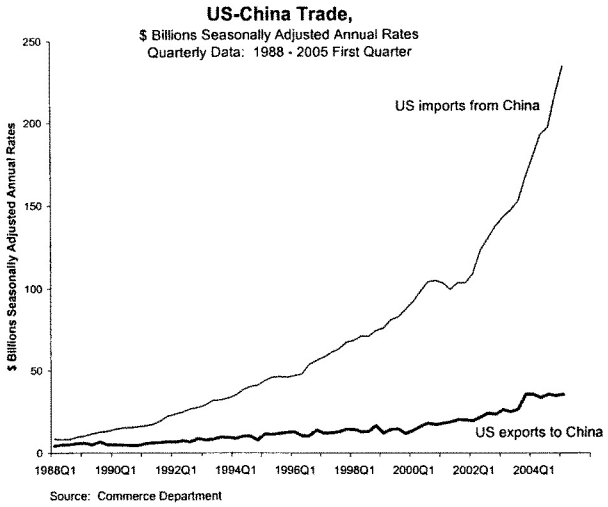
NAM member companies have a variety of views on China, but they all agree that the playing field has to be level and trade should follow market principles as closely as possible. During its three years of WTO membership, China has made progress in opening markets and adhering to international rules, but the benefits of the relationship still remain heavily one-sided in China's favor. Manufacturers continue to face an unlevel playing field that limits U.S. exports to China and gives Chinese products artificial advantage in the United States.

Many U.S. manufacturers can and will deal with the fact of China's low wages and lack of worker benefits through innovation and technology. But what is not fair and what we should not have to deal with is subsidized production or deliberate currency undervaluation and our government telling us there's nothing they can do to see that international rules are enforced.

We do not have five years or ten years to solve this problem. The issues I have outlined today are having a serious and negative effect on manufacturing in this country. We have an obligation to see that America's manufacturing base stays strong. We can do that within the rules of the international trading system. But we must not be timid in the insistence that those rules be enforced. Without enforcement when major trading partners egregiously violate these rules, many will lose faith in the efficacy of the system. We know that free trade properly administered benefits all of us. We must see to it that the consensus for free trade is maintained in this country. We look to the Administration and Congress to see to it that China plays by the rules and the system works.

Thank you, Mr. Chairman.

Exhibit 1


US-China Trade,
$ Billions Seasonally Adjusted Annual Rates
Quarterly Data: 1988 - 2005 First Quarter
$ Billions Seasonally Adjusted Annual Rates
250
200
150
100
50
0
US imports from China
US exports to China
1988Q1
1990Q1
1992Q1
1994Q1
1996Q1
1998Q1
2000Q1
2002Q1
2004Q1
Source: Commerce Department

US-China Trade Deficit,
$ Billions Seasonally Adjusted Annual Rates
Quarterly Data: 1988 - 2005 First Quarter
$ Billions Seasonally Adjusted Annual Rates
0
-50
-100
-150
-200
-250
U.S. Trade Deficit with China
1988Q1
1990Q1
1992Q1
1994Q1
1996Q1
1998Q1
2000Q1
2002Q1
2004Q1
Source: Commerce Department

Exhibit 2

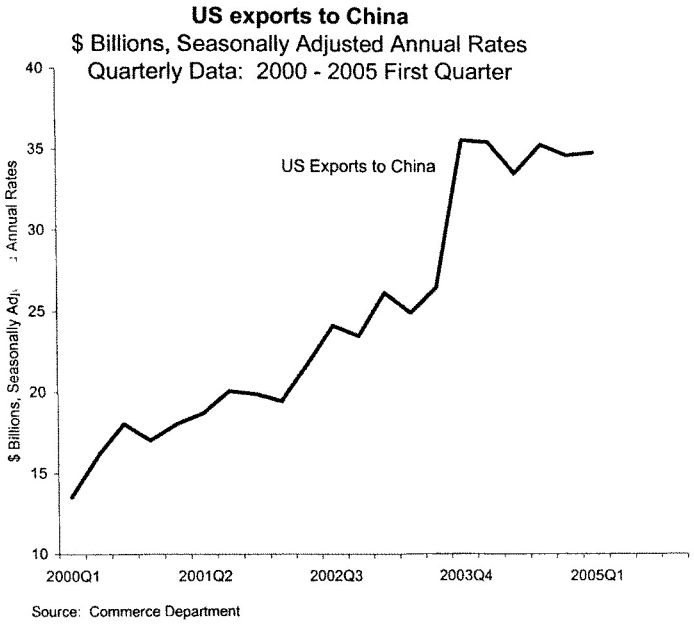

US exports to China
$ Billions, Seasonally Adjusted Annual Rates
Quarterly Data: 2000 - 2005 First Quarter
US Exports to China
$ Billions, Seasonally Adj. Annual Rates
40
35
30
25
20
15
10
2000Q1
2001Q2
2002Q3
2003Q4
2005Q1
Source: Commerce Department

Exhibit 3

Alternative U.S. Trade Deficits with China in Five Years

At current rates of U.S.-China export and import growth (22% and 24% respectively) the U.S.-China trade deficit in five years would grow to $492 billion, triple the size of 2004 U.S.-China trade deficit.

2004 U.S.-China Trade Deficit: $162 Billion

Alternative U.S.-China Trade Deficit in 5 Years:

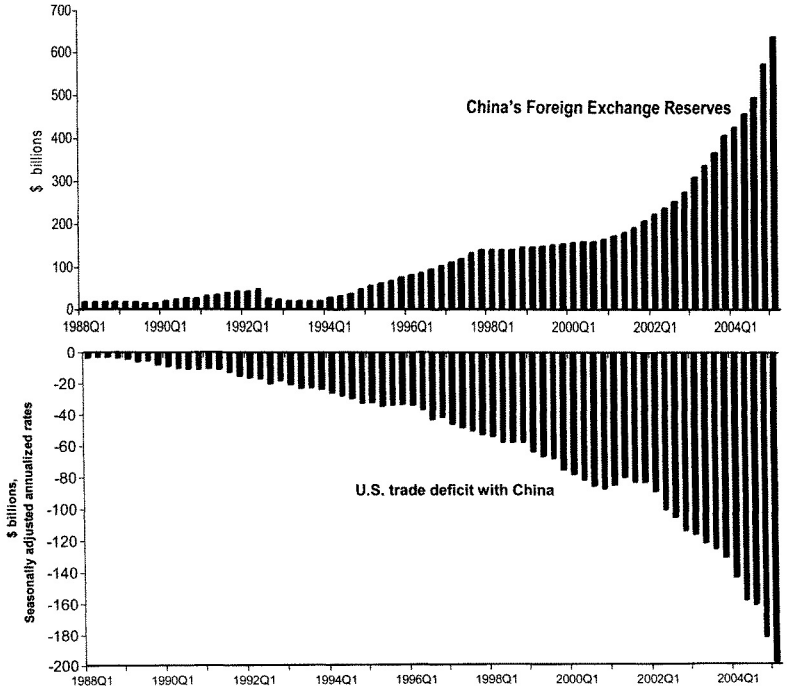
Using various export and import growth rates scenarios

US EXPORTS TO CHINA / US IMPORTS FROM CHINA	+22%[1]	+33%	+40%
+24%[2]	**-$482 billion**	-$432 billion	-$390 billion
+15%	-$302 billion	-$251 billion	-$209 billion
+10%	-$223 billion	-$172 billion	-$130 billion
+7%	-$182 billion	-$131 billion	-$89 billion

Source: NAM calculations based on Commerce Department trade data
Simulations are generated from 2004 trade data
1/ 2002-2004 Average US export growth to China: 22%
2/ 2002-2004 Average US import growth from China: 24%

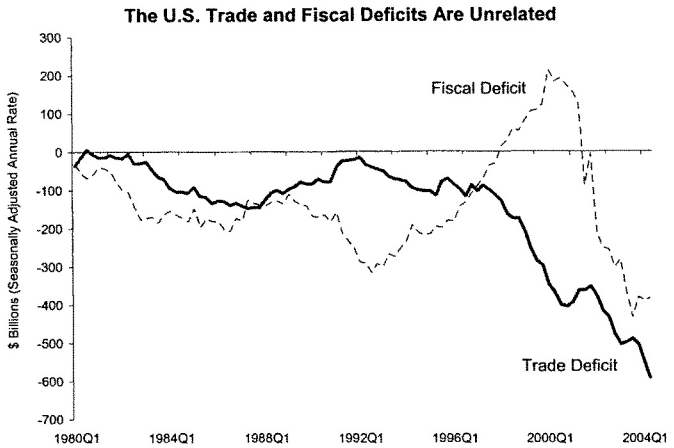
Exhibit 4

Comparison of Growth in China Foreign Exchange Reserves with U.S. Trade Deficit with China
Quarterly Data: 1988 – 2005 First Quarter



Sources: U.S. Census Bureau and International Monetary Fund

Exhibit 5



Source: Bureau of Economic Analysis -- Note that the trade deficit shown above is actually the current account deficit, the broadest measure of trade in goods and services.

It is frequently stated that the U.S. trade deficit is caused by the Federal budget deficit, the fiscal deficit. This actually is not the case, as is plainly evident the graph above. In fact, statistically, the coefficient of correlation for the trade and budget deficits is -.02, which is about as close to no relationship as possible.

Examination of the above graph shows, for example, that as the U.S. trade deficit *improved by $130 billion* between 1987 and 1992, the budget *deficit worsened $162 billion* during that time.

Moreover, the trade deficit *worsened by $306 billion* between 1992 and 2000, while during that same time, the fiscal balance *improved by $530 billion*.

APPENDIX I
Comments on Chinese Currency

U.S. Administration Officials

President Bush

- "There have been some indications that they're [Chinese government] thinking about ... an interim step toward floating the currency. We're constantly urging them, if they're going to take that step, to take it as soon as possible and eventually get to ... a currency which floats," "Obviously we're at a competitive disadvantage to the extent that their currency won't float."
  interview with CNBC, April 19, 2005

- "We've been talking to countries about currency policy to make sure that the currency policies of a government don't disadvantage America. Fair trade means currency policies are fair. .. We can compete with anybody. We just expect the rules to treat us fairly."
  Milwaukee, Wisconsin, Oct. 3, 2003

- "China should work to do something with her currency so that the trade between our respective countries is fair. That's all we want. We just want there to be a level playing field."
  WH Press Conference with EU leaders at U.S.-EU Summit, Washington D.C., June 20, 2005

Treasury Secretary John Snow

- "We feel there is a lot of mischief associated with that [China's fixed rate system] It's a way to get your currency out of alignment with underlying realities and thus confer unfair advantage on your own manufacturers and producers, to the detriment of American manufacturers and producers. The way to deal with that is to let the currency reflect those underlying market forces so nobody can be manipulating the currency."
  Edina, Minnesota, Oct. 26, 2004

- "We [the U.S. gov't] were straight with them [the Chinese gov't]. We said, this system doesn't hold together. It doesn't work. It's not right for the world economy. It's not right for the world trading system and you need to move to a flexible sort of exchange rate that allows the market to set the value rather than having you arbitrarily establish the value."
  Senate Budget Committee, Feb.13, 2004

- "Reform of the currency exchange regime in China is one of the highest priorities for our international economic policy...China has maintained an exchange rate peg for over a decade. This impairs adjustment throughout the international system...As members of the G7 have recognized, the time has now come for China to introduce flexibility into its exchange rate. The Chinese are now ready to adopt a more flexible exchange rate, they have sufficiently prepared their financial system to live in a world of greater flexibility and need to take action now."
  House Committee on Financial Services, April 19, 2005

- "Flexibility in its (China's) currency so it gets price signals right will help it and the global economy function better,"
  Centre for European Policy Studies, June 14, 2005.

Federal Reserve Chairman Alan Greenspan

- ``Fixing the renminbi to the dollar is beginning to work to the detriment of the Chinese economy. It's very much in their interest to move."
  Senate Budget Committee on April 21, 2005

- "Allowing revaluation in some form is very much to the advantage of the Chinese."
  June 2005

- "If the exchange rate is significantly undervalued, and indeed a reflection of that would be their (China's) accumulation of dollar assets, the accumulation of dollar assets will expand their money supply to the point that it will create problems in monetary policy and it will be to their interest to change. '
  House Finance Services Committee

Federal Reserve Governor Bernanke

- "..moving toward exchange rate flexibility is in the interest of China as well as the rest of the world."
  Cato Institute Monetary Conference, Washington, D.C. , Oct. 14, 2004

<u>International Institutions</u>

IMF Managing Director Rodrigo Rato

- "It is in the interest of the Chinese people and the advantage of the Chnese economy to move towards a more flexible exchange rate system...For China, this is now a good moment [to make a move]."
  Shanghai, March 15, 2005

- "If policies do not adapt, do not change to react to these imbalances, we run the risk of an abrupt correction of the markets ... [when] confidence for different reasons could evaporate or could be reduced. There is a need for Asian countries to have more flexible exchange rates."

Kenneth Rogoff, (then) Chief Economist, International Monetary Fund

- "If the euro has to bear the lion's share of the adjustment in the dollar, that is going to create a lot more difficulties than if all the Asian currencies also allow themselves to appreciate significantly against the dollar. It is bad enough that the global economy has been flying on one engine but it is going to be a lot worse if it has to land on one wheel."

  Sept. 19, 2003

From an IMF Discussion Paper, January 2005

- "The net adverse effects on the Chinese economy of any appreciation in the yuan resulting from a move towards greater flexibility would be quite modest" and "a relatively early move toward greater exchange rate flexibility would be in China's interest."

Haruhiko Kuroda, Asian Development Bank President

- "China should reform its yuan currency sooner rather than later." With Chinese trade surpluses now surging, the needed appreciation "would be larger than people thought in the past."

  Mr. Kuroda also cited China's fast-rising foreign exchange reserves as evidence of the need for China to change policy.

  May 10, 2005

European Central Bank Chief Economist Otmar Issing

- "The euro's advance against the dollar has gone too far. The key to this problem lies with Asia and especially in the hands of China."

  Jan. 12, 2005

G7 Communiqué, Dubai, September 20, 2003

- "... 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. Effective and persuasive IMF surveillance is crucial."

<u>Chinese Officials</u>

Yu Yongding, member of Central Bank of China's monetary policy advisory board

- "Now is the time to revalue the yuan. We need more flexibility. That means revaluation."
- "Our exports are too high right now, making the economy more susceptible to external shocks."

  Davos, Jan. 28, 2005

People's Bank of China Governor Zhou Xiaochuan

- "Rigid exchange rates amid imbalances in revenues and expenditures present huge risks."
  Dec. 7, 2004

- "There is definitely pressure, but that is beneficial to our reforms and our work." (Zhou acknowledged that the intense international interest in the renminbi regime has helped concentrate the minds of Chinese policymakers, and could end up helping to speed up the pace of exchange rate reform.)
  Hainan, Apr. 23, 2005

- "A long preparation for a yuan change is not needed."
  June 7, 2005

Guo Shuqing, director of the State Administration of Foreign Exchange

- "Indiscriminate support of exports and foreign capital influx has created short-term economic problems, including excessive speculation in the property market and the economic decoupling of the fast-growing coastal areas with the rest of China "We should gradually reduce the preferential treatment to exports and seriously review our foreign investment policy."

Researcher at China's State Council's Development Center

- The Chinese yuan is "clearly undervalued."

Xu Gang

- China should revalue the yuan as it is undervalued to some extent. An appreciation will have limited negative impact on the economy.
  reported in the China Securities Journal, May 13, 2005

<u>International Finance Ministries</u>

French Finance Minister Thierry Breton

- The Chinese yuan is "very undervalued" against the euro; "20-30% below its true value."
  May 2, 2005

Bank of England Governor Mervyn King

- The US trade and budget deficits and the purchase of large US dollar reserves by Asian countries were combining to cause "global imbalances."
  G7 Feb. 2005

Canadian Finance Minister Ralph Goodale

- "The point has been strongly made in the past and all of the countries around the table [at the G8 meeting] remain of the same opinion. The sooner that flexibility is shown in Asia, the better."
  June 2005

Bank of Canada Senior Deputy Governor Paul Jenkins

- "A critical issue is the need for some effective depreciation of the U.S. dollar against the currencies of emerging Asia…the key element here is China's fixed exchange rate."

Bank of Canada Governor David Dodge

- "Failure to let the yuan float freely against the U.S. dollar could also cause serious damage to the world economy."
  Montreal, May 31, 2005

Japanese Vice Finance Minister for International Affairs Hiroshi Watanabe

- "It is in China's interest to make a meaningful decision quickly,"
  June 2005

German Finance Minister Hans Eichel

- "The efforts of Asian countries for more flexibility in exchange rates are still not sufficient."

German Deputy Economics Minister Bernd Pfaffenbach

- "Just about every exporter to China would gain." – referring to a revaluation of the yuan.
  June 6, 2005

APPENDIX II

NAM STAFF ANALYSIS OF ARGUMENTS THAT A YUAN REVALUATION WILL NOT AFFECT U.S. TRADE

First: A revaluation of the yuan will have no effect on U.S. trade deficit, production or jobs.

Not so. First of all, it has long been established in economics that changes in relative prices, whether from tariffs or from changes in exchange rates, have a strong determining influence on trade. Why else then do we bother expending a great deal of time and effort to negotiate away tariffs of 6 or 7 percent? The experience of the U.S. trade balance bears this out. As recently as 1997, the U.S. trade deficit was only $183 billion, or 2.2 percent of our GDP – and had been growing moderately, However, as the dollar appreciated 25 percent against other currencies in the following years, the U.S. trade deficit exploded – more than tripling. U.S. trade experienced a similar pattern in the first half of the 1980's – the previous time the dollar had become very overvalued.

Second, while it is not unusual to hear individuals say that trade deficits are the result of too little savings and too much investment in the United States, this is not actually a cause of the trade deficit. Savings minus investment, production minus consumption, and exports minus imports are three different descriptions of the same economic concept. They are identities. One does not cause another. The cause is external – such as a price maladjustment with other economies because exchange rates are not allowed to equilibrate differences in price levels.

Additionally, some say that the U.S. trade deficit is caused by the Federal Government budget deficit, so if the deficit with China were to be reduced, the deficit would simply be moved elsewhere until the budget deficit was reduced. A glance at Exhibit 5 shows this argument doesn't hold water. There is absolutely no relationship between the Federal Budget deficit and the trade deficit. For the economists reading this analysis, the coefficient of correlation is -.02, which is about as close as you can get to no relationship whatsoever.

Prices DO matter, and the NAM has heard from many companies that they can be competitive with Chinese products were there to be a 10-20% increase in Chinese prices. Granted, that will not happen across the board. Areas like many consumer electronics which have been produced little in the United States for over a decade and for which China serves largely an assembly function, will likely see little effect. But in sectors like machine tools, hand tools, mold making, plastics, machine tools, furniture, fabricated metal products, and other sectors where we are hearing a lot from our member companies, there will be real benefit when prices reflect market based currencies.

Those who say that there is no way to compete against Chinese wages have to remember that wages are a relatively small factor in the overall price of U.S. manufactured goods. Census Bureau data show that for all U.S. manufacturing, direct wages and benefits average only 11 percent of the cost of the final product. When Chinese prices are half or less of U.S. prices, factors other than wages are at work – such as an undervalued exchange rate.

Second: Production will only move to other low cost producers.

Not so. Another argument is that Chinese imports substituted for imports from other countries, not U.S. production, and if Chinese prices rose then other countries would once again begin supplying these products and U.S. producers would see no gain. This argument has considerable merit for electronic products – which used to be imported from Japan and other Asian countries and are now largely imported from China. However, it has no merit for the broad range of products made by NAM members who tell us that they are being displaced by Chinese products in industries such as fabricated metals, plastics, tools, and others. These products were previously made in the United States, not other Asian nations – and it is likely that some or much of their production would return to the United States if the price relationship with China were to change as a result of China's currency moving up in value, or at least that further loss of production would be slowed or halted.

Since 2001, for example, total import penetration of the U.S. manufactured goods' market grew 2.2 percent. China's import penetration grew 1.6 percent during this period, three quarters of the total increase. At the same time, import penetration from the rest of Asia fell only slightly – 0.2 percent. Thus it is obvious that increased Chinese import penetration has not been offset by decreased import penetration on the part of other Asian countries.

Additionally, it is important to note that to the extent there would be production shifts from China to other Asian nations, U.S. exports and the U.S. trade balance would be likely to benefit. The U.S. share of China's imports is considerably smaller than the U.S. share of the import markets of other Asian or Latin American markets. For example, for every dollar of goods Malaysia sells to the United States, it buys two-thirds more from us than does China. If a Central American nation sells something to the United States, it is likely to spend more than 40 cents of every dollar in the United States, whereas China at best would spend 8 cents in the United States. The locational origin of what we buy can have a significant effect on how much we sell.

Another factor not considered in this argument is that other Asian nations have also been suppressing their currencies so as not to have their products too expensive relative to Chinese products. With a Chinese revaluation, these other nations would no longer be constrained by China's undervaluation and would be able to pursue market-determination for their currencies as well. As Secretary Snow said in his remarks upon releasing the Treasury report in May, "China's rigid currency regime has become highly distortionary... concerns of competitiveness also constrain neighboring economies in their adoption of more flexible exchange policies." Bearing out this point, Kwon Tae Kyun of the Korean Ministry of Finance recently said that "It is better to do it [yuan revaluation] as early as possible. Currency and oil costs have always been the two major risks the Korean economy faced. The yuan's revaluation would clear one of them."

Third: There is very little Chinese value-added in Chinese exports, so a revaluation would have little or no effect.

No so. This is probably true for Chinese exports of electronics products, most of which are made in foreign-owned plants operating in export processing zones and assembling components largely made in other Asian countries. But it is not true for the rapidly growing range of Chinese products that are competing with U.S. manufacturing production in the broad range of sectors that are feeling the pinch of Chinese competition – including auto parts, metal products, industrial supplies, plastics products, and the like. These, for the most part, are not made in China's export processing zones and are principally of Chinese origin and value-added. These products have benefited the most from China's undervalued exchange rate and would be the ones most likely to be less able to compete with U.S. production once the exchange rate reflected economic fundamentals.

China's trade data differentiate between exports (and the related import inputs) from processing zones, both by state-owned enterprises and foreign-invested enterprises. What these data show is that 55 percent of China's 2004 exports were either "process with assembly" or "processed with imported materials." The import content of these exports was 67 percent – meaning that the domestic content was only 33 percent.

The remaining 45 percent of China's exports were neither processed in assembly zones nor produced with imported components, and can be viewed as 100 percent domestic content (other than the costs of imported energy, etc. that is true with all countries). Thus, combining the 55 percent having 33 percent local content and the 45 percent having 100 percent local content shows that the overall local content of China's exports may be estimated at 63 percent. That proportion of China's export value would be affected by upward movement of its currency.

Fourth: Most imports from China are produced in U.S.–owned plants and a revaluation would directly harm U.S. firms.

While popular, this argument is absolutely false. U.S. Census Bureau data show that only 27 percent of U.S. imports from China are "related party trade" – i.e., are imported by one part of a company from another part of the same company. "Related party trade" covers all imports within the same corporate family, including those by foreign owned companies. Thus, 27 percent of U.S. imports from China are imports of U.S. companies from their Chinese subsidiaries, imports into the United States by Japanese affiliates from their Chinese branches, etc. Since most investment in China is not from the United States, but from Taiwan, Korea, Hong Kong, and Japan, a minority of related party trade is likely to be due to U.S. companies – but the Census Bureau data related party trade data do not distinguish trade by the country of parentage.

In addition, the Commerce Department's investment data show that the overwhelming amount of U.S. investment in China is for the purpose of supplying the domestic Chinese market. Very little of this production is shipped to the United States.

Fifth: U.S. interest rates will rise if China stops buying massive amounts of Treasuries to keep its currency artificially cheap.

Not so. An argument frequently heard is that if China moves away from its currency peg, it will stop buying Treasury bonds and interest rates will increase, housing prices will fall, and all manner of economic strife will be visited on the U.S. economy and citizenry. To see that this is not so, it is only necessary to quote two of many officials who have been asked that question.

Federal Reserve Chairman Alan Greenspan at the Economic Club of New York said, "The effect of a reduction in the scale of intervention, or even net sales, on U.S. financial markets would likely be small...Accordingly, any incentive for monetary authorities to sell dollars, in order to preserve market value, would be muted,"

U.S. Treasury Assistant Secretary for International Affairs, Randal Quarels said that the U.S. Treasury securities market "is the broadest, deepest, most liquid active capital market in the world, and will remain so. It's very unlikely that that sort of rebalancing would have significant effects on the U.S. Treasury market, the U.S.'s ability to finance itself."

To amplify Chairman Greenspan and Assistant Secretary Quarels remarks, the Treasury market trades roughly $600 billion a day, so if China were to stop purchasing an additional $20 billion a month – not all of which is in dollars, there would be little effect. Moreover, when Japan intervened heavily from December 2003 to March 2004 – increasing its reserves $156 billion in that period – more than $50 billion a month – and then suddenly stopped in April 2004, there wasn't a blip in the market. No one even noticed.

Sixth: A revaluation will hurt China

To the contrary, the Chinese economy will be helped by a revaluation and movement toward a flexible currency. One need only look at recommendations from the International Monetary Fund, the U.S. Treasury Department, Alan Greenspan and a number of Chinese sources among many others, who say that greater flexibility in China's exchange rate system is very much in China's self-interest. The current 10-year old peg is encouraging huge speculative inflows of capital betting on a revaluation, which in turn grows the Chinese money supply and encourages further uncreditworthy bank lending which only adds to the build-up of nonperforming loans and weakens the Chinese banking system. A key component of China's eventual move to a market-determined currency will be a functioning, solvent banking system and dampening speculative inflows through a significant revaluation would be a positive step towards that goal.

Those saying that it is China's own interest to make moves to a flexible currency are too numerous to cite here, but include Treasury Secretary Snow, Federal Reserve Chairman Greenspan, the Canadian Central Bank, the European Central Bank, the World Bank, the International Monetary Fund and a host of other economists. As Secretary Snow said, "China's rigid currency regime has become highly distortionary. It poses risks to the health of the Chinese economy, such as sowing the seeds for excess liquidity creation, asset price inflation, large speculative capital flows, and over-investment. "

As prepared for submission

Testimony of Sean Maloney
Executive Vice President and General Manager, Mobility Group
Intel Corporation

On behalf of
The US Chamber of Commerce

"US – China Economic Relations"

Before the
Finance Committee
United States Senate

June 23, 2005

Mr. Chairman and Members of the Committee:

Thank you for the opportunity to appear before you today at this important hearing on US-China economic relations. My name is Sean Maloney, I am Executive Vice President and General Manager, Mobility Group for Intel Corporation. I am pleased to testify today on behalf of Intel and the US Chamber of Commerce.[1]

Let me begin by thanking the members of this Committee for holding this hearing about the significance of our trade relationship with China.

China holds tremendous opportunities for US companies and for our industry specifically. In spite of these opportunities, concerns have been rising about the US - China economic relationship. Because of the importance of the Chinese market, it is not surprising that the challenges that arise can be difficult to address. We believe that clear and constructive dialogue between both governments is critical to resolving these problems. Industry and other stakeholders must also work together to implement capacity building programs and share best practices in order to help prevent future difficulties.

[1] For a more detailed review of the US Chamber of Commerce's position on the United States- China economic relationship, pleas refer to the testimony presented by Myron Brilliant Vice President East Asia of the US Chamber of Commerce before the Ways & Means Committee, April 14 2005.

US High Tech in the Global Economy

Intel Corporation was founded in 1968 with operations in California and since then we have become the world's largest semiconductor company and have expanded our manufacturing presence in the US and around the world. Today, 12 of our 16 factories are located here in Arizona, California, Colorado, Massachusetts, New Mexico and Oregon (the 4 others are in Ireland and Israel). In addition to these manufacturing facilities (called "fabs" in the semiconductor industry), we have supporting assembly and test facilities in various countries including in Costa Rica, China, Malaysia and the Philippines. These assembly and test facilities are used to package and perform tests on our products after the manufacturing process has taken place. These facilities have been established abroad since the early 1970's when we opened the first assembly & test facility in Malaysia.

As our industry has become more engaged around the world, we also have experienced strong growth at home. Intel's Shanghai assembly & test facility for example, is part of a network of such facilities worldwide that help make our US operations more competitive. The jobs created in Shanghai complement high-end US manufacturing jobs, as nearly all of the chips assembled and tested there are produced by Intel manufacturing sites in the US.

This global structure ensures our closeness to our customers, helps diversify risks in case of regional emergencies and allows us to tap into a talented workforce with a variety of skills around the world. Indeed, to optimize global competitiveness, it is important to locate manufacturing and other facilities around the world.

Although approximately 75% of the Intel Corporation's $34 billion annual sales come from outside the US, we employ 60% of our workforce here. Of our 80, 000 employees world wide, over 50,000 employees work in the US at average compensation levels substantially higher than the national average.[2] In addition, Intel facilities are often the central businesses of information technology "clusters" that, in conjunction with local municipal services, attract numerous other large and small information technology companies to an area. Intel's large facilities in Arizona, Oregon, California and other states have also had an economic multiplier effect that generates economic growth, tax revenue and personal income at substantially higher levels than that directly produced by Intel. For instance, EcoNorthwest estimated that Intel generated $9 billion in positive economic impact to the state of Oregon in 2003, substantially higher than Intel direct payroll of $1.5 billion.[3]

In addition to our contributions through direct employment in communities across the U.S, we have also invested over $40 billion in manufacturing, R&D, training and

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[2] According to AeA' s Cyberstates 2005, US high-tech industry workers were paid an average of $69,000 in 2003, the most recent wage data available for the tech industry. High-tech wages were 84 percent higher on average than other jobs in the private sector at $37,500 in 2003. (p. 7)

[3] "Economic Impact of Intel's Oregon Operations", EcoNorthwest, 2003

education across the country since 2000. Our commitment to the United States is manifest and enduring.

Our future ability to invest, grow and remain competitive however is clearly linked to our continued access to world markets. Sales to foreign markets will increasingly be an engine of growth of the technology industry. By improving access to these markets, US companies and their workers will be more competitive.

Growth through trade is also critical to our industry's success against competitors around the world. In fact, during the 2000- 2001 economic downturn, sales to China, Russia, Eastern Europe and other emerging markets were the bright spots in an otherwise soft market. These opportunities for our products abroad are illustrated by the sheer volume of US technology product exports. US high-tech merchandise exports reached $191 billion in 2004.[4] In 2004 tech goods exports represented 23% of all exports from the United States, while high-tech goods represented 18% of total US imports.[5] On average, over 60 percent of the US high-tech industry's revenues come from outside the US (compared to over 75% for Intel Corporation). Semiconductor industry exports specifically are the leading US high-tech industry export, reaching $48 billion in 2004, a 27% increase over the same statistic for 1998.[6]

Opportunities in China

The United States-China commercial relationship is of immense and increasing importance to both countries. US-China trade has boomed in recent years. The United States ranked second among China's global trading partners in 2004, and China was again the 3rd largest trading partner for the United States. US exports to China have grown by 114% since 2000—five times faster than to any other country.

From the US semiconductor industry's perspective, China represents an ever more remarkable opportunity. Semiconductors were the second largest US export to China in 2004 with a trade surplus nearing $1 billion.[7] Four of the ten most successful semiconductor companies in the Chinese market are American. This large market is expected to grow; in 2004, China' consumption represented 19.7% of the world semiconductor market ($35 billion); by 2006 the Chinese market is expected to account for up to 30% of the world market for semiconductors.[8]

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[4] AeA's Cyberstates 2005
[5] Ibid., p. 36
[6] Ibid., p. 41
[7] In 2004 soybeans were the largest US exports to China. Source: US Department of Commerce, Bureau of the Census. According to the US Department of Commerce, US semiconductor exports to China only reached $2.3 billion in 2004. However, this official data underestimates the size of the Chinese market for US semiconductor exports because it does not take into account the US semiconductor products that were manufactured in the US but exported to China via supply chains in 3rd countries.
[8] World Semiconductor Trade Statistics research presented at the World Semiconductor Council in May 2005.

In 1985, Intel became one of the first American semiconductor companies to establish a presence in the People's Republic of China. From that first 2 person office in Beijing, we have grown to a workforce of close to 5,000 people and have invested $1.3 billion in extensive research and development (R&D) centers, assembly and testing facilities, as well as sales and marketing operations across the country including in Beijing, Chengdu, Shanghai, and Shenzhen. Intel has invested in all these areas in order to ensure we remain one of the preeminent suppliers of IT to the burgeoning China market. Supply chain economics, brand-building, the access and recognition that comes from being part of the local community, all mandate that we "live near our customers".

As a young child in London in the 1960s, I lived near the British operations of the Ford Motor Corporation. Parents of classmates and friends worked for the plant. My friends and I regarded Ford as a British company, and Ford cars as British cars. To one day own a Ford automobile was a common dream for a teenager awaiting his license. It was during these years that Ford was growing rapidly and profitably in both Britain and Europe. By being aggressively local, Ford achieved foreign success that helped propel the domestic automotive industry forward as the then driver of the American economy. There is no other winning formula for American companies looking to succeed abroad.

This past week, I had the privilege of visiting Intel's partially-constructed assembly and test site in Chengdu, Sichuan province. There, Chinese citizens, Americans, and many other nationalities are working hand-in-hand to build a world-class facility that will import very high value integrated circuits, manufactured primarily in United States facilities, and complete their final assembly for sale across Asia. Intel's local presence in Chengdu gives it deep ties to a community that will undoubtedly help drive future commercial success in this rapidly growing region. That success will benefit US-based employees and their American employer.

In 2001, China became the fastest country to adopt our newly introduced Pentium 4 processor. Today, China is adopting the Intel® Pentium® 4 processor more quickly than any other country in the world and the Chinese notebook market has transitioned to Intel® Centrino™ Mobile Technology at a faster rate than any other region. As we celebrated the 20th anniversary of our presences in China just last week, we have become the world's largest semiconductor exporter to China. Intel sales to China were nearly $5 billion in 2004, representing over 10% of our worldwide sales.[9] This represents an almost 500% increase in revenue since 1997, Intel's first billion dollar year in China.

[9] According to the World Semiconductor Trade Statistics research presented at the World Semiconductor Council in May 2005, Intel Corporation's share of the Chinese semiconductor market was 16.6% of the Chinese market in 2004.

Improving US trade with China

Considering the importance of the US - China economic relationship and the speed at which it has developed spurred by China's World Trade Organization (WTO) accession, it is not surprising that when problems occur, they tend to have significant commercial and often political ramifications.

Since China's accession to the WTO in 2001, there has been remarkable progress in our ability to ship products to China. Most notably, tariffs on most high-tech products immediately went to zero when China joined the WTO's Information Technology Agreement (ITA).[10] Since the year 2000, US semiconductor exports to China have increased by just over 200%[11]. Our industry has also benefited from the Chinese government's efforts to improve transparency in the promulgation of laws and regulations in some areas. For example, the Ministry of Information Industry (MII) has worked very closely with the electronics industry to develop a feasible and effective regulation that restricts the use of certain hazardous substances in electronic products. When the regulated community at large is invited to provide technical expertise in the development of laws and regulations, there is an opportunity to ensure that various interests have been considered, thus preserving and promoting open trade.

Despite progress in some legal and policy areas, we must continue to work together to address the problems that remain and perhaps endeavor to avoid new ones. Looking at the opportunities for our industry to increase its exports, strong enforcement of intellectual property rules, commitment to global standards as well as open and transparent government procurement policies must be top priorities in China.

a) Intellectual Property Rights: improving protection and enforcement
Innovation driven by investment in R&D is the fuel of success in the information technology industry. Thus, intellectual property rights are the legal bedrock of the information technology industry. Maintaining these rights with equanimity and diligence is a fundamental joint responsibility of both industry and national governments that want to ensure the success of information technology endeavors.

However, Intellectual property (IP) theft today is an increasing global problem which has significant impacts on the growth of the high-tech industry. We recognize that the Chinese government, at the central level and under the leadership of Vice Premier Wu Yi and the Market Order Rectification Office of the Ministry of Commerce, is taking important and constructive steps to improve coordination among relevant agencies responsible for IP protection and enforcement. We also note that the Supreme People's Court and the Supreme People's Procuratorate recently [12/04] issued new Judicial Guidelines which have lowered the threshold for criminal prosecution of certain Intellectual Property offenses in China. While China's leadership is working on this

[10] Tariffs on semiconductors exported to China ranged between 6 and 12 percent prior to their joining the Information Technology Agreement (ITA).
[11] US exports to China for HTS 8542 increased by 207.45% between 2000 and 2004; for products in HTS 8541 exports increased by 23.50%. Source: US Department of Commerce, Bureau of the Census.

issue, we encourage them to continue to focus efforts on addressing these concerns to ensure that IPR infringers are effectively deterred.

Chinese companies are increasingly challenged by IPR infringement as well and are beginning to appreciate how strong IPR enforcement could contribute to their own competitiveness. Consequently, China's efforts to increase IPR enforcement will not only help our bilateral business relations, they will greatly benefit China by fostering incredible innovation, spurring private enterprise and jobs, and ensuring the health and safety of the Chinese people.

b) Global standards

The basic economic 'facts of life' in the information technology industry—economies of scale, economies of scope, steep learning curves and extremely rapid price-performance improvements of information technology products—make technology market segments based on open, global standards, for which companies worldwide can compete evenly, far more likely to flourish than those based on national or proprietary standards.

China has made progress in improving the transparency and openness of its own standards process. However, there is still a concern that China has moved to develop, and adopt unique technology standards across a range of technology products. Examples include a mandated encryption standard for wireless communications devices and the development of unique standards for AVS for media/TV, IGRS for connectivity and EVD for recording media among others. The trend toward mandated unique standards is of particular concern. Competition, innovation, and interoperability are best served by standards that are adopted through market forces.

With its strong manufacturing capabilities and rapidly growing consumer base, China is playing an increasingly important role in the development of the Asian and global IT industry. Although it may appear to be beneficial to local companies in the short term, the use of duplicative local standards as a tool to protect local industry or force technology transfer is harmful to China's interests in the long term. To compete in markets outside of China, these Chinese companies will need to continue to contribute to and adopt global standards as they have been doing in many instances through the International Organization for Standards (ISO), the International Telecom Union (ITU) and the International Electrotechnical Commission (IEC). Most successful high-tech companies have done well due to their ability to innovate based on global standards, including standards developed by ISO, IEC and ITU as well as those developed by other global standards setting organizations such as the Institute of Electrical and Electronics Engineers (IEEE). Doing so allows them to manufacture the same products for a global market, reducing product costs and increasing product value for end users in the process.

c) Government procurement

China became an observer to the WTO's Agreement on Government Procurement upon its accession in late 2001 and agreed at that time to enter into negotiations to join the agreement as soon as possible. China's passage in late 2002 of its new Government

Procurement Law that aimed to improve transparency, limit corruption, and remove local protectionism marked a step forward in these areas.

China's implementation of its procurement law should not exclude or diminish the ability of foreign companies to fully participate in China's procurement market. There is a concern that the recently issued Trial Implementing Regulations on Government Procurement of Software would effectively close the door for most non-Chinese companies trying to sell software products and services to China's largest purchaser, the Chinese Government.

An open, competitive, transparent, nondiscriminatory and technology-neutral government procurement regime is in China's interest and in the interest of China's trading partners. We hope that the Chinese government will commence negotiations to accede to the GPA. This would encourage investment and active participation by leading foreign companies in China's economy and bring the best products and services for the best value to China's government and consumers.

Strengthening the US- China economic relationship

Various factors have contributed to rising anxiety about US commercial relations with China. In the short and medium term, these concerns must be dealt with through clear and consistent communication between governments aimed at solving problems at hand in a timely manner.

From our industry's perspective, constructive negotiations and open communication between both governments have successfully resolved important issues while avoiding lengthy legal proceedings in the WTO.

Through 2003 and 2004, the Administration and Members of Congress worked with the Chinese government to resolve an important issue facing the US semiconductor industry: the value-added tax (VAT) rebate on semiconductors manufactured in China. China's VAT regime had provided for a rebate of all but 3 percent of a 17 percent VAT on semiconductors manufactured in China thereby raising market access concerns among non-Chinese semiconductor designers and manufacturers. In addition to the rebate for domestically produced chips, China's VAT regime also accorded favorable treatment to semiconductors manufactured abroad from Chinese designs.

In July 2004, the US and Chinese governments announced that they had successfully negotiated an agreement on the issue while avoiding a formal WTO dispute resolution proceeding. The quick and mutually satisfactory resolution of this problem was a very positive development US-China economic relations and for the worldwide semiconductor industry. We believe this approach provides a good example of how negotiations can help avoid a potentially damaging long term trade dispute. In light of this success, we

encourage both governments to exhaust all possibilities before resorting to litigation or retaliation.

Beyond areas where urgent action and government to government negotiations are required, industry and other stakeholders can play an important role in preventing problems from escalating into formal disputes, through capacity building and exchanges of best practices. Several companies, industry groups, universities and agencies have already engaged in capacity building programs in a variety of policy and legal areas.

For example, in November 2004, the Semiconductor Industry Association (SIA) worked with the US Department of Commerce, the Chinese government and Chinese industry to hold an IP seminar for China's semiconductor sector. This seminar informed Chinese policymakers and industry executives about the range of benefits of IP protection for both the domestic and worldwide semiconductor industry, the steps companies can take to protect their IP, and actions that can be taken to reduce IP violations in China.

The U.S. Chamber is also prepared to support the Chinese government in its efforts to extend greater protection to U.S. goods. They have embarked on a targeted program offering on the ground capacity building efforts in the provinces, fostering public awareness of the importance of IPR protection among the Chinese public, and advising on policy changes to better strengthen the legal framework.

Conclusion

The United States has a substantial proportion of the world's most successful and dynamic information technology companies---and they generate an incredible number of high-paying, desirable US-based jobs and pay billions in US taxes. Intel Corporation, and our American workers, benefited from our growth overseas. Between 1999 and the present day, while our foreign revenues increased substantially, Intel added over 15,000 net jobs at our US locations.[12]

Our industry, and our American workers, are extremely well-positioned to continue to benefit from the opportunities presented by large and growing global markets. It is through greater economic integration, the reduction of trade barriers, the mediated resolution of trade disputes, the growth of the information technology sector of China, and by 'going local' that these benefits will be realized. At the same time, China possesses a large number of information technology companies and a technically educated workforce that are ready and willing to compete on a world stage. It is through adherence to international technology standards, the reduction of tariff and non-tariff barriers, and the dedicated protection of intellectual property rights, that the Chinese government will encourage the success of these endeavors.

[12] Today, over 75% of Intel Corporation's revenues come from foreign markets, compared to 60% just 5 years ago.

We believe that positive and proactive steps taken by both Governments in cooperation with industry and other important stakeholders will be critical to improving our long-term economic relationship with China. As other countries and industry groups around the world are investing heavily in similar programs, it is essential that we continue to improve this type of US-led engagement over time.

Our economic relationship needs to remain healthy for both sides, indeed for the world economy, to prosper. The US and China must remain committed to resolving issues at hand without resorting to measures that will negatively impact workers and industries on either side.

United States Chamber of Commerce

STATEMENT FOR THE RECORD

For the

Senate Finance Committee Hearing on

U.S. - China Economic Relations

June 23, 2005

Testimony as prepared for the Ways and Means Committee Hearing on April 14, 2005

THE UNITED STATES-CHINA ECONOMIC RELATIONS AND CHINA'S ROLE IN THE WORLD ECONOMY

Myron Brilliant
Vice President, East Asia

Mr. Chairman, members of the committee, good morning. The U.S. Chamber appreciates your invitation to appear at this important hearing today on U.S.-China economic relations.

As the world's largest business representing more than 3 million members, the U.S. Chamber is keenly aware of both the opportunities and challenges that the U.S.-China commercial relationship presents to our companies. Our testimony today will focus on both these opportunities and challenges as well as identify priority areas where the U.S. Chamber believes that the People's Republic of China (PRC) government needs to take further steps in the near term to enhance its own economic development, bolster its credibility in the global trading community, and most importantly, address pressing issues in the bilateral commercial relationship. In particular, China should fully and consistently implement its World Trade Organization (WTO) obligations and continue on the path toward a clear and transparent rules-based regulatory environment that values equally the contributions of both domestic and foreign companies.

In May, U.S. Chamber President and CEO Thomas Donohue will lead a senior U.S. business delegation to Beijing for high-level discussions with China's government and business community. In particular, the Chamber looks forward to building upon recent discussions that we have been having with Chinese officials in Washington, D.C. and to exchanging views directly with China's leadership on the full range of issues in the commercial relationship.

On the currency issue, the Chamber wishes to state at the outset that we believe strongly that China should move as quickly as possible to an exchange rate system that allows market forces to determine the exchange rate of the renminbi. But we also believe that legislation in both the U.S. House of Representatives and U.S. Senate that would unilaterally retaliate against PRC currency practices by mandating tariff increases on Chinese products is an ineffective tool to increase U.S. manufacturing employment and pressure the PRC government to move in the direction on currency that we all continue to seek. Furthermore, these proposed measures that would impose WTO-unauthorized tariffs on PRC exports would legitimize almost certain PRC retaliation against billions of dollars in U.S. exports to China and would amount to a steep tax on millions of American consumers.

Before returning to the currency matter at the end of our testimony, we would first like to address both the opportunities and challenges that China presents

for our members and highlight U.S. Chamber priority issue areas in the bilateral commercial relationship for this year.

China as an Opportunity and a Challenge

It is now trite to say that the U.S.-China commercial relationship is of immense and increasing importance to both the U.S. and Chinese business communities. U.S.-China trade has boomed in recent years. The United States ranked second among China's global trading partners in 2004, and China was again the 3rd largest trading partner for the United States. U.S. exports to China have grown by 114% since 2000—five times faster than to any other country. In particular, flourishing U.S. agricultural trade with China is one of many recent success stories for our exporters. The following statistics are illustrative, if not breathtaking, in their sheer magnitude:

- From 2000 to 2004, U.S. agricultural exports to China increased approximately 224% from $1.7 billion to $5.5 billion. Meanwhile, U.S. exports to the rest of the world increased only 4% during the same period.

- Or put another way, from 2000 to 2004, U.S. agricultural exports to China accounted for approximately 50% of the increase in total U.S. agricultural exports to the world.

- The U.S. in 2004 enjoyed a $3.9 billion agricultural trade surplus with China.

- U.S. cotton exports to China increased by 86% from $769 million in 2003 to more than $1.4 billion in 2004.

- Soybean exports to China in 2003 and 2004 constituted the largest on-record exports of U.S. soybeans to any country.

Year-on-year increases of U.S.-manufactured exports from 2003 to 2004 reveal similar trends: exports of U.S. power generation equipment increased by 34%; exports of electrical machinery and equipment increased by 27%; and exports of optics and medical equipment jumped by more than 30%. These statistics underscore the opportunities that China offers to U.S. exporters, to investors, and, more broadly, to U.S. economic development.

In contrast, we also recognize that concerns are rising in many quarters over

the U.S. trade deficit with China, rising competition from Chinese imports, and concerns about China's currency regime. The U.S. Chamber feels strongly that China must do significantly more to comply fully and on time with its WTO commitments in critical areas such as intellectual property rights (IPR).

We also share the concerns of many over the continuing role of state intervention in designated strategic sectors of China's economy. For example, China's continuing inability to establish independent regulators in the telecommunications and express delivery services sectors is symptomatic of continuing resistance within the government to fully divorce itself from key decision making that affects the commercial environment for both foreign and domestic companies.

And China's post-WTO accession use of industrial policy—including the use of targeted lending, subsidies, mandated national technology standards rather than voluntary, industry-led international standards, discriminatory procurement policies, and potentially, antitrust policy—to structure the development of strategic sectors is also of mounting concern.

But while China's continued economic emergence undoubtedly presents many challenges for certain segments of the U.S. economy, the U.S. Chamber continues to believe that engagement is preferable to unilateralism and that the economic and commercial relationship was and still is the core of our engagement. This core must be nurtured. China has demonstrated a willingness to work with us, but we need to see continued, visible progress in the near term.

WTO Implementation

Now in year four of China's WTO implementation, the U.S. Chamber believes that the process by which the business community in both China and the United States and their governments are working together to fully implement China's WTO commitments is fostering positive changes in China's trade and investment regimes. We agree with the United States Trade Representative's (USTR's) December 2004 report to Congress, which stated that China "deserves due recognition for the tremendous efforts made to reform its economy to comply with the requirements of the WTO." Moreover, we continue to believe firmly that engaging China in the rules-based trading system has resulted in important progress in key areas, particularly in tariff reduction, revising existing laws and drafting and passing new ones to comply with its WTO requirements, and educating its officials and companies about its WTO obligations.

Positive steps by China to implement its outstanding and new WTO commitments not only improve the Chinese business environment to the benefit of U.S. and Chinese companies alike, but they also underscore China's broader credibility in the global trading system. If China falters in meeting its commitments and its adherence to WTO disciplines, such as in the areas of intellectual property (IP) and transparency, there will be ramifications that will constrain the full potential of this relationship to the detriment of both countries as well as companies from both countries.

As examples of progress, we note China's early phase-in of trading rights for wholly foreign-owned companies on July 1, 2004; decisions by China's insurance and commercial regulators to reduce burdensome capitalization requirements for foreign investment in the insurance and trading sectors; and increased transparency in the Ministry of Commerce's (MOFCOM's) regulatory drafting process. China has also made progress in addressing a range of problems with the implementation of its tariff-rate quota (TRQ) system, including poor transparency, delays in announcing quotas, insignificant and uneconomic quota allocations, and restrictions on foreign enterprises that are not required of domestic producers or merchants. As noted at the outset, U.S. agricultural trade to China is booming, and this reflects, at least in part, regulatory improvements and enforcement executed by China in accordance with its WTO commitments.

But despite notable progress in some areas, problems remain in others, and after more than three years in the WTO, China should work to eliminate what we termed in our most recent WTO report "the cyclical nature of its implementation efforts." More specifically, even as China has made positive regulatory changes that appear to presage greater market access for foreign companies as specified under its WTO commitments, China is simultaneously adopting new policies that undercut these changes in sectors of significant interest to our members.

China's continuing reliance on high capitalization requirements to restrict the market access that it promised in its accession agreements and use of proprietary standards and other industrial policy tools that discount foreign IPR and shield emerging domestic players from global competition are examples where China is undercutting meaningful implementation of its WTO commitments. Even as we tout progress in the area of agriculture, we note that Announcement 73, which was not properly notified to the WTO and which appears to provide China's General Administration for Quality Supervision,

Inspection and Quarantine (AQSIQ) with blanket authority to annul or void import permits in the case of a government-issued warning or ban, remains in effect. We are concerned, in particular, that Announcement 73 could result in government-sanctioned defaults on contracts for imported agricultural products similar to those that occurred in 2004 when a host of Chinese importers defaulted on soybean contracts on a massive scale. The U.S. Chamber hopes that China's courts will fully enforce the forthcoming decisions by arbitration panels in London on those defaults. Without consistent and enduring improvements in the course and spirit of implementation, there will be political consequences as well as a possible souring of business views about the China market.

Equally important, the U.S. Chamber believes that China should actively adopt measures that open its market in ways that comply with the spirit of its WTO obligations, even if it is not strictly bound to do so under its WTO commitments. New PRC policy directives that affect sectors of strong interest to U.S. Chamber member companies could greatly limit their ability to provide goods and services in the China market. These include Decrees 113, 114, 159, and 200 in the area of construction services, recently released regulations for autos that classify for tariff purposes imported vehicle components as finished vehicles, and just-released draft regulations on PRC government procurement policies for software. At a minimum, China should not adopt policies that are more restrictive than those in place prior to its WTO accession, as it has done in the case of construction and engineering services and as it is threatening to do in the area of government procurement. In these cases, U.S. goods and service providers face a rolling back of the market access they have enjoyed.

To further highlight this issue and by way of example, we wish to call the committee's attention to the distorted playing field on which U.S. film producers and distributors currently operate in China. In addition to lax enforcement of IPR, an equally important—and indeed often related—factor preventing the media and entertainment industry from realizing its full potential is the range of market access restrictions that inhibit content providers from building a legitimate market and satisfying Chinese consumer demand for legitimate product. Film import quotas, the import monopoly, and release delays for distribution of approved film and video products create a vacuum filled by copyright violators. This negatively impacts the entire value chain of the industry in China, from importation to distribution to exhibition.

Equally striking, at the same time that the absolute box office generated by U.S. films in China remains anemic, U.S. companies are importing PRC films into

the United States and other markets and repatriating considerable revenues to Chinese producers. PRC films have performed well in the United States, grossing tens of millions of dollars and benefiting handsomely from strong marketing and wide distribution arranged by U.S. distributors in our market. *Crouching Tiger Hidden Dragon* grossed more than $125 million in the United States, *Hero* opened #1 in the United States on its first week of release and grossed a total over $50 million, and *House of Flying Daggers* has generated more than $10 million to date.

In sharp contrast, the total box office generated in China by all U.S. films last year, of which U.S. companies receive only the government-determined 13% to 14%, was about $60 million, or only slightly more than one PRC film (*Hero*) earned in the United States. To further put this figure in context, in Hong Kong, which has less than 1% of China's population, the top 10 U.S. films alone generated just over $25 million in the box office. If this trend continues, it is possible that the balance of trade could shift in favor of Chinese films in a sector where U.S. film companies have traditionally enjoyed a competitive advantage.

The U.S. Chamber is fully engaged in representing the business interests of our entire membership across the full range of industrial and services sectors. We wish to focus your attention today on five priority areas where we believe U.S. companies are continuing to face difficulties in the China market.

Intellectual Property Rights

Notwithstanding China's agreement to fully comply with Trade Related Aspects of Intellectual Property Rights (TRIPS) Agreement obligations upon its accession to the WTO over three years ago, it is clear that the protection which China is actually providing to companies of all sizes fails to meet the standards of "effectiveness" and "deterrence" set out in the TRIPS. IPR violations now severely affect virtually all industries, from consumer and industrial goods, medicines, autos and auto parts, food and beverages, and cosmetics to copyright works, including entertainment and business software, movies, music, and books. In sum, the scope of counterfeiting and copyright piracy in China worsened for most of our member companies in 2004, and we believe that this problem has reached epidemic proportions.

IP violations are not just affecting the PRC market. But China is the single largest source of counterfeit and pirated products worldwide, and the failure to control such exports is eroding our companies' profit margins, diminishing brand value, and, in many cases, endangering public safety. U.S. Customs

statistics showed an increase of 47% in the value of counterfeit goods seized in the year ending October 31, 2004. Statistics compiled for 2004 by other governments are expected to reflect a similar trend.

Increasingly, counterfeiting in China is harming small and medium-size U.S. businesses, many of which do not even have operations on the Mainland and must confront a flood of Chinese knockoffs in the U.S. market or in third-country markets where they export. Smaller companies clearly have fewer resources to deal with investigations and legal actions against pirates in China and their middlemen in other countries, and thus the need for more convincing and proactive government intervention is becoming increasingly apparent.

The U.S. Chamber was heartened by the promises of Vice Premier Wu Yi at the April 2004 Joint Commission on Commerce and Trade (JCCT) meetings on the intention of the Chinese government to significantly reduce IPR violations. And we acknowledge that the PRC government, at the central level and under the leadership of Vice Premier Wu Yi and the Market Order Rectification Office of the Ministry of Commerce, is taking important and constructive steps to improve coordination among relevant agencies responsible for IP protection and enforcement.

The U.S. Chamber also notes some recent progress in the Chinese government's willingness to engage directly with companies and industry associations in addressing problem cases and cooperating on capacity-building. In a further positive development, China's Supreme People's Court and Supreme People's Procuratorate issued a long-awaited Judicial Interpretation on December 21, 2004. This interpretation included a number of important changes that can strengthen the deterrent impact China's criminal enforcement efforts in the IP field.

Regrettably, though, the Judicial Interpretation contains a number of problems that leave potentially gaping loopholes for infringers, and industry is closely monitoring their impact. Key examples include the following:

- Unclear methods for calculating case values, including the lack of standards for valuing semifinished products and raw materials.

- Lack of clarity whether trading companies caught dealing in fakes can be held criminally liable for counterfeiting and piracy.

- Lack of provisions to clarify the conditions under which vendors and accessories meet the requisite knowledge requirements to be held criminally liable.

- Lack of provisions to criminalize repeat offenses by smaller-scale infringers.

- Whether sound recordings are even covered by the Judicial Interpretation.

- Significantly higher monetary thresholds for enterprises than for individual persons.

As the U.S. Chamber stated in its fall 2004 report on China's WTO implementation record, enforcement of IPR will not be effective until civil, administrative, and criminal penalties are routinely applied to IPR infringers. While China's government modestly improved its regulatory environment for IPR protection and carried out raids and other enforcement actions at the central, local, and provincial levels in 2004, administrative penalties—mainly limited to fines and confiscation of fake products—remain too small to create deterrence. Despite some signs that new efforts are under way and an increased level of arrests and raids, China has not "significantly reduced IPR infringement levels" as Vice Premier Wu Yi promised at last year's JCCT meetings.

The U.S. Chamber remains concerned that the limited legal reforms and enforcement campaigns commenced in 2004 are insufficiently bold, and that more focused action plans are needed at both the national and local levels in order to bring counterfeiting and copyright piracy under control. While it will take time to design and implement such plans, we do not yet see a commitment on the part of the Chinese to developing them.

Based on inadequate levels of IPR protection and enforcement in China and their adverse impact on U.S. economic interests, the U.S. Chamber recommended earlier this year that the USTR request consultations with China in the WTO and place China on the Priority Watch List in its upcoming 2005 Special 301 Report.

The Chamber also believes that the USTR should conduct a second Special 301 Out-of-Cycle Review for China later this year to assess China's implementation of the Judicial Interpretation and other enforcement efforts, including success

in adding additional police resources in regions where this is most needed, in criminalizing export-related cases, and in introducing new enforcement guidelines that will significantly boost fines and other penalties imposed by administrative enforcement authorities.

The Chamber and its members are seeking convincing evidence in 2005 from Chinese authorities that the IPR climate is improving and creating a climate of deterrence, including through data that confirms a much more substantial increase in proactive government investigations into cases, and substantial increases in prosecutions, convictions, and incarcerations of counterfeiters and copyright pirates.

Aside from liaison with China in the WTO context, the U.S. Chamber strongly supports the continuing efforts by the U.S. government to address China's failure to comply with its IPR commitments through the JCCT, other bilateral forums, and multilateral policy mechanisms.

We are eager to support capacity-building efforts in China this year at the central and provincial levels and we are now working with the PRC government to carry out a coordinated IPR educational and public awareness campaigns. To achieve these goals, we have placed people in China to identify appropriate opportunities and projects.

The Chamber is also working closely with U.S. and foreign governments, our corporate members, and counterpart associations, including with AmCham network in China, to benchmark China's progress in implementing the new Judicial Interpretation through monitoring the number of judicial prosecutions, convictions, and jail sentences for IP crimes in 2005. In addition to monitoring the criminal enforcement, we will collaborate with these partners to track enforcement by administrative authorities, including administrative fines, confiscations of production equipment, export enforcement, and the success of the government in transferring cases from administrative enforcers to the police for criminal prosecution.

A reduction in China's piracy and counterfeiting levels in 2005 will ultimately hinge on the political will of local governments, as well as the national government. Police investigations into new cases need to be proactive and adequately resourced in order to send a proper message to criminal networks that are increasingly behind the problem.

The sincerity of China's pronouncements that it is serious about protecting and enforcing IP rights will further be tested by its willingness to eliminate loopholes for infringers in existing and new regulations and to resolve high-profile cases, such as the Pfizer patent case on Viagra and the General Motors auto case, that impact domestic and foreign IP owners.

Full protection under PRC law and enforcement of IPR in China as set forth in China's TRIPS obligations are critical to the interests of foreign and PRC companies in China, as well as to China's public health and safety, the integrity and attractiveness of China's investment regime, and its broader economic development goals. We hope that the PRC government will accelerate IP enforcement in 2005 by further enhancing national leadership and dedicating additional capital and resources. Only through the exercise of even more aggressive measures will China's IPR protection enforcement regime be effective and respected.

China's accession to the WTO afforded it an opportunity to sell increasing quantities in the United States of the products where it has a comparative advantage. But by tolerating massive counterfeiting and piracy, China is denying U.S. companies the chance to do the same in China. Moreover, by tolerating the export of such counterfeits, China strips our companies of the opportunity to exploit their comparative advantage—and thus WTO benefits—in third countries as well. Ultimately, it is essential that China purchase the foreign IP-based products it is illegally using. That would translate into billions of dollars of sales and exports by U.S. and other foreign companies and more accurately reflect the balance of trade between the U.S. and China.

Distribution

China's full and consistent implementation of its distribution services obligations is also of critical interest to our members. The U.S. Chamber applauded China's early phase-in of trading rights for wholly foreign-owned companies on July 1, 2004. And we had hoped that MOFCOM would release by December 11, 2004, the date set forth in China accession commitments, implementing regulations that clarified how new and existing wholly foreign-owned businesses in China could acquire distribution rights to allow foreign businesses to begin distribution services. Regrettably, the U.S. Chamber and its members are still waiting for China to implement fully and transparently this core commitment.

We are encouraged that recent discussions in Beijing have yielded some

progress on this matter, and we anticipate that China will act to remedy its non-compliance soon. But we are distressed that many of the domestic issues now cited by the PRC government as excuses for slow implementation—tax, business scope, and zoning— were raised by our business community with PRC authorities years ago. Unlike most WTO members, China negotiated phase-in periods to gradually implement its commitments; other countries that have sought to join the WTO have not had this luxury. Going forward, the U.S. Chamber expects that China will address relevant regulatory issues in advance of key implementaion dates instead of using them as an excuse to delay timely implementaion and promised market access.

China's market access commitments under the WTO also include its commitment to permit sales away from a fixed location, which is also known as direct selling. The implementing regulations, which have not yet been formally released but which have been shared with several companies, will not permit direct selling to operate as it does around the world. The U.S. Chamber has asked the Chinese government to adopt final regulations that allow directs selling companies to conduct their operations by paying for both sales and marketing services provided to the companies by independent contractors as opposed to employees.

Standards

The U.S. Chamber is further concerned about China's use of discriminatory standards to erect barriers to fair competition and in violation of its WTO obligations. China's recent performance in this area has been mixed.

China has moved to develop, adopt, and increasingly mandate unique national technology standards across a wide range of technology products. Examples include a mandated encryption standard for wireless communications devices and the development of unique national standards for AVS for media/TV, IGRS for connectivity, TD-SCDMA for telecom, and EVD for recording media. Competition, innovation, and interoperability are best served by standards developed by market forces.

China's adoption of mandatory national technology standards that are out of step with international standards efforts and that don't consistently respect IP are troubling to U.S. Chamber members, many of whom have made significant investments in China. With its strong manufacturing capabilities and rapidly growing consumer base, China will play an increasingly important role in the development of the Asian and global IT industry.

In particular, the U.S. Chamber believes that compulsory patent licensing should not be used to resolve patent-infringement issues, even for China's mandatory national standards. For standards based on open and voluntary participation to be successful, IPR of patent holders must be respected, including the right to derive reasonable compensation (e.g., royalties or one-time payments) from IP. Compulsory licensing of patents is inconsistent with that fundamental principle and undercuts the value of Chinese patents both for foreign patent holders and even more so for Chinese technology companies. We believe that the best way to address patent infringement issues and create superior standards is to encourage wide participation of patent holders in the standards-development effort and also allow them to recover reasonable and nondiscriminatory patent licensing revenues from their R&D investments in technology and innovation.

The Chamber was pleased by China's decision in April 2004 to suspend indefinitely its unique standard for WLAN products. But we remain concerned that China's WLAN encryption standard is but a leading example of a clear and disturbing trend across many technology products. The Chamber hopes that the PRC government will consider its decision as a precedent to be extended more broadly to standard setting in China's IT sector, as well as to other industrial sectors that are considering the development of unique standards that are incompatible with their international counterparts.

Use of standards as a tool to protect local industry and force technology transfer is harmful to China's interests. Keeping foreign goods and services out of China will only hold back China's economic development and deny its government, people, and businesses of some of the best tools available to fuel growth and productivity. Foreign companies can help China achieve many of its development goals if they are permitted to compete fairly in the marketplace and if their IP is protected.

Transparency

Regulatory transparency remains a key concern of U.S. Chamber member companies. China has made important progress in improving the transparency of its rulemaking and other regulatory activities since its WTO accession in 2001, but China must do much more to ensure that it develops and implements laws and regulations in a manner consistent with international practices and WTO commitments. The U.S. Chamber applauds the measures that MOFCOM adopted at the end of 2003 to promote the ministry's compliance with China's WTO transparency commitments, specifically those that require PRC authorities to provide a "reasonable period for comment to the

appropriate authorities" before trade-related measures are implemented.

Other PRC ministries and agencies, however, have been far less progressive in their approaches to circulating draft regulations to foreign companies and in providing a reasonable window for comment. We urge the Chinese government to have all its rulemaking ministries and agencies follow MOFCOM's example in fulfilling China's transparency obligations under the WTO. Abrupt issuance of draft regulations by many ministries in China are still far too often followed by one-week windows for public comment. The Ministry of Finance's release three weeks ago of draft regulations on government procurement for software, for which a 10-day comment period was provided, is the most recent and pressing example of this practice.

Government Procurement

In its ongoing effort to combat corruption, the U.S. Chamber welcomes China's efforts to achieve greater transparency and to provide greater market access in the area of government procurement. China became an observer to the WTO's Agreement on Government Procurement upon its accession in late 2001 and agreed at that time to enter into negotiations to join the agreement as soon as possible. China's passage in late 2002 of its new Government Procurement Law that aimed to improve transparency, limit corruption, and remove local protectionism marked a step forward in these areas.

The U.S. Chamber is highly concerned, however, that the government procurement sector in China will be substantially closed off to foreign suppliers of goods and services through the implementation of the Government Procurement Law, which requires government entities to procure only domestic goods, services, and public works, with limited exceptions. The Chamber feels strongly that China's implementation of its procurement law should not exclude or diminish the ability of foreign companies to fully participate in China's procurement market. In particular, we are very concerned that the recently issued Trial Implementing Regulations on Government Procurement of Software (Implementing Regulations) are a significant step backwards. Of equal concern, it is our understanding that the draft Implementing Regulations are the first of what will likely be a series of sectoral rules promulgated by the Chinese government to implement the new Government Procurement Law.

The proposed Implementing Regulations would severely restrict market access by non-Chinese companies in a manner that goes far beyond the procurement practices of the United States and other nations. In a market where more than

90% of software is pirated, costing U.S. companies billions of dollars in lost exports, such a discriminatory procurement regime would effectively close the door for most, if not all, U.S. companies—and for that matter, non-Chinese companies—to sell software products and services to China's largest purchaser, the Chinese Government. Effective denial of the ability to sell to China's government market would also render meaningless to U.S. and other foreign software companies China's stated goal to promote the use of legally purchased software in its government.

The Government Procurement Law and the Implementing Regulations strike us as moving in precisely the wrong direction from China's WTO accession pledge, yet unfulfilled, to "initiate negotiations for membership in the GPA [Government Procurement Agreement] . . . as soon as possible." We are particularly concerned that now, more than three years from its WTO accession, China has yet to begin the process for GPA accession and has proposed procurement regulations that severely restrict access by non-Chinese companies.

As concerns in the United States increase over the growing U.S. trade deficit with China, the Chinese government's closure of its government procurement market in software and other industries appears to undermine Premier Wen Jiabao's pledge to foster an improved U.S.-China trade relationship based on increasing, not restricting, market access for U.S. exports, and to be inconsistent with the spirit of openness China embraced in joining the WTO. We hope that the Chinese government will quickly renew its commitment to open, inclusive, nondiscriminatory and transparent procurement policies by commencing negotiations to accede to the GPA and suspending adoption of the *Implementing Regulations* and any similar discriminatory procurement rules.

An open, competitive, transparent, nondiscriminatory and technology-neutral government procurement regime is in China's interest and in the interest of China's trading partners. This would encourage investment and active participation by leading foreign companies in China's economy and bring the best products and services for the best value to China's government and consumers.

The Chamber hopes that China's new procurement rules in this area will not discriminate between domestic and foreign suppliers. At a minimum, we expect that China's decision as to what constitutes a "domestic manufacturer" will adhere to the principle of national treatment so that Chinese subsidiaries of foreign companies will enjoy the status of domestic suppliers in the market.

Currency

China's status as a large, developing economy that is not yet fully market-based poses special challenges to world trade and financial systems. The Chamber encourages China to pursue economic reform and development through reliance on market principles.

We also believe that countries should not manipulate currencies to gain a competitive advantage. The U.S. Chamber has and will continue to support the administration's engagement of the Chinese government in discussions on such matters as currency levels, trade flows, investment regimes, and compliance with international agreements. In addition, the Chamber supports the increased attention of the International Monetary Fund and the Group of Seven industrialized nations to China's exchange rate policies.

And as stated at the outset of our testimony, the U.S. Chamber believes strongly that China should move as quickly as possible to an exchange rate system that allows market forces to determine the exchange rate of the renminbi.

But we also submit that our relationship with China should not be managed by a unilateralist approach. Unilateralist approaches, such as those that call for the WTO-unauthorized assessment of massive tariffs on PRC exports, would not have the intended result, particularly given the complexity of the issues involved, as made clear by testimony to Congress by the nonpartisan, objective Congressional Budget Office and the Congressional Research Service (Testimony of Douglas Holtz-Eakin, Director, Congressional Budget Office, "The Chinese Exchange Rate and U.S. Manufacturing Employment" (October 30, 2003); "China's Currency Peg: Implications for the U.S. and Chinese Economies," Wayne Morrison and Marc Labonte, CRS (September 29, 2003). In fact, the imposition of massive U.S. tariffs on Chinese exports would only undermine efforts to achieve the critical objective of a Chinese currency exchange rate determined by market forces.

The United States was a chief architect of the WTO in large part to prevent unilateral actions that would close markets abroad to the detriment of U.S. farmers, manufacturing and service companies, and their workers. Our companies have worked with successive administrations and members of Congress to ensure that a fair and objective system was put in place to protect U.S. interests both at home and abroad. A unilateralist approach would abrogate decades of work by having the United States engage in a violation of

its WTO commitments. If the United States starts unilaterally imposing additional tariffs when we do not like another government's policies, imagine the multitude of circumstances in which other countries will do the same to U.S. agricultural and industrial exports, with enormous consequences for the U.S. economy as a whole.

A unilateralist approach on currency would likely result in massive retaliation on U.S. exports to the detriment of farmers, exporters, and workers throughout the entire United States. U.S. exports to China, which have grown by 114% since 2000, would be hit by retaliatory tariffs or other actions. American businesses and consumers would face higher prices, and the U.S. trade deficit would likely increase as Americans import the same goods at higher prices. Moreover, American strategic interests in North Korea and the war on terror could be undermined. At the end of the day, the United States would lose much more than we could ever hope to gain from such an approach. Endorsement of this approach would be used for years to come as an example that even the United States does not believe in playing by the rules of global trade—of which the United States is perhaps the largest beneficiary.

Conclusion

The U.S. Chamber and our members appreciate the opportunity to participate in China's continuing development. We applaud the many cases in which Chinese authorities have worked closely with the U.S. business community to implement WTO commitments, as well as to resolve disputes that have arisen during the implementation process. As stated at the outset of this report, China is now the fastest-growing trading partner of the United States. Rapidly expanding bilateral economic and commercial ties underscore the market opportunities that China offers to U.S. exporters and investors, which support the creation of high value-added jobs at home.

But China can and must do more. The U.S. business community and others that vigorously advocated China's WTO membership premised their support on expectations that China is evolving into a more open and transparent market based on the rule of law. China's unsuccessful efforts to consistently enforce its IPR laws and to vigorously deter IP theft represent the most visible examples of these expectations remaining unfulfilled. Similarly, China has continued its reliance on state guidance and industrial policies—capitalization requirements, mandated national technology standards, procurement preferences and subsidies—in key sectors. Not only is this a breach of China's market access commitments or the spirit of openness China embraced when joining the WTO, but it also gives credibility to China's critics who doubt

China's commitment to create a business environment that values equally the economic contributions of domestic and foreign companies.

At the same time, the Chamber underscores that for all the fits and starts, for all the examples of China's sluggish WTO compliance, none of these trumps the value of engaging the world's most populous nation in the rules-based trading system. For all those who care about the future of our economy, jobs for Americans, stability and peace in the world, the protection of global health, and the advancement of environmental quality and human rights, we must continue to encourage China to become an active and committed member of the world trading system. Working within the WTO framework remains the most promising path to progress and is vastly superior to approaches that seek to punish and isolate this emerging global power.

Premier Wen Jiabao told us during his visit to Washington D.C., in December 2003, "The way forward in our trading relationship is to increase U.S. exports to China . . . not restrict Chinese imports into the United States." The only way this strategy can succeed is if China opens its markets further and more rapidly to U.S. goods and services. We fully expect China to implement Premier Wen's strategy.

The U.S. Chamber, the world's largest business organization, will remain fully engaged on these critical issues on behalf of American business. We will continue to lend our strong voice to ensure that China fully adheres to market principles and WTO disciplines.

Thank you, Mr. Chairman and members of the committee, for this opportunity to express the views of the U.S. Chamber on these important matters.

Testimony of George Scalise
President, Semiconductor Industry Association
Before the US China Economic and Security Review Commission
"China's High-Technology Development"
April 21, 2005
Palo Alto, California

Introduction:

Mr. Chairman, members of the Commission, my name is George Scalise, I am president of the Semiconductor Industry Association. SIA represents the largest US headquartered semiconductor companies. I also serve on the President's Council of Advisors on Science and Technology – the PCAST – where I recently chaired a subcommittee on Information Technology and Manufacturing Competitiveness.

I want to start by thanking you for inviting me to testify here today. I think this hearing – with its focus on the opportunities and challenges that face the US high technology industry vis-à-vis our Chinese competitors -- is very timely. As I will explain in my testimony, Chinese government policies, and not lower labor costs, are the major contributor to 10 year, a $1 billion cost differential, between building and operating a semiconductor plant in China compared to the U.S.. This Commission has a responsibility to help build the consensus among U.S. policy makers to develop an effective response to this challenge.

I would like to begin with a brief overview of the US semiconductor industry and the mission of the SIA before going into more detail on the challenges presented by Chinese policies.

First, though, I want note that China can and should pursue its desire for a strong microelectronics industry. China is a very compelling market for US companies, and it is home to some very strong competitors. SIA has since its inception favored free and open trade, and the case of China is no exception – robust competition is what drives the industry to invest ever higher amounts in research and technological advances in order to stay ahead.

U.S. leadership in advanced technology is not guaranteed, and foreign competition is intensifying. Many other countries – including China -- are aggressively pursuing policies to build technical capabilities and to attract semiconductor and other high tech investments. The issue before us today is to understand the competitive factors influencing our industry, ensure that competition is fair and unencumbered by government barriers or market distortions that prevent the best company from winning, and develop policies that will help us retain our leadership position in the years ahead.

Overview: The US Industry

Today, the US semiconductor industry is the most competitive in the world in terms of market share. US chip companies account for almost half of the world market in terms of sales – more than any other country. Over three quarters of US-owned wafer capacity is in this country despite the fact that three quarters of our sales are outside the US; almost 80% of the US industry's total labor compensation is in the US, while only 55% of our labor force is here.

The US also has the lead in terms of technology and manufacturing capacity. US semiconductor firms as a whole still account for the largest percentage of purchases of semiconductor manufacturing equipment, but that lead is diminishing. Purchases by American companies have gone from just over 43% in 2001 to roughly 25% last year. Chinese companies' share of equipment purchases grew from about 2.6% to over 8% over that same period. The second metric we look at is the geography where the equipment will be located. In terms of leading edge capacity, the US has declined from a high of 36% in 1999 to just over 20% in 2004, and that trend is continuing. Two-thirds of the world's new 300mm fabs will be built in Asia.

These numbers represent a geographic shift, and also a structural shift from so-called integrated device manufacturers to foundries. Foundries manufacture product designed by others – Taiwan built its industry on the foundry model, and China appears to be following suit.

A large part of the reason for this dramatic shift, though, is cost based. As I mentioned previously, there is a $1-plus billion 10-year cost difference between building and operating a fab in Asia versus the U.S.. About 70% of the cost difference is due to tax benefits, 20% due to capital grants, and only 10% due to lower labor costs. Operating costs such as lower utility costs or cheaper logistics are also slightly lower overseas.

As taxes represent 70 percent of cost differential, it is instructive to compare tax rates in specific countries. In the U.S., the Federal income tax rate is 35%, and state and local taxes typically equate to an additional 6% rate (after adjusting for the Federal deduction). In contrast, China offers a five-year income tax holiday, and an additional five years at half the tax rate. Singapore and Malaysia offer five- to 10-year tax holidays. Ireland has a 12% tax rate, which is still a third of the U.S. rate. Taiwan's tax holiday and accumulated tax credits have resulted in Taiwan chip companies reporting higher net profitability after rather than before taxes. These tax benefits often also apply for research, development, and design centers.

The mission of the SIA is to ensure that the US retains its lead in terms of both market share and technology. Chip manufacturing, corporate R&D, product design, semiconductor equipment and materials producers, and university research are all key elements of the semiconductor technology ecosystem, and erosions in any one part affects the other parts. The data I've just shared with you makes clear that while we have a solid lead today, we face significant competitive threats that I believe must be dealt with quickly and forcefully if we are to retain our lead in the future.

China's Market

China's semiconductor market was estimated at $25 billion in 2003, with annual growth rates ranging from 15-20%. China today is the third-largest country market worldwide, and is predicted to become the second-largest overall market by 2010. China is already the world's largest mobile phone market, and second largest personal computer market. The demand for chips is driven by China's increasing role as an electronics manufacturing hub, producing everything from PCs and cellular phones to flat panel displays, digital cameras, and DVD players.

Semiconductors exports to China in 2003 were $2.4 billion and $2 billion for the first nine months of 2004 – making them the second largest manufactured export from the US to China. These figures may actually under-report the full value of U.S. semiconductor products exported to China, as the distributed nature of assembly and final testing in third-countries is not captured in U.S. export figures.

Chinese Government Incentives

This very rapid market growth is accompanied by a very ambitious policy agenda to foster the semiconductor industry in China. These policies range from direct incentives to manufacture in China to support for R&D, coupled with a willingness to utilize the standards setting process quite aggressively to favor specific firms. Some of these policies represent an effort to make rapid progress in an important industry. Others, unfortunately, represent violations of World Trade Organization (WTO) rules.

In 2004, the Office of the United States Trade Representative (USTR) brought the first WTO case against China on that country's Value Added Tax (VAT) rebate on semiconductors. In summary, that policy provided for rebates of 14% of the 17% VAT paid to companies who manufactured their semiconductors in China, while imposing the full 17% VAT on imported chips. This created a substantial incentive for Chinese chip purchasers to utilize domestically made product. The WTO case was always about more than fair market access – it was about making sure that investment decisions will be based on sound market factors and not government interference. The policy was very effective in skewing investment decisions and led to substantial increases in manufacturing capacity in China. In July 2004 the case was settled, and on March 31, 2005, all remaining elements of the program were halted. To its credit, the Chinese Government implemented in full and on time all of the commitments made as part of the settlement agreement.

Following resolution of the VAT case, it appears that the focus is shifting to R&D. At the point in time the VAT replacement policy was to be announced, China issued "Temporary Measures of Special Funds in R & D in the Semiconductor Industry"– these measures will reportedly go into effect on April 30, 2005. The policy was jointly announced by the Ministry of Finance (MOF), the Ministry of Information Industries (MII) and the National Development and Reform Commission (NDRC). The notice itself does not indicate funding amounts, although press reports indicate that the fund may pay up to 50% of a firm's R&D costs. Press reports also indicated additional income tax breaks for semiconductor makers, reportedly lengthening tax breaks to five years exemption and five years at half rate, up from the current two-year exemption and three years at half rate that is granted to preferred companies. The SIA is actively seeking additional details regarding this policy, and would be happy to share them with the Commission when they become available.

In addition to these direct subsidies, the Chinese Government has also shown an interest in utilizing the standards setting process to impact the market. I'm not going to spend much time on this issue here today, but would be happy to answer any questions you may have at the conclusion of my testimony.

Chinese Manufacturing Capacity and Technology Trends:

The combined impact of China's compelling market opportunities and Chinese Government subsidies has been noticeable – By 2007, the projection is that almost 10% of global semiconductor capacity will be in China – up from barely 2% only a few years ago.

Much of the investment going into China today is in the foundry area. In the year 2004 alone, foundry capacity in China doubled to approximately 500,000 wafer starts per month – revenues earned by Chinese foundries also doubled from 2003 to 2004 to approximately $1.8 billion. By 2006, Chinese foundry capacity at the 0.18 um node will be approximately 28% of world total.

While much of the capacity in China today is 200mm and in some cases employs used equipment, experts project that there will be up to five 300 mm fabs operational in China by 2007. While the majority of Chinese capacity in 2004 continued to be at 0.5 um, the capability and capacity are rapidly expanding for more advanced nodes upto 0.13um – and one foundry even announced that it will soon have available 90nm (0.09 um) process technology.

Most Chinese foundries have entered into – or are in the process of entering into – process technology licensing agreements with leading semiconductor companies in Taiwan, US, Japan and Europe. Foreign companies also represent the bulk of the customer base for these foundries. Last year, foreigners accounted for approximately 80% of Chinese foundries revenues. However, Chinese fabless companies are growing rapidly – their revenues are expected to quadruple between 2003-2008, to $1.2 billion. Although this is still a relatively small number, Chinese foundries expect that local design houses will drive demand for advanced manufacturing capabilities in the future.

Semiconductor technology has been making rapid strides in China by virtually any metric one can imagine. The determined resolve of the local authorities to build a strong local semiconductor industry, coupled with the attractiveness of China as a market, is acting as a powerful accelerator.

The decision to locate new capacity in China is not driven primarily by low labor costs – semiconductor fabs are capital and technology intensive and even an 80% differential in wage rates results in barely a 10% difference in final costs. The difference lies mainly in Government incentives such as favorable taxation and other benefits.

Although China has chosen the low end of the foundry business as their entry vehicle into the global semiconductor industry, Chinese foundries are advancing rapidly to becoming world-class in leading-edge process technology. In addition, the Chinese Government proactively supports an entire local ecosystem including fabless design houses, integrated device manufacturers (IDMs), contract manufacturers (EMS) and designers (ODMs), test and packaging houses, venture capital and start-up firms. The rapid growth of the Chinese electronics ecosystem is likely to make the global environment far more competitive than ever before.

Steps the US Must Take: Technology Policy

Again, I believe that China can and will have a competitive semiconductor industry, and we welcome it as a competitor. That said, my concern is what the United States must do to ensure that we do not lose our position as technology leaders going forward. We must recognize that what is true for us in industry is true for the country as a whole – retaining our lead in this newly more globally competitive era will require a focused effort, and significant investments.

As I mentioned, I serve on the President's Council of Advisors on Science and Technology – the PCAST – and I recently chaired a subcommittee on Information Technology and Manufacturing Competitiveness. We delivered our report to President Bush in January of last year. Among our key findings were:

- Manufacturing share of US GDP and employment fell by half over 50 years, but productivity increases allowed output to remain steady;
- Technology improvements drive approximately half of US GDP, and two-thirds of productivity gains. While IT-producing industries generate less than 5% of GDP, they accounted for nearly half the surge in productivity growth since 1995. Continued advances in information technology are the key to continued economic growth.
- There is growing international competition for leadership in high tech fields – our foreign competitors aren't content to be low cost commodity suppliers anymore
- Many of our competitors have low labor costs, and benefit from significant foreign government incentives; and finally, and I think most importantly,
- US leadership is not guaranteed.

Retaining our technological leadership depends on the existence of a healthy innovation eco-system, and that in turn relies on a number of key components, including among other things:

- Strong investments in basic R&D
- Skilled scientists and engineers
- Laws and regulations that support domestic investment
- A competitive investor and tax environment
- A level playing field with effective IP protection

There are a number of government policies that support and help strengthen this eco-system. A cornerstone is supporting a strong and vibrant university R&D capability. Our university system is the best in the world, and federal investment in university research is critical to retaining current leading edge industries and also creating new ones.

Before addressing what I believe the government should do, let me make clear that the US semiconductor industry invests heavily in this area. In recent years, semiconductor firms have invested between 19-22% of sales in R&D, for a total of $16 billion in 2004 – more as a percentage of sales than virtually any other industry. Although much of this investment is on the product development side, basic university research and consortia activities represent important components, especially as we reach the physical limits of CMOS. Exclusive of consortia such as the SIA affiliated Semiconductor Research Corporation (SRC) and the SIA-founded Focus Center Research Program (FCRP), semiconductor companies contribute $50-60M annually to university research. In addition, industry consortia contributions to universities, SEMATECH and other programs totaled $320 million in 2003, tripled the level from $110M in 2001.

Federal funding for R&D as a percentage of GDP, though, declined from 1.2% in 1985, to only 0.7% in 2003. While the downward trend was slightly reversed from 2000-2003, it is important to return to the levels of the mid-1980s as a percentage of GDP. In addition to overall funding levels, we need to think about balance. Within university R&D, the physical sciences have remained largely flat, and engineering only recently showed modest increases. In 2005, overall Federal R&D investment was $132.2 billion, a 4.8% increase from the previous year. The Department of Defense (DoD) accounted for 80% of the increase.

The National Science Foundation Authorization Act of 2002 called for doubling the NSF budget over 6 years, but appropriations have not followed. In FY 2003, a 10.1% increase was a good start, but a 5% increase in FY2004 fell well short of the goal – I believe this year it is imperative that the NSF receive at least a 7% increase in funding to keep up with technology demands. This would lead to doubling by 2014.

SIA has first hand experience with the federal funding challenge. The Focus Center Research Program (FCRP), jointly funded by SIA companies, equipment suppliers and DoD, sponsors university-based research across the country. Federal funds are leveraged through matching industry contributions. Due to budget constraints, the Administration has not been requesting its share of funding for this program in the last two years. Congress has added money to fund the program. Government funding for FY 2006 should be $20M, to be matched by $20M by industry. It is important to the continuity of research that this program has a predictable funding mechanism from our federal partners.

These investments in R&D are as much economic policy as they are technology policy. It is not in our national interest to try to compete as a low labor cost supplier, and even if we did choose to compete on this level we could not compete against China. Our goal must be to create high wage jobs, which can only be achieved with higher productivity and products that command a premium in the market place.

A perfect emerging example can be found in the area of nanotechnology. The worldwide annual industrial production in the nanotechnology sectors is estimated to exceed $1 trillion in 10 - 15 years from now, which would require about 2 million nanotechnology workers. Recognizing the importance of this new area, the President signed the 21st Century Nanotechnology Research and Development Act in December 2003. Since FY 2001, federal spending on nanotechnology has more than doubled, to a total of $1 billion in the FY 2005 request. In 2004, U.S. nanotechnology investment was estimated at nearly $1B. Yet, the EU, Japan, the combined total of Korea, China, and Taiwan, each invested at nearly the same levels, and their investments are growing.

SIA has proposed the Nanoelectronics Research Initiative to find the next foundation for information technology – the successor to CMOS – by the year 2020. The NRI will be a collaborative effort between the U.S. government, industry, and academia. This year, SIA gained significant understanding of existing government programs in this area, and the NRI will continue to augment, link and accelerate these efforts.

Steps the US Must Take: Tax Policy

In addition to technology policy, America's federal and state governments need a coordinated strategy to reduce the cost differential created by foreign government tax and incentives policies. This strategy should include several elements, including competitive federal tax policies, a permanent R&D tax credit, and other elements.

The Federal government should match the tax holidays offered overseas and it must correct many of its misguided policies that discourage investment in the U.S. and consider other measures to close the tax gap with our trading partners. Specifically Congress should:

- Make the R&D tax credit permanent, enact the Alternative Simplified Credit and other R&D credit enhancements such as those included in the Senate bill last year, and increase the credit rates so that the foreign tax cost differentials are eliminated. The credit is

currently scheduled to expire at the end of 2005. Equally important, many companies invest significant sums on R&D yet cannot use the credit as currently structured.

- Allow companies to expense high technology equipment and thereby improve their cash flow and their ability to invest in new high technology equipment.
- Rethink international taxation rules and consider alternatives to the current rules on taxing foreign source income. Many of the companies that compete against the U.S. operate under territorial tax systems, or otherwise more favorably treat foreign income. The move toward contract manufacturing, a result of the escalating cost of chip factories, puts an additional burden on U.S. companies because their offshore income may be treated under Subpart F rather than as deferred income. Taxes on repatriated funds make it more likely that these funds will be reinvested overseas.
- Consider significant rate reductions to allow manufacturing to remain in the U.S. SIA is encouraged by last year's FSC/ETI resolution that will effectively reduce the rate for domestic production to 31.85 percent over five years. As result of recent reductions in Europe, U.S. corporate tax rates also even now exceed most European nations.

State and local governments also have a role to play. They must ensure that their tax policies must take into account the capital intensity of the semiconductor industry. Sales and property taxes fall disproportionately on businesses that provide their workers with the expensive tools that drive productivity. To counter foreign tax holidays, states that have succeeded in attracting new facilities or retooling of existing fabs have adopted policies such as sales tax exemptions for machinery and equipment, property tax caps, R&D tax credits, business tax apportionment and ad valorem tax abatements. Successful states have also emphasized prompt and flexible environmental permitting to reduce cost and respond to the short product life cycles in the chip industry.

Conclusion:

The question posed to me today by the panel was two-fold: the state of China's manufacturing and technology capabilities, and what the US can do to address these challenges.

As noted, I believe the stated of China's technological and manufacturing capabilities are rapidly increasing. They are able and talented competitors, who will increasingly pose a challenge to the US. I believe it is incumbent upon us not to seek to dampen this competition, but to embrace it fully while at the same time making the investments needed to retain the US competitive lead. It is not in our interest to try to compete as a low labor cost supplier – our goal is to pay high wages which can only be justified with higher productivity and products that command a premium in the market place.

The US competitive lead is ours to keep – or ours to lose. The investments and policy changes needed to achieve this goal are neither easy nor inexpensive, but it is vital that we make them.

COMMENTS OF THE SEMICONDUCTOR INDUSTRY ASSOCIATION FOR THE 2005 NATIONAL TRADE ESTIMATE REPORT ON FOREIGN TRADE BARRIERS--CHINA

December 21, 2004

The Semiconductor Industry Association (SIA) represents the U.S. semiconductor industry, which employs a domestic workforce of 226,000 people, registers annual worldwide sales of $80 billion, and captures nearly half of the world market. Since U.S. firms are leading global competitors, fair market access and barrier-free trade remain critical, especially in rapidly-growing markets such as China. China is the third-largest country market worldwide for semiconductors, and is predicted to become the second largest by 2010.

Since last year, two major issues facing the U.S. semiconductor industry in China have been addressed and successfully resolved—the value-added tax (VAT) rebate and the wireless encryption standard (WAPI). SIA expresses its sincere appreciation to the Office of the U.S. Trade Representative and the U.S. Departments of Commerce and State for their outstanding efforts in resolving these two issues. SIA values the responsiveness of the Chinese Government in addressing these issues in a constructive manner.

SIA's submission for the China chapter of the 2005 National Trade Estimate Report will focus on the following key areas of interest to U.S. semiconductor firms: 1.) VAT rebate repeal and support for domestic industry 2.) intellectual property protection 3.) standards and 4.) trade and investment regime reform.

1. VAT Rebate Repeal and Support for Domestic Industry

On July 8, 2004, Ambassador Zoellick announced that the United States and China had reached an agreement in the WTO dispute regarding China's VAT rebate on semiconductors. The quick and mutually satisfactory resolution of this case was a very positive development for the worldwide semiconductor industry, and a positive development in U.S.-China economic relations.

China's VAT regime, which had provided for a rebate of all but 3 percent of a 17 percent VAT on semiconductors manufactured in China, was a source of concern to the SIA since its adoption in 2000, before China joined the WTO. In addition to the rebate for domestically produced chips, China's VAT regime also accorded special favorable treatment to semiconductors manufactured abroad from Chinese designs. Each of these measures violated the relevant national treatment obligations of the WTO agreements which require that foreign goods and services (where scheduled) be treated at least as favorably as domestic goods and services.

The United States requested the WTO consultations with China in March 2004, with the strong support of SIA. The governments of Japan and Mexico, and the authorities of the European Union, joined the consultations, having expressed their own concerns over China's VAT policy on semiconductors.

The United States and China signed the official memorandum of understanding to settle the case on July 14, 2004 in Geneva. Under the terms of the agreement, China will eliminate its VAT rebate for domestically produced or designed semiconductors. A VAT rate of 17% will apply across the board for all semiconductors, imported or domestic. Effective immediately, the Chinese government would not accept any new applications to certify firms or products for the VAT rebate. This provision was critical to provide an immediate corrective to prevent investment decisions that might be driven primarily by the discriminatory rebate.

China agreed to issue a notice to revoke the rebate policy on imported chips designed in China by September 1, 2004, effective no later than October 1, 2004. This notice was issued by the Ministry of Finance and State Administration of Taxation on September 1, 2004.[1] By November 1, 2004, China was to issue notice to amend its policy to eliminate VAT rebates for domestic production, with an effective date no later than April 1, 2005. The Ministry of Finance and State Administration of Taxation issued the notice to terminate the VAT rebate on domestic manufacturing effective April 1, 2005.[2] This notice also stated that rebates would only be available to firms certified before July 14, 2004 until March 31, 2005. In other words, there was a rapid end of the rebates even for firms currently receiving the rebate, and no new firms or products will be allowed to qualify.

While China's prompt fulfillment of the VAT rebate settlement terms is encouraging, recent reports indicate that the Chinese government is considering new industry-targeted measures to take effect by April 2005. The new policy is reported to be in interagency discussions involving MII, NRDC, MOF, SAT, and Customs, with a target promulgation date of January 2005. The proposed semiconductor-specific policy reportedly consist of four key elements, to:[3]

1.) establish a special development fund of RMB 0.5-1 billion (approx. $60.4-120.8 million) allocated from the Ministry of Finance to the chip industry every year;
2.) create a personnel training fund of RMB 10-100 billion (approx. $1.2-12.08 billion) annually for the industry;
3.) relax income taxes from two years of tax-free followed by three years of half tax to five years of tax free followed by five years of half tax (or possibly ten years of tax-free); and
4.) provide 1% discount on loans for new investments.

Since details on these policies are still emerging, SIA urges USTR to closely monitor any potential new Chinese government measures designed to encourage the development of the semiconductor industry. Any promotional measures should be developed and implemented in a transparent manner and be fully consistent with China's WTO obligations.

In particular, the development fund must be implemented with full transparency to ensure that it does not amount to a pass-back of the VAT that otherwise would have been rebated to domestic firms. The Chinese government must establish a clear and public notice procedure for

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[1] Ministry of Finance, Customs, State Administration of Taxation Notice No. CAI GUAN SHUI [2004] 40. August 31, 2004.

[2] Ministry of Finance, State Administration of Taxation Notice No. CAI SHUI [2004] 174. October 25, 2004.

[3] "Four Supporting Policies of the New No. 18 Gazette Emerge, the Chip Industry is about to be Upgraded," *China Business* http://www.ceic.gov/cn December 6, 2004.

disbursement from the fund, and a list of recipients, amounts, and purposes should be publicly available. Further, this fund should not have the effect of distorting trade or investment by directly supporting product development or equipment purchase. If such a fund is established, it should instead focus on pre-competitive R&D activities and be open to participation of foreign firms.

SIA believes that subsidies hold the potential to disrupt market-based competition and distort trade. Specific financial intervention by governments to assist individual companies should be discouraged and should be subject to remedial action where such assistance causes injury or other adverse trade effects.

2. Intellectual Property Protection

As in prior years' submissions, the SIA underscores the importance of China's full compliance with its commitments to improve intellectual property (IP) protection. Last year, the semiconductor industry spent $14 billion, or 17 percent of sales, on research and development. Indeed, five of the top seven U.S. corporate recipients of U.S. patents were major semiconductor producers.

Protection of IP is critical not only to U.S. firms doing business in China, but also is in China's self interest, as it will encourage the high technology foreign investment China seeks in order to promote the development of its economy while simultaneously encouraging local entrepreneurs to engage in innovation.

In November 2004, SIA worked with the U.S. Department of Commerce and with the Chinese government and industry to hold an IP seminar for China's semiconductor sector. This seminar informed Chinese policy makers and industry executives about the range of benefits of IP protection for both the domestic and worldwide semiconductor industry, the steps companies can take to protect their IP, and actions that can be taken to reduce IP violations in China.

China has the substantive intellectual property laws required under the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS), but enforcement remains an issue. The adequacy of enforcement is a WTO issue because under TRIPS Article 41, WTO members are required to ensure that IP enforcement procedures "are available under their law so as to permit effective action against any act of infringement of intellectual property rights covered by the Agreement."

The World Semiconductor Council (WSC)[4] devoted a significant amount of time during its May 2004 meeting in Korea to the protection of intellectual property. The WSC joint statement called "on all Governments and Authorities to implement effective IP enforcement measures in their jurisdictions," noting that "The WSC believes that enforcement in some countries remains ineffective and lacking in deterrence."

As has been widely observed in U.S. government reports, damages in Chinese civil suits are relatively small, while thresholds for criminal action are high. Chinese courts also have a number

[4] The WSC, composed of the European, Japanese, Korean, and Taiwanese semiconductor industries as well as the SIA, has formed a special IP Task Force.

of procedural barriers that make it difficult to bring cases – for example a member company has reported to SIA that China requires a notarized statement from witnesses to the sale of the copied goods, and the sale must be to a "legitimate" customer and not a purchase made as part of an anti-counterfeiting investigation. In two intellectual property disputes of which SIA is aware, the plaintiff has chosen to file in courts outside of China because of perceived inadequacies of the Chinese legal system.

SIA supports a three prong strategy to increase the protection of IP in China:

1) changing Chinese law to ensure that penalties are a deterrent to infringement and not merely an infringer's cost of doing business;
2) increasing public awareness in China about benefits to China of increased respect for IP; and
3) encouraging businesses in China to take precautions to protect not only their own IP, but also that of their customers and third parties.

China should make a number of changes to its laws to ensure that penalties are a deterrent to infringement and not merely an infringer's cost of doing business. SIA is pleased that China agreed at the April 2004 JCCT meeting to take steps in this direction. The Chinese Supreme People's Court was expected to promulgate a new judicial interpretation by the end of 2004 regarding lower thresholds for applying criminal sanctions in IP cases and increased sanctions for import, export, storage, and transport of counterfeit and pirated products and for on line piracy.[5] In addition, SIA is hopeful that the new interpretation will add teeth to the criminal enforcement of China's IP laws. SIA is also encouraged by China's commitment at the JCCT meeting to continue and intensify its national campaign to investigate IP violations, close down producers of counterfeit and pirated goods, and increase inspection of exports.

Because of the short product life cycles of many semiconductor products, the WSC has encouraged governments and authorities to adopt fast track procedures allowing for quick review of counterfeit activity and appropriate and effective action to stop it. The Chinese government has established a fast track procedure to address semiconductor IP violations, but it lacks effective sanctions to deter the infringer from future copying. China should be encouraged to ensure that infringers can be both quickly stopped and penalized to deter future infringement by allowing injured parties to participate in both the fast track procedures and the court system.

The second plank in SIA's IP strategy is to increase public awareness of the benefits from IP protection to a country's economy, to its industries, and to its consumers. SIA welcomed China's commitment at the JCCT meeting to further intensify its efforts to increase awareness among Chinese consumers of the economic harm and risks to safety that result from using fake goods.

One form of IP that is unique to semiconductors is the IP involved in layout designs of the circuits that comprise a semiconductor chip. This form of IP is incorporated in the

[5] At the time of this submission, the judicial interpretation had not been issued, but was expected by the end of December 2004.

Semiconductor Chip Protection Act in the United States,[6] and is a requirement under TRIPS.[7] These laws are intended to stop the unauthorized copying of a chip protected by valid IP rights. The WSC policy paper regarding layout design IP calls for all segments of the semiconductor production industry to adopt principles that state the company's respect for intellectual property rights and willingness to investigate IP allegations when presented with convincing evidence that a design is a counterfeit. In the case of companies that manufacture layout designs for others, guidelines should be established so that the manufacturer is assured that the person requesting that a layout design be fabricated is the legitimate owner or licensee of that design.

IP protection in the semiconductor industry and other high-technology sectors is critical to continuing the R&D investments that lead to technological advancement in the United States, China, and other nations around the world. SIA welcomes the efforts of the U.S. government to address and prevent IP losses worldwide, specifically the 2005 China out-of-cycle Special 301 review and the Strategy Targeting Organized Piracy (STOP!) initiative announced in October 2004.

3. Standards

At the conclusion of the Joint Commission on Commerce and Trade (JCCT) in April 2004, China announced that it would indefinitely delay implementation of its proprietary "WAPI" wireless encryption standard. In addition, China agreed to work with international standards bodies in the wireless encryption area.

The proposed Chinese WAPI standard differed significantly from and was incompatible with internationally-recognized protocols, and would have required creation or adaptation of products solely for the Chinese market. It was planned for implementation even though the technical details of the Chinese requirements were not readily available to international firms. Later reports indicated that Chinese authorities would require foreign firms to engage in value-added production with a select list of local firms to obtain import permits in order to sell wireless LAN equipment in China. Products already in-country would have also required permits. If enacted, such requirements would have set a dangerous precedent by imposing technology transfer and local content requirements that China committed to eliminate with WTO accession. SIA appreciates the extensive effort by the U.S. Department of Commerce, USTR, and the State Department to resolve the WAPI issue at the JCCT.

The commitment of China to work with international standards bodies on WAPI is important, and should be encouraged in other areas. In addition, the JCCT announcement on 3G wireless telephone standards was very positive by supporting technology neutrality and freedom of choice for service providers. However, SIA understands that there is still significant pressure for a unique Chinese standard, and in August 2004 a Chinese firm announced it had developed a 3G chip for the home-grown standard.[8] In addition, the 3G license process should move forward without delay.

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[6] U.S. Semiconductor Chip Protection Act, 17 U.S.C. Section 901-914.

[7] TRIPS Code, Articles 35-38.

[8] "China's First Homegrown Mobile Phone Chipset Developed," People's Daily August 24, 2004.

Despite encouraging developments on WAPI and 3G, USTR should continue to closely monitor the trend toward unique national standards in China that are designed to favor domestic suppliers. Other attempts to create unique national standards include DVD, HDTV, RFID, digital cameras, and electronic imaging for cell phones. SIA has long advocated that standards should be industry-driven and determined in the marketplace, without government mandates.

In particular, the RFID standard will be important, as China is one of the world's largest manufacturers of consumer goods for large U.S. retailers who increasingly use RFID in tracking shipments. SIA members producing RFID chips and devices as well as those using RFID in logistics operations will be affected by the standard China adopts. SIA appreciates the efforts of NIST to organize a workshop on RFID standards in July 2005.

Standards in China are often developed by government authorities through a non-transparent process, and without input of key stakeholders, in particular neglecting international ones. Unique Chinese requirements in many cases would require product redesign, creating additional costs to U.S. firms in development expenses and lost revenue. In addition, Chinese firms would also be disadvantaged by such standards if their products needed adaptation for export markets.

In addition to the attempted use of standards to foster domestic industry development, another driving force is the idea that Chinese companies should reduce "foreign dependence" on IP, thereby lowering royalty payments. Efforts to create new Chinese standards, which may be incompatible internationally, would be much better directed toward working with international standards bodies and improving IP protection through better enforcement and procedures as discussed in the previous section.

China's development of standards in the electronics area should not be used as an industrial policy tool to foster information technology production goals by creating market access barriers. Standards should not create obstacles to international trade, impair intellectual property rights, force technology transfer, or require local content or partnerships. China has committed to abide by the WTO's Technical Barriers to Trade (TBT) Agreement, including publication of notices of adopted and proposed technical regulations, standards, and conformity assessment procedures.[9] Therefore, China should notify standards development activities to the WTO's TBT committee as early in the process as possible. SIA looks forward to working with the U.S. government on developing programs to encourage China's participation in international standards fora.

4. Trade and Investment Regime Reform

China should continue efforts to reform its trade and investment regime. Specific areas of interest to the U.S. semiconductor industry include:

Transparency

Several WTO commitments are expected to improve transparency in China's administrative rule-making. For example, China agreed that only those trade-related measures that are published and readily available will be enforced. China has also agreed to make information on trade-

[9] China's WTO Accession Protocol, *Technical Barriers to Trade* P.I.13.2, and China's Accession Working Party Report IV.D.3.177

related measures available to WTO members upon request before those measures are implemented or enforced. Additionally, China has committed to establish or designate an official journal for the publication of all trade-related measures and to provide a reasonable period of time for comment to the appropriate authorities before measures are implemented. The official journal may be published in English and on the web, which would be an important step towards improving transparency. The private sector's greatest challenge is to have a meaningful opportunity to comment on draft laws and regulations. Currently, Chinese governmental authorities are very inconsistent in allowing industry to provide meaningful input on such measures before they are implemented. Such transparency measures are especially important as applied to the China's formulation of industry-specific promotional policies and development of standards as discussed earlier in this submission.

SIA urges the U.S. government to work with the Chinese government in increasing transparency prior to publication of laws and regulations. Specifically, China should refine its administrative law to establish a uniform and effective system – at least at the national level – that requires all draft laws and rules issued by Chinese ministries to follow the same process, including reasonable access by stakeholders and consideration of relevant comments provided by the regulated community. These refinements could then serve as a model for provincial and local PRC governments.

Investment Restrictions

As part of the final WTO accession agreement, China agreed to fully implement the WTO Agreement on Trade-Related Investment Measures (TRIMs), eliminate export performance and local content requirements, and only impose or enforce laws related to the transfer of technology if they are in accordance with WTO rules. China also agreed that it will not condition investment or import approvals on performance requirements of any kind, including: local content requirements, offsets, transfer of technology, or requirements to conduct research and development in China.

Historically, Chinese regulations and informal practices have placed a number of restrictions on foreign investment, such as ownership percentages, export targets, local content requirements, and forced technology transfer. While nominally eliminated, SIA remains concerned that informal practices may persist.

Fortunately, the WAPI local production requirements under consideration were not enacted, as they would have set a dangerous precedent. The creation of unique Chinese standards that attempt to de facto force investment, technology transfer, or local content, are contrary to China's WTO obligations. USTR should continue to closely monitor China's formal and informal practices regarding investment for WTO compliance.

Environmental Regulations

U.S. industry remains concerned that any environmental regulations under consideration be scientifically-based and pass a cost/benefit analysis. China is currently drafting a regulation on "Management Methods for the Prevention and Control of Pollutions from Production of Electronic Information Products." Imported and domestic products would be subject to these regulations. In this case, the Chinese authorities involved have demonstrated a willingness to

involve stakeholders and a commitment to transparency by making drafts at each stage available for comment. U.S. industry has been actively engaged in the process. The final regulation is expected to be promulgated in early January 2005, after China notifies the WTO TBT Committee. The relatively transparent drafting process and WTO notification are very positive developments from a process standpoint.

China's State Environmental Protection Agency (SEPA) is undertaking a broad regulatory effort, including coordination with MII and other agencies. The agencies will issue a formal announcement in late December to announce the formation of six electronics sector teams, which should include participation by foreign companies. U.S. industry has expressed interest to the Chinese government in being involved in the process, and continues to work through the U.S. Information Technology Office in Beijing.

Estimate of Potential Increase in Exports

China's semiconductor market was estimated at $25 billion in 2003, with annual growth rates ranging from 15 to 20 percent.[10] China is the third-largest country market worldwide, and is predicted to become the second-largest market by 2010.

The demand for chips is driven by China's increasing role as an electronics manufacturing hub, producing everything from PCs and cellular phones to flat panel displays, digital cameras, and DVD players. China is also the world's largest mobile phone market, and second largest personal computer market.

Semiconductors were the second-largest U.S. manufactured product export to China.[11] U.S. exports to China in 2003 were $2.4 billion, and $2 billion for January-September 2004.[12] These figures may under-report the full value of U.S. semiconductor products exported to China, as the distributed nature of assembly and final testing in third-countries may not be captured in U.S. export figures.

Given the expected growth in China's semiconductor market and overall electronics sector, the barriers discussed in this submission affect exports of U.S. semiconductor products valued in excess of $500 million annually.

Conclusion

China is a large and rapidly-growing market for semiconductors. U.S. firms must be able to compete on a fair and open basis for sales in the Chinese market. The resolution of the VAT and WAPI issues removed significant impediments to the semiconductor sector in China. The Chinese government should now focus on identifying, addressing, and resolving potential WTO concerns or are otherwise trade restrictive or trade-distorting before such measures are enacted. It

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[10] China's Center for Information Industry Development

[11] Soybeans in 2003 were the largest U.S. export to China based on dollar value. Aircraft were second overall, and first among manufactured goods.

[12] U.S. Department of Commerce Trade Figures, combined U.S. exports to China of HS 8541 and 8542.

is critical that the U.S. government closely monitor any potential new Chinese government measures designed to encourage the development of the semiconductor industry, especially those involving direct subsidies. China should also improve and vigorously enforce protection of intellectual property. Improved IP protection will benefit both U.S. and Chinese firms. The standards development process in China, especially in the electronics sector, should also be closely observed to ensure fair market access and consistency with WTO obligations. Improved transparency in regulatory and administrative processes will significantly improve China's trade and investment regime. Finally, formal or informal investment requirements, such as efforts to force local content requirements and technology transfer, should be eliminated.

Testimony on "U.S. China Economic Relations" to the Senate Committee on Finance, Thursday, June 23, 2005

Kenneth Rogoff, Professor of Economics and Thomas D Cabot Professor of Public Policy, Harvard University

The massive and growing United States current account deficit, presently running at over 6% of GDP, is a key point of vulnerability –perhaps the key point of vulnerability -- in the global economy today. Incredibly, if one adds up the surpluses of Japan, Germany, OPEC, China and *all* the other countries in the world running current account surpluses (a broad measure of the trade balance), the United States is absorbing three quarters of the global total. It is unprecedented to have the world's largest country soaking up so much of the world's excess savings. When Britain was an empire in the 1800s, it ran giant *surpluses* sometimes running as high as 10 percent of GDP. Whereas it is perfectly possible that the present situation will resolve itself in a relatively benign fashion – especially if the US current account very slowly shrinks as a share of GDP over fifteen to twenty years – there is also a significant chance of much more rapid and painful adjustment. This would imply, at the very least, a sharp further collapse in the dollar against a broad index of currencies, a collapse of 20% or more. Such an appreciation might be relatively benign as in the 1980s, but more likely, a sharp closing up of the US current deficit will imply a significant slowdown in global growth, particularly in regions like Europe, Japan and Latin America, with their relatively inflexible economies. Some of this will surely boomerang on the United States in form of lower exports. In a worse case scenario, a global slowdown and sharp drop in the dollar will set off a series of financial crises, and a sharp rise in United States borrowing costs.

Unfortunately, there is no painless way to defuse the global imbalances. Financial globalization may help explain why the US has been able to borrow so much, but adjustment must ultimately come through the real side of the economy, with the US needing massive rises in exports and probably even larger falls in imports to bring the two into balance.

One can outline a mix of factors that might soften the landing for the economy, if not necessarily for the dollar. American citizens, whose savings rates are hovering below 1% (excluding capital gains on homes) could start saving more. The consolidated government sector of the United States could also contribute more savings, or at least less dissavings. Ideally, the European and Japanese economies would grow faster through increased domestic demand, not just higher imports. Finally, in almost any scenario, the real value of the dollar needs to weaken further, especially against the major surplus regions. The dollar has already declined somewhat against the flexible rate currencies like the euro, the Canadian dollar and British pound (though substantial further depreciation would still be needed if the US current account were to close up completely). But the largest adjustment has to come from the Asian currencies, many of which have moved very little against the dollar. According to my calibrations with

Professor Maurice Obstfeld of Berkeley[1] the Asian currency block would need to appreciate against the dollar by an average of 18% in a scenario where the US current account deficit is cut in half over two years. The appreciation would have to be 36% in a scenario where the United States current account is completely eliminated (and that is assuming no exchange rate "overshooting"). I hasten to add that a dollar depreciation will be as much a consequence of a closing of the US current account deficit (say because a flattening of house prices raises other forms of US savings), rather than a cause of it. Absent savings or productivity shifts, if the dollar were to magically depreciate by 20% against all other currencies (not just Asia), it would probably not knock off little more than a third of the US trade and current account deficits, even after the effects had fully played out.

Where does China fit in? Even if *all* Asian currencies were to rise by 20% of the dollar, it would not begin to solve the US trade and current account deficits. But Asian exchange rate flexibility would be helpful. Most importantly, it would help cushion the potential effects of a lower US trade deficit on the rest of the world outside Asia. In my calibrations (with Obstfeld), we find that if the Asia sticks to its de facto peg against the dollar while, say, a shift of global savings towards the US eliminates the global imbalances, the non-Asian currencies would have to appreciate by more than 50% against the dollar versus 10-15% if Asian currencies are flexible. And to add insult to injury, Europe alone would lose over a trillion dollars in this scenario, as its Asian and US currency holdings fell in value. Europeans should be even more concerned than Americans about having more flexible exchange rates in Asia.

It is important to recognize that while China may be the coming economic giant, it is not yet the colossus that it is sometimes portrated as. China, for example, is not yet nearly the world's largest (current account or trade balance) surplus country. That distinction belongs to Japan and Germany, with oil producers also collectively becoming important as oil prices rise. Indeed, China's giant bilateral trade surplus with the United States is partly an illusion. In the typical Chinese export good to the United States, about 80% of the value added comes from other countries, mostly in Asia. When a Korean manufacturing firm decides to fill a shirt order in the United States, it may well have the yarn spun and dyed in the Philippines, the yarn woven into fabric in Thailand, and only then will the shirt be cut and packaged in China. But when the shirt arrives in the United States, it will only say "made in China." So pointing to China's bilateral surplus with United States is extremely misleading; if assembly did not occur in China, it would be occurring in other low cost countries outside the United States. Unless Americans started saving more, the overall results would not be so different.

I have argued that a more flexible Yuan exchange rate would help cushion adjustment to global trade imbalances, even if it did not provide a cure. That is, by making its currency more flexible, China could play the role of good global economic citizen, helping deal with the a problem that it fundamentally did not create, the US trade

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[1] See Maurice Obstfeld and Kenneth Rogoff, "Global Current Account Imbalances and Exchange Rate Adjustments," forthcoming (with revisions) in William Brainard and George Perry (eds.), *Brookings Papers on Economic Activity*, Spring 2005.

deficit. There is, however, the small matter of whether a more flexible exchange rate is in China's best interests. On balance, I would say the answer is definitely yes, but it not the black and white case that many seem to believe. The problem is that China today is really two countries. There is booming coastal China with about 450 million people that is an emerging market; like any emerging market it will eventually have a catastrophe if it sticks to a fixed rate. Right now, all the pressure on the currency is up, which is not such a problem. But exchange rates have a habit of boomeranging, and some day the pressures may all be in the opposite direction. A high level of reserves will offer scant protection if a severe political crisis or a financial meltdown suddenly has Yuan holders fleeing for the exits. So the emerging economy in China needs to learn to float.

But then there are the 850 million people in the rest of China, where more than a 150 million unemployed workers sit on the sidelines, waiting for a chance to be allowed to migrate to the high-growth coastal cities. This part of China is still a poor developing economy. Poor developing economies generally do better by having a fixed exchange rate rather than a floating one.[2] Balancing the needs of these two worlds is a genuine source of tension for China's leaders. On balance, the need for China to protect the fast growing coastal regions from overheating and crisis probably trumps over factors. But one should not pretend this transition, inevitable as it may be, is necessarily going to be riskless or painless. As such, it is important that the United States show that it, too, is willing to take painful measures to deal with a global imbalance problem that has much to do with low American saving levels.

The United States China economic relationship has been, on balance, a lynchpin in both countries' success over the past decade. For the United States, the pressures from globalization have not only provided US consumers with massively better and cheaper goods than they would otherwise enjoy, but it has also helped make the United States the most competitive and flexible economy in the world. For China, export led growth has helped lift hundreds of millions out of desperate poverty over the past two decades. The United States' open trade policy has been the most successful aid policy in history, helping countries to help themselves. Whereas the time has come for China let its currency appreciate and become more flexible, Americans must not pretend China, or more broadly Asia, is the main source of our country's trade deficit. Low US savings is at least as great a problem, if not more so. For better or for worse, the US trade deficit is one thing we thing we Americans consume that is still has a large American content.

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[2] See Aasim Husain, Ashoka Mody and Kenneth Rogoff "Exchange Rate Durability and Performance in Developing versus Advanced Economies," *Journal of Monetary Economics* 52 (January 2005), 35-64.

Statement of the Record
United States Senator Rick Santorum
Committee on Finance
Hearing on U.S. - China Economic Relations
June 23, 2005

Chairman Grassley and Ranking Member Baucus, I appreciate the consideration you have shown to Members of the Senate who have been eager to examine a variety of issues that have risen to the forefront in U.S.-China relations. The witnesses you have assembled, beginning with Chairman Greenspan, ought to provide the Committee with a deeper understanding of the problems American businesses face in competing with Chinese firms, and also some of the risks associated with responding to these challenges.

As Members of this committee know, American manufacturers are fighting to remain competitive in the international marketplace. One of the recent accomplishments of this committee was the JOBS Act--which replaced the previous FSC/ETI regime with a new system that seeks to provide incentives for companies to remain in the United States and to improve their global competitiveness. The Committee has been responsive and proactive in trying to enhance the ability of American businesses to compete and, through the review of trade agreements negotiated by the Administration, to ensure U.S. exports substantially improved market access from our trading partners.

Unfortunately, some of the problems we are seeing and experiencing today have their origin in the unfair trade practices, financial policies, and enforcement failings of our trading partners. With respect to China, the size of the U.S. trade debt is also a matter of concern. Issues such as China's fixed rate of the renminbi, the desire to retaliate against subsidized Chinese products, and China's failure to protect the intellectual property of American businesses and companies are concerns I have encountered when I meet with constituents in Pennsylvania.

China's rate of growth since 1999 has been nothing short of astounding. In 2004, China's trade growth, combining imports and exports, reached 35%. As the China Business Forum notes, the last time the U.S. economy grew by more than 30% or more was 1946. Foreign direct investment (FDI) in China has also accelerated. In 2004, China garnered $60.6 billion in FDI, while the U.S. accumulated only $3.9 billion during that same year. This rapid rise in investment has created an increase in global manufacturing capacity. As Members of Congress know, China's total exports jumped from around $400 billion to nearly $600 billion. At the same time, according to the U.S. International Trade Commission, the U.S. trade imbalance with China grew substantially from roughly $80 billion in 1999 to $200 billion in 2004.

The Senate has wrestled with the possibility of unilaterally applying a tariff of 27.5% to Chinese imports as a way to counter China's fixed renminbi policy. I know that many Americans favor this approach as a way to either counter a perceived Chinese subsidy or as a way of getting the attention of the Chinese that this policy is a significant problem in the U.S.-China relationship. I commend Secretary Snow for his efforts to impress upon the Chinese the importance of addressing this policy and encouraging China to move to a flexible exchange rate. I recognize that this is a complex matter, so I look forward to Chairman Greenspan's comments on this subject and those of Dr. Rogoff. I am particularly keen to hear about the possible unintended consequences of unilaterally applying a tariff to Chinese products entering the U.S. as is specified in S. 295, the Graham-Schumer China currency bill, and the potential destabilization of China's economy if it were to quickly adopt a flexible currency exchange rate.

China's ability to enforce intellectual property rights and to effectively curb these violations are a concern. China's record on cracking down on violations and making sure its companies adhere to international intellectual property rights obligations is poor at best. Not only are current profits of American companies

compromised, but these violations rob U.S. companies of the ability to innovate and stay ahead of foreign competitors. In essence, China's inability to enforce the intellectual property rights of American companies compromises our future in the international marketplace. I commend the Administration for initiating the Strategy Targeting Organized Piracy (STOP!) program to empower U.S. businesses to help reduce trade in pirated or counterfeit goods.

The lack of transparency in Chinese governmental actions and policies means that prohibited export subsidies may still be continuing in another form or guise. I am also concerned that many barriers still exist for U.S. companies trying to enter China's historically protected services market. I believe that more can be done to press for greater market access and transparency in sectors such as insurance, banking, telecommunications and express delivery sectors.

Responding to these and other challenges in our trade relationship will not be easy as, noted by the U.S. Chamber of Commerce, U.S. exports to China have grown by 114% since 2000--five times faster than to any other country. From 2000 to 2004, U.S. agricultural exports to China increased approximately 224% from $1.7 billion to $5.5 billion. China represents a huge market to U.S. exports and to the health of the U.S. economy. On the other hand, relying on a fixed exchange rate, not enforcing intellectual property laws, failing to ensure transparency and continuing to erect barriers to U.S. companies will require Congress and the Administration to think creatively about ways to ensure change in China without destabilizing an important U.S. export market.

Mr. Chairman and Ranking Member Baucus, I look forward to receiving the testimony of today's witnesses and I look forward to working with others on this committee to help improve economic relations between the U.S. and China.

Testimony of Treasury Secretary John W. Snow
before the
Senate Committee on Finance

June 23, 2005

Chairman Grassley, ranking member Baucus, members of the Committee, it is a pleasure to appear before you to testify on the matter of our economic relations with China. This hearing could not be more timely. China is playing a larger and larger role in the global economy and the Treasury Department has been intensely engaged on a broad range of Chinese financial and economic issues over the course of the last several years, particularly on the question of the yuan and flexible exchange rates. It is important that China move to a more flexible exchange rate regime, we have urged them to do so, and they have agreed that it is in their interest to adopt greater exchange rate flexibility. While it is in China's interest that they do so, it is also in the interest of the global adjustment process, which is a shared responsibility.

I appreciate the chance to address the issue of our economic relations with China in the context of this shared responsibility among major economic regions for tackling imbalances in the global economy. I had the opportunity to address some of these issues when I released my report last month on the foreign exchange practices of America's major trading partners and I look forward to revisiting these issues today. China's role in the global economy and its impact on this country are receiving a great deal of attention here at home and among traders and investors in financial markets around the world.

Although U.S. trade with China represents only about 10% of our overall trade, China is beginning to play a more significant role in the global economy. For the past decade China has pegged its currency to the value of the U.S. dollar. There was a time when such a policy may have contributed to global economic stability, but that is no longer the case today.

In my report to Congress, I determined that China did not meet the technical requirements for designation under the statute. However, it would be wrong to interpret this as acquiescence with China's currency regime. We have made it clear to China's economic leadership that reform of its currency policy is in its own interest, and in the interest of global financial system. After two years of intense engagement, it is clear that China today is prepared to introduce greater currency flexibility. China's currency regime contributes to distortions in its own economy and blocks the smooth adjustment of global imbalances. Furthermore, if current trends continue without substantial alteration, China's policies will likely meet the technical requirements of the statute for designation. China is now ready and should move without delay in a manner and magnitude that is sufficiently reflective of underlying market conditions.

Members of this Committee and many others in Congress have expressed to me their own dissatisfaction with China's currency policy. I take these concerns very seriously and I have enormous sympathy with these concerns. In addition, China, like all trading partners of the United States, must play by the rules. China's economy must be open to competition. Intellectual property rights have to be honored and violations effectively prosecuted under Chinese law.

But I cannot overstate my firm belief that resorting to isolationist trade policies would be ineffective, disruptive to markets and damaging to America's special role as the world's leading advocate for open markets and fair trade.

Acting on any of the punitive legislative proposals before Congress now would be counterproductive to our efforts - at this time. The unintended consequence would be to delay the concrete steps on currency reform that China should take for its own sake and for the sake of the global economy.

In addition, implementation of trade sanctions would lead to retaliatory policies against our exports, damaging the U.S. and the global economy. Walls will not protect America's workers and industry. We succeed not with barriers, but with the openness and dynamism which has always characterized our nation.

It is also appropriate to consider China's role in the global adjustment process.

Addressing Current Account Imbalances

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

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

The United States is doing its part to address imbalances by aggressively tackling our fiscal deficit and our long-term liabilities. Because of strong growth and appropriate fiscal policy, the U.S. budget deficit in 2004 was well below projections, and with recent data, I expect further improvement in our fiscal deficit position this year. Some private forecasters predict that our fiscal deficit will be below 3% of GDP this year if we continue to hold the line on spending. We are also working to put in place innovative policies to increase the savings rate.

Our actions are important, but they alone will not be sufficient to unwind global imbalances. Simply put, large imbalances will continue if growth in our major trading partners continues to lag. European and Japanese GDP together exceeds that in the United States. These economies must continue to adopt and implement vigorous and necessary structural reforms to establish robust rates of growth – both for the good of their own citizens and to contribute to reduction in the imbalances in the global economy.

Greater flexibility in China is also a necessary component of the global adjustment process. Concerns of competitiveness with China also constrain neighboring economies in their adoption of more flexible exchange policies.

In China's interest

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

A more flexible system will also support economic stability in China. Currently, China relies largely on administrative controls to manage its economy – controls that are cumbersome and increasingly ineffective. An independent monetary policy will allow China to more easily and effectively pursue price stability, stabilize growth, and respond to economic shocks.

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

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

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

U.S. – China Engagement

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

* It has introduced a foreign currency trading system permitting onshore spot trades in eight foreign currency pairs and allowing banks to act as market makers.
* It has adopted measures to increase the volume of foreign exchange trading, for example: eliminating the foreign exchange surrender requirement for many commercial firms; allowing domestic Chinese insurance firms and the national social security fund to invest in overseas capital markets; and increasing the amount of foreign currency business travelers can take out of the country.
* It has taken steps to develop foreign exchange market instruments and increase financial institutions' experience in dealing with fluctuating currencies. Foreign exchange forward contracts can now be offered in China; foreign exchange futures are being developed; and domestic Chinese banks can now trade dollars against other foreign currencies, not just remnimbi.
* It has also acted to strengthen its financial sector and regulation, so that this sector is more resilient to any fluctuations in exchange rates.

As a result, China is prepared to introduce flexibility and should do so now.

China should take intermediate steps that reflect underlying market conditions and allow for a smooth transition – when appropriate – to a full float. A flexible system will provide China with a more sophisticated array of policy tools – namely an independent monetary policy – that will prove much more effective in achieving price stability and the ability to adjust to shocks. Today, I believe that the risks associated with delaying reform far outweigh any concerns with immediate action. The current system poses a risk to China's economy, its trading partners, and global economic growth.

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

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Questions from Senate Finance Committee Ranking Member, Senator Baucus, for Secretary Snow

Question 1:
Mr. Secretary, you have called our current account deficit a "sign of strength" of our economy.

According to the Department of Commerce, we are now on track for a current account deficit of $780 billion, another record.

Do you still assert that this is a sign of strength, rather than a sign of an economy heading in the wrong direction?

Answer:

The growth of the U.S. current account deficit over more than a decade has been linked to high levels of domestic U.S. capital formation compared to domestic U.S. saving. Perceived high rates of return on U.S. assets, based on sustained strong productivity growth relative to the rest of the world, sound U.S. economic performance, and the very good U.S. investment climate, attract foreign investment.

Question 2:

Much has been made of our economy's ability to attract foreign investment. Again, this is said to be a sign of strength. According to the Treasury Department statistics, foreign governments have become massive buyers of U.S. treasury bonds and notes.

Between 2001 and 2004, purchases increased by over 5,600 percent. On the other hand, the same statistics show foreign purchases of corporate and other securities are flat or negative.

To me, this kind of investment in the United States is not a "sign of strength," but rather of weakness and imbalance. Foreign governments are not investing in our future productivity, but simply buying government debt. Do you agree with this assessment?

Do you think that these massive purchases or our government debt distort our economy?

Does the lack of private investment inflows not point to weakness, rather than strength, in our economy?

The average maturity of U.S. treasuries has decreased since 2000 and there is a real possibility of higher interest rates. Does this combination of shorter average maturities and higher interest rates present increasing financing cost for our federal debt?

Answer:

Sustained external demand for United States assets has both supported the dollar in the foreign exchange markets over the years and allowed the United States to achieve levels of capital formation that would have otherwise not been possible. The U.S. capital market is the deepest, most liquid, and most resilient in the world. Robust growth in investment is critical to the non-inflationary growth of production and employment.

Net foreign (private and public) flows into U.S. *long-term* securities remain robust. Foreigners purchased $893.8 billion in long-term securities net in the twelve months through May 2005 compared with $819.3 billion in the twelve months through May 2004.

Net foreign official purchases of long-term U.S. securities have, in fact, recently been modest. They averaged $13 billion per month over the last twelve months. These flows are important, but net foreign official purchases are much smaller than foreign private purchases, which averaged $62 billion a month over the same period.

Private foreign purchases of corporate bonds continue to increase strongly, totaling $311 billion in the twelve month period through May 2005 compared with $243 billion in the preceding twelve month period. Moreover, U.S. financial markets intermediate between sources and uses of finance and greater foreign purchases of Treasury securities can allow greater U.S. purchases of domestic private securities.

The Treasury Department's primary goal in debt management is to finance government borrowing needs at the lowest cost over time. The best way to meet this objective is to issue debt in a regular and predictable pattern, provide transparency in our decision-making processes, and seek continuous improvements in the auction process. The Treasury does not try to outsmart the market at any one moment, or try to be a "market timer" with respect to any particular shape or level of the yield curve.

The Treasury portfolio is designed to meet the Treasury's objective and provides flexibility for higher or lower than forecasted deficits. Average maturity is within the historical range and the percentage of debt maturing with three years or less to maturity is projected to remain stable at slightly more than 60%. Rollover is not high by the standards of the past thirty years.

Question 3:

Mr. Secretary, you consistently call upon our trading partners to reform their economies to boost consumption and economic growth. You recently returned from Europe where you again delivered this message of reform.

I am concerned that by repeatedly emphasizing what other governments must do, we are overlooking shortcomings to our own competitiveness. After all, even vigorous growth in Europe would not erase a $780 billion current account deficit. Much of the solutions to our problems can be found at home, such as by reducing the budget deficit, boosting national saving, training more scientists, etc.

What exactly is the administration doing to address the domestic factors contributing to our current account deficit? More specifically, what is the administration doing to enhance the long term competitiveness of our economy?

Answer:

The U.S. current account deficit is the counterpart of the aggregate surplus of other economies in the world. The policies of all countries affect the global pattern of current account balances. The adjustment of global imbalances is a shared responsibility.

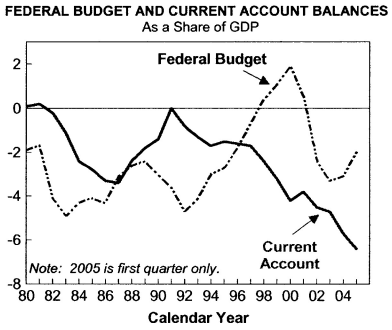
First, the United States will do its part through policies aimed at increasing saving of the public and private sectors. The decline in the Federal budget deficit to below 3 percent of GDP in 2005 shows we are making good progress at the Federal level, State and local governments in the aggregate are again net savers, and the Administration has proposals in place to encourage private saving and will soon advance a tax reform proposal intended, in part, to boost private saving further. Second, in Europe and Japan, policies for further structural reforms are needed to boost sustainable growth. Third, greater flexibility of exchange rates is needed, particularly in emerging Asia economies that lack such flexibility.

The United States does not have a current account target. It is important that U.S. policies keep the United States and the world economy strong. Blindly targeting a current account target will not accomplish this.

It is important that U.S. economic policies sustain strong non-inflationary growth and support efficient and flexible markets that, with the strong growth in U.S. productivity, are the core drivers of U.S. competitiveness.

Question 4:

What is the impact of the federal budget deficit on the current account? What is the impact on the current account (in percentage terms), for each dollar by which the budget deficit is reduced? Are these estimates broadly supported in economic literature?



Answer:

Historical data show little "twin deficit" effect in the United States (See attached chart), or in many other countries. Japan, for example, has a large fiscal deficit while running a current account surplus, as do several European countries.

Quantitative estimates on how much the current account would narrow from a given amount of Federal budget deficit reduction can differ markedly, depending in part on specific factors included in the model used to estimate the effect. Reducing the fiscal deficit should help increase national saving, although the correlation between the fiscal and current account deficits is weak. A recent study by the Federal Reserve Board staff suggests that a $1 reduction in the federal budget deficit would cause the current account deficit to decline around $0.20.

Questions from Senator Kyl for Secretary Snow

Question:

What U.S., WTO, and other legal means does the Unites States have to require China to abide by its global trade obligations (meaning, intellectual property protections, WTO accession commitments, transparency, etc)?

Answer:

Answer:

Since China joined the WTO in December 2001, the Administration has closely monitored China's progress in implementing its WTO commitments. When concerns arise, there are, of course, a variety of means of resolving them. These include, among other things, bilateral discussions, such as the recently concluded Joint Commission on Commerce and Trade meetings, co-chaired by the Secretary of Commerce and the U.S. Trade Representative on the U.S. side and China's Vice Premier Wu Yi; the use of U.S. trade laws, such as the Special 301 intellectual property rights process; WTO committee interventions and – when these fail and we believe that a country's actions are WTO-inconsistent – recourse to the WTO dispute settlement mechanism. Pursuing a dispute settlement case is not always the speediest or most appropriate means to resolve trade disputes, although we have not hesitated to use this tool when it is appropriate.

The United States filed, and was able to successfully resolve, the first-ever dispute settlement case brought against China at the WTO. In that case, the United States, with support from four other WTO members, challenged discriminatory value-added tax policies that favored Chinese-produced semiconductors over imported semiconductors. In July 2004, about three months after the United States had initiated the case, China agreed to end its discriminatory policies, allowing U.S. manufacturers to preserve and expand their $2 billion export business to China. The Administration is committed to continuing to use all the tools available to us to ensure that China lives up to its WTO commitments and that US companies and workers have the access to the China market that they deserve.

Even though the terms of China's accession agreement are directed at the opening of China's market to WTO members, China's accession agreement also includes several mechanisms designed to prevent or remedy injury that U.S. or other WTO members' industries and workers might experience based on import surges or unfair trade practices. These include a unique, China-specific safeguard provision allowing a WTO member to restrain increasing Chinese imports that disrupt its market (available for 12 years, running from the date of China's WTO accession), a special textile safeguard (available for 7 years) and the continued ability to utilize a special non-market economy methodology for measuring dumping in anti-dumping cases against Chinese companies (available for 15 years). The Administration is committed to maintaining the effectiveness of these mechanisms for the benefit of affected U.S. businesses, workers and farmers.

United States Senate Committee on Finance
U.S. China Economic Relations
Senator Olympia J. Snowe
STATEMENT
June 23, 2005

Thank you Chairman Grassley and Ranking Member Baucus for calling this hearing today to address what I believe to be one of the most pressing issues facing our country today--U.S.-China Economic Relations.

As we hold this vital discourse however, we must realize that *economic* issues are only *one* facet of the U.S.-China relationship that warrants significant attention and policy discussion by Congress. Hearings on U.S.-China relations also have their place in the Committees on Armed Services, Foreign Relations, Intelligence and Commerce . . . because this is how vast and how far-reaching the questions and concerns are about China's role in shaping the world today, and in the future, and how U.S. policies must be formed as a result.

Consider the facts: since 1978, China's GDP has risen fourfold . . . in straight dollar terms, China is the world's sixth largest economy with a GDP of roughly $1.4 trillion . . . and China is the world's third most active trading nation--behind the U.S. and Germany--and ahead of Japan. As staggering as these numbers are, when we consider the possibilities of China's future, we need to keep in mind something mentioned in a recent New York Times Magazine article; in the last century, the U.S. went through twenty-one recessions, a depression, two stock market crashes and two world wars . . . and none of these have stopped U.S. economic growth over that time. China may be poised to exhibit the same economic resilience in *this* century!

Mr. Chairman, this hearing is long overdue. China continues to violate international laws aimed at ensuring that free trade is also fair trade, which has left our nation's businesses, and particularly its manufacturers, struggling to compete with Chinese producers. The issues likely to be discussed here today are not new. We have all heard them over and over again, yet not enough has been done to address them. China continues to manipulate its currency, to subsidize its industries, to fail in its WTO obligations, and to erect barriers to entering its markets.

And for those U.S. companies that *are* able to penetrate the Chinese market, they risk immediate piracy of their products and a diminution in the value of their brand because, as we all know, China has utterly failed to protect U.S. intellectual property rights.

I certainly do not come here today as a "China basher" . . . I deeply respect the people of China, and their heritage, and I understand the difficult task that the Chinese government has in trying to improve the standard of living for its 1.3 billion citizens. And I am also not blind to the benefits that increasing trade with China brings. Since 1999, the value of Maine's exports to China have risen by an impressive 319%. Clearly, US businesses are increasingly taking advantage of the growing Chinese market.

However, a great deal of China's progress is needlessly and unfairly gained at the *expense* of our businesses here in the United States. This simply must end!

China's deliberate and unfair trade practices have *contributed* to our nation's trade deficit with China, which reached a record $162 billion last

year. How much longer will we stand by while these international laws are being violated? What will it take to effectuate change? One thing is certain, words are not enough! I am tired of hearing the rhetoric and I echo the scores of voices heard in Maine and throughout the country when I say that we are ready for action.

We hear weekly from businesses that employ our constituents about the problems, concerns and real dangers they are facing in fighting IPR violations in China. In my state, the New Balance Athletic Shoe company employs 880 people at three sites. They have spent at least *$1 million over a five-year period* fighting the Chinese system and the corrupt, illegal practices that flourish there. Between August, 1999 and December, 2004, raids on 131 illegal facilities in China resulted in the seizure of nearly 1 million pirated New Balance items! And this is just one example from one company. U.S. industry analysts estimate that in 2004, intellectual property piracy in China cost U.S. copyright firms $2.5 billion in lost sales--that's $2.5 billion less that went into the U.S. economy, into the paychecks of American workers.

Another issue that has been at the forefront of the China debate is China's currency practices. While economists differ over the extent that China's currency is undervalued, estimates often range between fifteen to forty percent, rendering Chinese goods cheaper in the U.S. and U.S. goods more expensive in China. I am disappointed that the U.S. Department of Treasury again failed to designate China as a "currency manipulator" in its semiannual report to Congress on International Economic and Exchange Rate Policies [released May 17, 2005]. That is why I encourage my colleagues to support legislation I offered this year [S. 984], which was referred to the Senate Banking Committee and is targeted toward increasing the likelihood that Treasury will label countries as currency manipulators and will be

forced to enter into negotiations with those countries to end the unfair practices.

In terms of industry specific problems, we are seeing Chinese dumping of such items as wooden furniture and honey. In addition, China is now on the verge of capturing much of the U.S. textile market. Domestic textile jobs have evaporated rapidly in the last decade--Maine had 7,800 textile and apparel industry jobs when NAFTA went into effect in January 1994. Today, Maine has only 3,400 textile and apparel jobs left. Nationwide, some 680,000 textile jobs remain but are at grave risk. Once these jobs are gone, they are lost forever. Our nation's workers deserve better.

Mr. Chairman, I will conclude my remarks today where I started . . . by reminding everyone that the issues we face as we address our relationship with China are greater than those that fall under the jurisdiction of this committee. *Economic* concerns vis-a-vis China are indeed serious, but are not singular. Just as the U.S. failed to adequately counter the developing threat of terrorism as we focused solely on the Cold War threat, I am concerned that we should not now focus solely on terrorism and ignore the growing likelihood of a regional peer competitor in the Pacific region. The Chinese strategy seems geared toward weakening the American presence in its immediate region and simultaneously extending Chinese influence through an ever-expanding military capability in international waters off China's coast.

Consequently, I am alarmed by the rapid and unprecedented build up of naval forces, particularly destroyers and submarines, by the Chinese People's Liberation Army and Navy. By 2010 it is anticipated that China will have up to 72 major surface combatants and 62 submarines. And I am

doubly concerned when the Pentagon sends Congress a budget that radically cuts the number of next generation destroyers and submarines to be built by the U.S. Navy. As I have stated, I realize this is not necessarily the intended focus of this hearing, but it is part of the much larger "writing on the wall" that too many in our government are failing to properly acknowledge and act on.

As in the past, I will continue to strive to draw greater attention to the effects of China's unfair trade practices and to find solutions that enable our domestic industries to compete on a fair and level playing field. I look forward to hearing from the witnesses today and in finding potential solutions to our concerns so that our nation's businesses and workers receive the environment of fairness they rightly deserve.

Thank you once again, Mr. Chairman, for holding this hearing and for allowing me the opportunity to offer these remarks.

Testimony
Senator Debbie Stabenow
Committee on Finance
Hearing on U.S. – China Economic Relations
June 23, 2005

Chairman Grassley, Ranking Member Baucus, and Committee Members, thank you for holding this hearing and allowing us to address the committee today.

Beyond healthcare, I cannot think of another issue that lurks so ominously over our economy than the issue of on-going illegal trade practices by China.

In Michigan we are experts at many things, but we excel at making things and growing things.

Whether it's cars or office furniture, apples or cherries, we lead the way in innovation and efficiency.

These jobs are the life blood of every community.

Even today Michigan forges ahead. For instance, Michigan is at the forefront of micro- and nanotechnology development.

However, Michigan has one of the highest state unemployment rates in the United States.

While the nation has added jobs, Michigan has added another 9,600 people to our unemployment rolls over the past eight weeks.

Our current economy is moving through a period of great uncertainty. It would be easy to blame this on a particularly bad business cycle – a business cycle that will

eventually correct itself. But, to do so would require us to overlook a very real threat to our economy and our way of life.

That threat is the lack of a level playing field for American businesses and workers in the global marketplace.

For example, China currently exports to the United States some $160 billion more than it takes in.

A significant portion of this deficit is driven by consumer demand here in the U.S., but a shockingly large portion of it is due to illegal trade practices, namely currency manipulation and the theft of intellectual property.

Since 1995 China has pegged its currency.

The impact of this illegal action is clear. It gives a distinct advantage to Chinese companies that export into the U.S. and diminishes our ability to export to the Chinese market – China is effectively giving its exporters an exchange rate subsidy.

This manipulation increases the price of our goods while making their goods appear cheaper.

As an example, a mid-sized American car sold in China or Japan is $2,000 more expensive than it should be because of currency manipulation.

Last week, I spoke with employees of a large auto parts supplier who told me they had recently lost a parts contract to a Chinese company despite the fact that they were the lowest bidder. The reason: when you factored in the impact of the artificially low yuan, the Chinese company had a cheaper bid.

As we all know, such currency manipulation is illegal under the terms of China's International Monetary Fund and World Trade Organization membership.

Some economists have calculated that this price differential may amount to as much as 40%. It is simply devastating our manufacturers in Michigan and it is costing us jobs everyday.

In the past ten years the State of Michigan has lost more than 196,000 manufacturing jobs. According to the Economic Policy Institute, between 1989 and 2003 Michigan lost 51,000 of those jobs to China alone.

This is an unacceptable situation that calls for immediate action.

That is why I am cosponsoring both of Senator Schumer's currency bills and I am cosponsoring Senator Collins' and Bayh's countervailing duty bill that they spoke about.

I think it is important to note, though, this is not just a China problem. This is a pan-Asian problem that includes Japan among the offenders.

Importantly, currency manipulation is not the only illegal trade practice we need to address.

Intellectual property theft and counterfeiting are enormous problems for manufacturing in my home state of Michigan.

Let me give you just two examples of the problem that we in Michigan currently face with regard to this unfair competition.

Counterfeit automotive products not only kill American jobs, but they have the potential to kill Americans. When shoddy counterfeit automotive products replace

legitimate ones of higher-quality our manufacturers lose, and our consumers are put at risk.

The Federal Trade Commission estimates that the automotive parts and components industry loses an estimated $12 billion annually in sales on a global basis to counterfeiting.

It's estimated that if these losses were eliminated, and those sales were brought into legitimate companies, the automotive industry could hire 200,000 additional workers.

And, we don't even keep statistics on the potential loss of life.

We should understand that, if left unchecked, penetration by counterfeit automotive products, as well as other manufactured goods, has the potential to undermine the public's confidence and trust in what they are buying. We can't let that happen.

The second example I want to share involves a small manufacturer located in western Michigan.

Peter Perez is the president of Carter Products Company located in Grand Rapids. He is also the national president of the Wood Machinery Manufacturers of America.

Carter Products employees 15 people and holds numerous patents...one of which belongs to this small piece of equipment, the Carter Stabilizer Guide.

It is used to support a band saw blade in such a way as to allow for a wood worker to make nearly any type of angled cut.

Shortly after introducing the Stabilizer – the product, its installation instructions, and instruction photos were copied by a Chinese company and resold into the American

market. Under normal circumstance the Stabilizer would cost a retail customer about $70. The pirated product was being sold for less than $10 – which is far below the cost of the raw materials necessary to create the product.

Carter Products had to launch a case at its own expense to stop this infringement. After spending more than $20,000 the company was able to keep the illegal product out of the U.S. market by stopping its distribution in markets covered by the company's patents.

But, what company can ever be sure that they've achieved victory against this type of illegal behavior if the country of origin – in this case China – is not going to abide by their obligations under the WTO?

We must stand up for our manufacturers and farmers, and insist that our trading partners play by the rules they agreed to when joining the World Trade Organization.

And those of us in Congress must hold the federal government accountable too. The federal government must do its part to enforce our trade agreements and ensure fair play for our American companies.

Mr. Chairman, in the strongest terms possible I urge this committee to address these issues. Every day that we wait is another day that our workers and companies suffer unnecessarily at the hands of illegal competition.

Our workers can compete with any one in the world if they are assured of a level playing field – a playing field where all of the competitors play by the rules.

Thank you.

COMMUNICATIONS

FINANCE COMMITTEE

HEARING ON

U.S. – CHINA ECONOMIC RELATIONS

JUNE 23, 2005

TESTIMONY

SUBMITTED FOR THE RECORD

BY

THE ADVANCED MEDICAL TECHNOLOGY ASSOCIATION (AdvaMed)

Bringing innovation to patient care worldwide

AdvaMed and its member companies would like to thank the Committee for holding this important hearing. China continues to be a growing market for medical devices. We are grateful that the U.S. and Chinese Governments are working with our industry in a number of constructive ways to address issues affecting sales on the Chinese market. Resolution of these issues would benefit the U.S. economy, as well as the health and welfare of the Chinese people.

AdvaMed represents over 1300 of the world's leading medical technology innovators and manufacturers of medical devices, diagnostic products and medical information systems. Our members manufacture nearly 90% of the $83.4 billion in health care technology products purchased annually in the U.S., and nearly 50% of the $175 billion in medical technology products purchased globally. Exports in medical devices and diagnostics totaled $22.4 billion in 2003, but imports have increased to $22 billion - indicating a new trend towards a negative trade balance for the first time in over 15 years.

The medical technology industry is fueled by intense competition and the innovative energy of small companies – firms that drive very rapid innovation cycles among products, in many cases leading to new product iterations every 18 months. Accordingly, our industry succeeds most in fair, transparent, global markets where products can be adopted on their merits. We face both challenges and opportunities in the China market.

Global Context

Innovative medical technologies offer an important solution for nations that face growing health care needs and constraints on resources, including the demands of aging populations. China will be the first developing country to experience an aging workforce. Advanced medical technology cannot only save and improve patients' lives, but also lower health care costs, improve the efficiency of the health care delivery system, and improve productivity by allowing people to return to work sooner. Our industry saves lives and money.

To deliver this value to patients, our industry invests heavily in research and development (R&D), and US industry is a global leader in medical technology R&D. The level of R&D spending in the medical device and diagnostics industry, as a percentage of its sales, more than doubled during the 1990s, increasing from 5.4% in 1990, to 8.4% in 1995, to 12.9% in 1998. In absolute terms, R&D spending has increased 20% on a cumulative annual basis since 1990. This level of spending is on par with spending by the pharmaceutical industry and more than three times the overall US average.

AdvaMed greatly appreciates the support we have received from U.S. Government agencies. Trade agencies -- such as the Office of the U.S. Trade Representative (USTR), the Department of Commerce (DOC), and the Department of State, with strong support from U.S. Embassies and Consulates -- have helped us open markets for our products around the world, including in China. Regulatory agencies, such as the Department of Health and Human Services and the Food and Drug Administration, have worked with foreign governments, including China's, on improving the regulatory environment for our products.

AdvaMed believes the USTR, DOC and Congress should monitor regulatory, technology assessment and reimbursement policies in foreign health care systems and push for the creation or maintenance of transparent assessment processes and the opportunity for industry participation in decision making. We believe China is making progress on these important procedural matters. We welcome China's willingness to continue to improve its administrative and regulatory processes.

AdvaMed strongly supports trade liberalization globally and throughout the Asia-Pacific region. We believe China can and should play a key role in this effort. As a prominent member of the World Trade Organization (WTO) and a substantial beneficiary of the global trading system, China should lend its weight to further trade and investment liberalization. In this regard, the Doha Development Round of the WTO offers a major opportunity to continue to reduce tariffs and address non-tariff measures.

AdvaMed also recognizes that international negotiations and discussions occur in variety of venues. We seek medical device regulatory regimes that conform to these guiding principles:

- acceptance of international standards;
- transparency and national treatment;
- use of harmonized quality systems or Good Manufacturing Practice inspections;
- recognition of others' product approvals (or the data used for those approvals);
- development of harmonized auditing and vigilance reporting rules;
- use of non-governmental accredited expert third party bodies for inspections and approvals, where possible.

Similarly, many economies require purchases of medical technologies to take place through centralized and/or government-administered insurance reimbursement systems. China is still in the process of reforming and developing its reimbursement system. To ensure timely patient access to advanced medical technologies supplied by foreign as well as domestic sources, member economies should agree to adopt these guiding principles regarding the reimbursement of medical technologies:

- establish clear and transparent rules for decision-making;
- develop reasonable time frames for decision-making;
- institute data requirements that are sensitive to the medical innovation process;
- ensure balanced opportunity for the primary suppliers and developers of technology to participate in decision-making, e.g., national treatment;
- establish meaningful appeals processes.

Challenges and Opportunities in China

The Chinese market presents excellent opportunities for the U.S. medical technology sector. China has already become an important market for our industry. While reliable statistics are not yet available, AdvaMed estimates that the Chinese market for medical technology is at least $3 billion and growing rapidly. It is on pace to surpass some of the key European markets for medical technology in a few short years. As global leaders, U.S. medical technology firms already account for a significant portion of sales in China, and the position of these firms underscores the importance of ongoing efforts with the U.S. government to open the Chinese market further.

At the same time, AdvaMed members must overcome hurdles to realize further opportunities. AdvaMed and its member companies have identified a number of priority issues we are seeking to address in China. AdvaMed looks forward to working with the Government of China, the U.S. Congress and the U.S. Administration to address the following barriers:

- redundancy in the regulatory process;
- unnecessary regulatory burdens on diagnostic products; and
- difficulties with the centralized tendering system.

For the medical technology industry, the Bush Administration's efforts with China under the U.S. – China Joint Commission on Commerce and Trade (JCCT) are critical for allowing U.S. medical technology firms broader access to the burgeoning Chinese health care market. The JCCT has been a valuable forum for the open discussion of specific regulations affecting medical devices, including between the U.S. FDA and the Chinese State Food and Drug Administration (SFDA). This forum allows us to gain a better understanding of the status of China's regulatory process -- including some of its regulations we believe to be duplicative and unnecessary for patients' health, and its unique treatment of certain diagnostic products as pharmaceuticals instead of devices. We would like to see this forum enhanced to include discussion of other issues.

In addition, we have appreciated the Government of China's willingness to meet with us and representatives of our member companies on issues not covered under the JCCT. For example, we have benefited from China's explanation of its centralized tendering system, but difficulties remain. We hope to have additional exchanges with the Ministry of Health and other appropriate agencies to address a number of lingering questions and concerns.

The nascent U.S. – China Health Care Forum initiative, led by the U.S. Department of Commerce and supported by AdvaMed and other health care partners, holds great promise as another vehicle for addressing many of the trade-related and health policy-related barriers confronting U.S. medical technology firms in China. AdvaMed looks forward to participating in this forum at its inaugural meeting this July.

Conclusion

AdvaMed appreciates the shared commitment by the President and the Congress to expand international trade opportunities and encourage global trade liberalization. We look to the President and his Administration to aggressively combat barriers to trade throughout the globe, including China. The medical technology industry is committed to working with Congress and the Administration on upcoming trade policies and agreements to ensure patients throughout the world have access to medical products

Written Statement of Kevin M. Burke
President and CEO
American Apparel & Footwear Association

Before the Senate Finance Committee

United States-China Economic Relations
June 23, 2005

Submitted June 22, 2005

Thanks you for providing us this opportunity to submit a statement for the record in connection with this hearing.

The American Apparel & Footwear Association (AAFA) is the national trade association representing apparel and footwear companies, and their suppliers. AAFA members produce, market, distribute and sell clothing and shoes in virtually every country in the world, including China and the United States.

Our comments are structured to offer commentary on the role of China in the post textile and apparel quota world as well as the role of China as a potential consumer market for U.S. footwear and apparel companies. We will then make recommendations on U.S./China trade policy, particularly with respect to China's compliance of its World Trade Organization (WTO) obligations.

Role of China in the Post-quota World
On January 1, 2005, the United States and other WTO member countries discontinued the use of quotas to restrain imports of textile and apparel products from WTO and many non-WTO countries. The end of quotas has generated considerable anxiety among textile and apparel interests worldwide as the prevailing view, reinforced by a number of academic studies and some industry assessments, is that China will become a dominant player in the industry in the coming years. While many developing countries have traditionally viewed quotas as a policy tool to limit their exports to the United States, they have only recently begun to view them as a mechanism that prevented one country from gaining a single dominant share in the marketplace.

We have made no official assessment of how China will perform in the post-quota world. While statistics on some products freed from quotas in the past few years and other anecdotal evidence derived from other industries backs up the view that China will gain an enormous share

1601 North Kent Street, Suite 1200, Arlington, VA 22209 www.apparelandfootwear.org p (703) 524-1864 (800) 520-2262 f (703) 522-6741

of the U.S. import market, equally compelling facts show that China will have difficulty assuming this role. Many companies are reluctant to commit additional orders to China because they want to achieve diversity in their sourcing. Companies cite many reasons for retaining business in other countries, including proximity to markets, uncertainties in China, preferential trade arrangements, and pre-existing partnerships with factories.

Much attention has focused recently on the role that China safeguards -- negotiated as part of China's accession package to the WTO -- can play in the coming four years. The United States has already invoked the safeguard on eleven different occasions. With all the hype surrounding these cases, it is important to understand several issues relating to the safeguard tool.

First, although many in the textile industry support their aggressive use, safeguards on U.S. imports of textiles and apparel from China are not likely to promote textile and apparel manufacturing in the United States. U.S. imports already supply 96 percent of the U.S. apparel market, so quotas on U.S. imports from China will merely divert some U.S. imports of Chinese-made apparel to other countries, primarily those in Asia. Moreover, safeguards only restrict the cutting and sewing of Chinese made apparel, and not whether that apparel contains Chinese fabrics. The safeguards may succeed in shifting some apparel operations from China to other countries but those diverted garments may still contain significant amounts of Chinese textiles. At a minimum, safeguards on U.S. imports of Chinese apparel do not promote the use of U.S. inputs.

This is a critical point to understand as there is considerable expectation that quotas on U.S. imports from China will result in increased business in the United States. Up until the end of last year, the United States maintained quotas on U.S. imports of hundreds of textile and apparel articles from dozens of countries. Many of these quotas were in place for several decades. During that time, apparel import penetration grew to high levels while U.S. textile and apparel employment fell steadily. If quotas on U.S. imports from dozens of countries for 30 years did not help protect the U.S. textile and apparel industry, it is unlikely that quotas on U.S. imports from a single country for only four years will now accomplish that goal.

Second, the safeguard tool is intended to be used when there is market disruption in the United States that has occurred because of U.S. imports from China. In other words, it is intended to stop market disruption when the source of that disruption can be traced directly back to China. It is not intended, as some argue, to address real or perceived concerns with the Chinese economy or to encourage China's adherence to its WTO obligations. In fact, use of the safeguards as an enforcement tool, without data to show an explicit Chinese role in U.S. market disruption, may cause the WTO to find that the United States is violating its own WTO obligations with respect to China.

Third, there is an unintended side effect of quota restraints on U.S. imports from China that should be more fully understood by the Committee. Efforts to restrain U.S. imports from China, or encourage the Chinese government to impose additional taxes on their textile and apparel exports to the United States, do indeed result in an additional cost. That cost is either borne by the U.S. apparel company or passed on to the U.S. consumer. In either case, that cost represents a transfer of funds from U.S. citizens to the Chinese government. We fail to understand why a policy promoting such a financial transfer is in the best interest of the United States, especially when the quota restraints do not promote U.S. jobs.

Role of China as Consumer Market
With a middle class of over 200 million people and growing, China represents the next great market for U.S.-made and U.S.-branded products. Many of our members, including such well-known household names as Reebok and New Balance, have already blazed the trail for American brands by aggressively pursuing the Chinese consumer. Even so, multiple obstacles abound that restrict the access of U.S. footwear and apparel brands to this lucrative and growing market.

While we applaud the huge strides China has already made in meeting its WTO obligations, China has fallen short in two important areas that directly affect both our footwear and apparel members.

First, China continues to delay the issuing of regulations providing foreign firms distribution rights in the Chinese marketplace, particularly at the regional and local levels. In addition, the regulations issued to date allowing foreign firms trading rights in China are vague in many key aspects. As a result, our members must comply with a myriad of often conflicting regulations that can vary from region to region and forces them to enlist a Chinese partner in order to sell their products in China. More importantly, without clear rules on distribution rights, particularly at the regional and local levels, our members are unable to sell their product in the Chinese market *even if the product is made in China in Chinese factories*. For example, with over 98 percent of the shoes sold in the United States being imported, U.S. footwear firms produce a significant percentage of shoes in China to serve not only the U.S. market but also many other countries around the world. Despite the fact China accounts for over half of the shoes produced worldwide, U.S. footwear firms currently cannot sell the shoes they make in China to the Chinese market. Under current rules, these firms are required to export the shoes out of China and then re-import them back into the country. Until China issues and then enforces a single and simple set of clear and transparent rules granting foreign firms distribution rights throughout the country, U.S. footwear and apparel brands and the U.S. workers they employ in marketing, distribution, and research & development will continue to lose out on one of the biggest consumer markets in the world.

Second, the scourge of counterfeiting continues to run rampant in China, with knock-offs of well-known U.S. footwear and apparel brands sold in markets in virtually every Chinese city and town. Even if U.S. footwear and apparel firms are granted full distribution rights, they will have to compete against these inferior knock-offs that dramatically undercut U.S. brands. Not only are these products priced well-below actual market value, but the low-quality of the counterfeit products also tarnish the hard-earned reputation of U.S. brands.

Again, China has made significant progress in Intellectual Property Rights (IPR) enforcement. However, by all accounts, the most recent rules promulgated by China fall well short of what is needed to ensure that the intellectual property rights of U.S. footwear and apparel firms are protected. Among other problems, the new rules lack the criminal penalties needed to deter counterfeiting.

As you know, many of these same counterfeit products end up on the streets of U.S. cities, hurting U.S. footwear and apparel brands in their own home market. We believe concrete steps, such as those proposed in new bi-partisan legislation introduced at the beginning of this Congress, are needed to punish those in the United States that attempt to benefit from Chinese counterfeiting. The Stop Counterfeiting in Manufactured Goods Act, introduced by U.S. Representative Joe Knollenberg (R-MI) and recently passed by the U.S. House of

Representatives by Unanimous Consent, requires the mandatory destruction of equipment used to manufacture and package counterfeit goods. In addition, it addresses methods that counterfeiters have used to evade prosecution, such as the selling of patch sets or medallions that can later be attached to generic merchandise and given the appearance of a genuine product.

As the Committee moves forward with its deliberations, we would make several policy recommendations.

First, to the extent that Congress wishes to discourage sourcing in China, there are several policy options that are far more effective than the imposition of additional safeguard quotas. Swift implementation of new trade agreements with Central America, such as the U.S./Central America-Dominican Republic Free Trade Agreement (CAFTA-DR), would promote more imports from a region with a demonstrated capability and a supply chain that favors U.S. textiles and yarns. This, in turn, would promote more U.S. textile jobs. Similarly, enactment of programs, such as that proposed in the Tariff Relief Assistance Development Act of 2005 (S. 191), which would eliminate tariffs on countries like Bangladesh, Cambodia, and Sri Lanka, would promote sourcing in poor, developing countries that are highly dependent upon textiles and apparel for employment and foreign exchange revenues.

Second, we encourage the Committee to focus on those areas of China's WTO commitments where more progress can be made and where there are demonstrated U.S. commercial interests at stake. From our perspective, we believe greater attention to intellectual property rights (in particular preventing counterfeiting of trademarks or trademarked goods), distribution rights, and market access can promote greater use of U.S. exports or U.S. branded products in China while reducing revenue loss to U.S. intellectual property holders.

We also support resolution of the currency issue, primarily to induce more certainty into the relationship. Some of our apparel members and many of our footwear members are very dependent on China, both to import inputs that are used for U.S. assembly as well as finished products that are sold throughout the United States. Sudden shifts in the currency value would disrupt supply chains in a way that would ultimately harm U.S. interests. Likewise, imposition of additional taxes on U.S. imports from China, such as recent Congressional proposals, only raise emotions and uncertainty without making a positive contribution to the bilateral economic policy debate.

Third, we believe the China safeguards should only be invoked where the data shows a precise cause and effect between U.S. market disruption and imports from China. Above all, we believe safeguard policy should be part of a transparent process that leads to predictable, fact-based outcomes.

In conclusion, we are mindful that many in our industry, and many around the country, are concerned over the role that China will play in the coming years. At the same time, we know that many in our industry view China as an important strategic partner. While many disagree over whether China is more a challenge or an opportunity, most agree that the way forward involves a predictable and comprehensive approach that is based on rules and not political imperatives.

Thank you.

AMERICAN FOREST & PAPER ASSOCIATION

**1111 NINETEENTH STREET, NW, SUITE 800,
WASHINGTON, DC 20036**

STATEMENT SUBMITTED FOR THE RECORD

**UNITED STATES SENATE
COMMITTEE ON FINANCE**

**HEARING ON
UNITED STATES-CHINA ECONOMIC RELATIONS
JUNE 23, 2005**

The American Forest & Paper Association (AF&PA) appreciates this opportunity to present the forest and paper products industry's views regarding United States-China Economic Relations. AF&PA is the national trade association of the forest, pulp, paper, paperboard and wood products industry. The forest and paper products industry accounts for more than 7 percent of total U.S. manufacturing output and ranks among the top ten manufacturing employers in 42 states. The more than 200 companies and related associations AF&PA represents have a strong interest in making sure that commitments made by China are met from the outset to establish a solid basis for the continued growth of business and economic opportunities.

AF&PA was a strong supporter of Permanent Normal Trade Relations for China, and of China's accession to the WTO. Our industry's support was based on the prospect that China's rapid economic growth would generate strong demand for U.S. exports of paper and wood products. At the same time, we recognized that the expectation of market opportunities could only be achieved if China implements commitments to open up its market and removes trade barriers--which were a condition of its accession to the WTO.

While China has made progress toward becoming a market economy, the Chinese government continues to employ an array of industrial policy tools to grow its manufacturing capacity and become a top supplier of manufactured products to the world. In the forest products sector, this has resulted in the rapid expansion of China's paper and wood production. Consequently, there has been a substantial drop in market opportunities for U.S. manufacturers and rapid growth in China's exports of paper and wood products. This is particularly troubling since China doesn't have the large fiber resource base traditionally needed for a competitive forest products industry, and is almost wholly dependent on imported fiber in the form of logs and other wood products, wood pulp and recovered paper.

FORESTS PRODUCTS TRADE WITH CHINA

U.S. exports to China of paper and paperboard reached $491 million in 2004, up from $328 million in 2001. While this is a healthy increase and reflects China's rising paper and paperboard consumption and overall reduction in tariffs, the longer term prognosis is not encouraging as China's production capacity is rising at a rapid pace as part of a concerted industrial strategy, which is already displacing imports in key paper and paperboard grades. Additionally, over the same time period, U.S. paper and paperboard imports from China more than doubled, from $635 million to $1.3 billion last year.

To supply China's massive paper and paperboard capacity growth, Chinese producers have had to turn to foreign supplies to meet their fiber needs. The results have been skyrocketing demand for imported wood pulp and recovered paper. In particular, the U.S. has become the main source of China's recovered paper imports, affecting the U.S. market for certain recovered paper grades. U.S. recovered paper exports to China rose from just 1 million metric tons in 1998 to 5.9 million metric tons in 2004, representing 13 percent of total U.S. paper recovery.

China is a major market for U.S. wood products, particularly for hardwoods used domestically in architectural applications and flooring. U.S. hardwoods are also used for furniture, picture frames and other manufactured wood articles exported back to the U.S., and to Europe and other markets. As it currently stands, China is now the fourth largest importer of all wood products; the largest importer of logs and the world's second largest plywood producer, behind the United States. U.S. wood product exports to China rose from $140 million in 2001 to $378 million in 2004. The U.S. is the fourth largest supplier of wood products to China, behind Russia, Malaysia and Indonesia.

SUBSIDIES

China's domestic forest products industry faces a large fiber supply gap due to insufficient domestic forest resources and strong growth in demand for solid wood, pulp and paper to fuel both the domestic market and exports. To assist the domestic industry, the Chinese government has implemented a number of policy measures aimed at better balancing China's fiber supply with domestic fiber demand over the long-term as well as reducing dependence on imported processed wood and paper products.

With a stated objective of encouraging domestic investment and expansion in value-added forest products processing industries, China has expanded its production capabilities in many valued-added paper and wood processing enterprises. Many of the measures used to achieve this rapid industry development include certain subsidy related measures that may be in violation of WTO rules. In particular:

- Using the tariff structure to encourage imports of raw materials versus finished products (tariffs on pulp, logs and lumber reduced to zero);
- Protecting domestic producers via various non-tariff and product standard barriers and anti-dumping investigations (newsprint-1998, coated art paper- 2002, kraft linerboard-2004, wear resistant overlay-2005);
- Policy loans, subsides, and preferential tax polices for domestic enterprises to invest in forest resources, processing operations, and capacity expansions;
- Expanding border trade value added tax (VAT) provisions to allow for large increases in low cost wood imports;
- Active government and banking sector involvement in financing, including subsidies and/or low interest loans and debt forgiveness or extension of repayment terms.

Last year, AF&PA completed the study *"China's Subsidization of its Forest Products Industry"*, which examines and documents the various financial, trade and policy measures that the Chinese government is using to build its pulp, paper and wood processing industries and supporting fiber resources. Some key findings from the study:

- $1.67 billion in government financing and loan interest subsidies were granted for technology renovations of 21 state-owned paper mills from 1998 to 2002.

- Policy banks such as the China Development Bank and the Agriculture Bank of China are providing companies in the forest products sector with low interest loans or loans with unusually long repayment terms.
- At the provincial and municipal levels, banks are engaged in non-standard lending and other practices to attract foreign investment, including debt forgiveness and debt-for-equity swaps, extended loan repayment terms and preferential loan interest rates.
- The Ministry of Finance has designated $1.73 billion for the development of fast-growth-high-yield plantations by 2015.

AF&PA has consulted with USTR and the Department of Commerce on these findings. Last fall, the U.S. submitted a series of questions to China in the WTO regarding China's subsidy practices, including subsidies to the forest products sector. The Chinese government committed to respond to the U.S. questions regarding its subsidy practices by the end of 2005.

While USTR has expressed concerns over China's subsidies practices in the WTO, U.S. industries have not been able to resort to the use of countervailing duty (CVD) law to counter such subsidy practices. Since 1984, the U.S. Commerce Department has not applied CVD law to non-market economies (NMEs) such as China, even though the WTO does not prohibit the application of CVD law to NMEs. Consequently, AF&PA, together with a large group of U.S. industries, urges the passage of H.R. 1216 and S. 593 as the legislation would clarify the intent of Congress by expressly providing for the application of CVD provisions to China and other NMEs.

CURRENCY MANIPULATION

Under its WTO accession agreement, China committed to open up its market across the board by reducing tariffs and other impediments to trade. However, China effectively has nullified this commitment by engaging in protracted large-scale build-up of foreign exchange in order to keep its currency, the Yuan, at a fixed exchange rate of 8.28 Yuan to the U.S. Dollar for the past ten years. This exchange rate level is significantly weaker than the Yuan would be otherwise based on international market forces alone. Many economists estimate that China's currency is undervalued by as much as 40 percent. As a result, U.S. exporters of forest and paper products, as well as other U.S. exporters, have been at a significant competitive disadvantage when doing business in the Chinese market or when competing in the U.S. or third country markets against Chinese products.

China has been able to maintain its currency peg by purchasing dollars in foreign exchange markets and accumulating huge dollar reserves. This accumulation of reserves has allowed Chinese state-owned banks to subsidize the massive capacity growth in China's manufacturing, including the paper and wood products sector in which China has no comparative advantage.

For more than a year, the Administration pursued a policy of quiet diplomacy to convince China to change its currency policy and to allow market forces to set the Yuan's value. U.S. officials agreed with China that it needed to set its financial house in order before introducing a flexible exchange rate. AF&PA supported the Administration's policy but over time it became clear that China was in no hurry to revalue its currency in the near term. AF&PA agrees with the Administration that China must act and that stronger action is necessary.

AF&PA was disappointed that the U.S. Treasury Department's semi-annual report on international exchange rate policies issued May 17 failed to name China as a currency manipulator. We were encouraged that for the first time, Treasury warned China that it would take a tougher stand if China didn't revalue its currency by October. AF&PA agrees with current Administration policy that China must act expeditiously to introduce a flexible exchange rate.

AF&PA has endorsed the Fair Currency Practices Act of 2005, S. 984 and H.R. 2208. We believe these bills properly clarify the definition of currency manipulation under the 1988 Omnibus Trade Act to include those nations involved in a "protracted large-scale intervention in one direction in the exchange market." Moreover, they also would broaden the requirement for the Treasury to enter into negotiations with currency manipulators, something of great importance in the current international economic environment.

ANTIDUMPING PROCEEDINGS

China has used antidumping investigations to protect inefficient producers and to reduce import competition for new manufacturing capacity. On March 31, 2004, China initiated an antidumping investigation against U.S. unbleached kraft linerboard – the raw material used in the manufacture of corrugated shipping containers. If China proceeds to impose antidumping duties on U.S. kraft linerboard, it would severely impact more than $120 million in U.S. exports to that country.

This is the third Chinese antidumping investigation against U.S. paper products in the past six years; with a fourth case initiated just a week ago. All four cases follow a pattern whereby antidumping investigations are launched against imports of paper products that are experiencing significant growth in domestic manufacturing capacity. Indeed, in the kraft linerboard case there is no evidence that the domestic Chinese linerboard producers identified in the petition are in any way injured. Based on publicly available information, all the identified producers are profitable, have ready access to capital, are expanding rapidly, and increasing market share at the expense of imports. It would be especially egregious should China stop imports of U.S. kraft linerboard that is primarily used to package China's massive exports to the United States that have resulted in the U.S. bilateral trade deficit with China which reached a record $162 billion last year.

On May 31, 2005, the Chinese Ministry of Commerce (MOFCOM) issued its

preliminary determination in the kraft linerboard antidumping case against the United States, Korea, Taiwan and Thailand, finding that U.S. producers were dumping unbleached kraft linerboard at margins ranging from 16% to 65.2% and that cumulated subject imports are causing material injury to the Chinese linerboard industry.

It is not in China's interest to impose antidumping duties on U.S. kraft linerboard. While there is some production of this product in China, the quality of U.S. kraft linerboard is superior to the quality of the Chinese domestic products. U. S. product is used to a great extent for packaging exports to the U.S. and other markets such articles as electronics, food and beverage, automotive and heavy equipment goods, and other high value products requiring the highest quality packaging materials.

AF&PA's analysis of the preliminary determination found that it is inconsistent with China's WTO obligations.

- Subject imports held only a small and shrinking percentage of the Chinese market over the period of investigation while the domestic industry was growing rapidly.
- There is no positive evidence supporting MOFCOM's conclusion that the subject imports had any negative effect on domestic prices.
- MOFCOM fails to adequately account for the injury caused to the domestic industry by its rapid expansion in capacity and production in excess of the growth in demand.
- MOFCOM acknowledges the Chinese government's role in promoting the development of the domestic industry.

There is no causal link between the imports of kraft linerboard from the United States and any findings by MOFCOM of injury to the Chinese industry because it is clear that other causes were the main determinants of domestic pricing during the period of investigation. We urge Congress to work with the Administration to press China to act consistently with its WTO obligations and terminate the antidumping case against U.S. kraft linerboard suppliers.

ILLEGAL LOGGING/SMUGGLING

Of growing concern is the amount of illegally harvested timber that may be entering the China market. International environmental agencies have documented significant discrepancies between China's import statistics and the export statistics of some of China's wood trading partners, particularly in border areas with Myanmar and Russia. Illegal logging affects not just the health of the forest in particularly sensitive regions, but also undermines public acceptance of commerce in legally harvested and traded forest products. U.S. trade opportunities in China are directly affected by the abundance of inexpensive, illegally harvested timber. Points raised in a study recently commissioned by AF&PA, *Illegal Logging and Global Wood Markets: The Competitive Impact on the U.S. Wood Products Industry (November 2004)* include:

- China is a price sensitive wood market where an exploding demand is fueling wood imports, much from countries without strong environmental or forest management controls.
- Despite a logging ban and other cutting restrictions which have led to a significant decline in Chinese timber harvests, unauthorized timber harvesting continues to be a problem.
- It is estimated that 40% of Russian log imports entering China are suspicious (potentially illegal) because of excess cutting, harvesting without authorization or as undocumented/unreported exports. Imported Russian lumber is also suspicious (manufactured from illegal logs).
- The impact of illegal wood in China extends to Chinese exports, for example plywood or wooden furniture, made with illegal tropical hardwoods from Africa and SE Asia.

Compounding the problem is that illegally logged wood is frequently smuggled into mainland China in an effort to avoid the 17% VAT, or is sent to a third country where it is processed and then re-exported to China. The smuggling activity is putting U.S. exporters at a competitive price disadvantage. Progress is being made in shutting down smuggling operations, but concern still exists over the presence of illegally logged wood in the marketplace.

CONCLUSION:

AF&PA agrees with the Administration that China has made important strides in meeting its WTO obligations. However, the benefits of the economic relationship with China have been largely one sided, with China continuing to use capacity building subsidies, antidumping investigations, currency manipulation and other industrial policies to significantly reduce export opportunities for U.S. industry and give Chinese producers an unfair advantage in the U.S. and third country markets. China also needs to take stronger measures to end the flow of illegally logged timber.

AF&PA believes the Congress can take action in the short-term by passing H.R. 1216 and S. 593 to clarify the intent of Congress by expressly providing for the application of CVD provisions to China and other NMEs. Furthermore, it is imperative for Congress to approve H.R. 2208 and S. 984 in order to facilitate negotiations with China over revaluing its currency in an accelerated manner. Finally, Congress needs to continue to monitor Chinese compliance with its WTO obligations and ensure that U.S. business gets full access to the Chinese market. AF&PA does not support legislation which would impose retaliatory tariffs on Chinese products entering the U.S. market.

AF&PA appreciates this opportunity to provide comments on U.S.-China Economic Relations. Please do not hesitate to contact us for further information regarding this submission.

American Iron and Steel Institute

SUBMISSION BY THE AMERICAN IRON AND STEEL INSTITUTE REGARDING U.S.-CHINA ECONOMIC RELATIONS

Submitted to the Committee on Finance of the U.S. Senate
June 23, 2005

I. INTRODUCTION

In response to the request of the U.S. Senate Finance Committee (the "Committee"), the American Iron and Steel Institute ("AISI"), on behalf of its U.S. member companies that together account for approximately three-fourths of the raw steel produced annually in the United States, is pleased to provide the following comments in connection with the Committee's June 23, 2005 hearing on the U.S.-China economic relationship.

The economic relationship between the United States and China is one of the most important bilateral relationships in the global economy. Steel is a strategic industry and a critical component of the manufacturing base in the United States -- and in China. Members of AISI are, of course, particularly sensitive to the implications of this relationship with regard to steel. China is already the world's largest consumer and producer of steel by far, and its production (which is increasing faster than consumption) is expected to keep on growing. This means that China's importance in the global steel market will only increase. At the same time, the unprecedented expansion of manufacturing in China is placing increasing pressure on other American manufacturing industries. This could have profound implications, not only for steel and its domestic customer base, but also for the entire U.S. economy and U.S. national economic security.

Policy makers have in recent months given ever increasing attention to problems with the U.S.-China economic relationship, including China's unsustainable trade surplus ($161.9 billion in 2004) with the United States, as well as the enormous distorting effect of China's currency policies (i.e., keeping the yuan pegged to the U.S. dollar at an artificially low rate). Ignoring the problems inherent in our trade relations with China will not solve the problem; if anything, it will likely lead to worsening relations, which could have serious implications for the entire multilateral trading system.

This submission discusses some of the major developments in the Chinese steel industry, including the growing number of market-distorting practices occurring in China, along with their potential implications for the global steel industry. The paper also identifies several priorities for U.S. policymakers in seeking to remedy market distortions and improve our trading relationship with China.

II. MAJOR ISSUES PRESENTED BY THE GROWTH OF THE CHINESE STEEL INDUSTRY AND GOVERNMENT MARKET INTERVENTION

A. Chinese Industry Growth and State-Supported Steel Capacity

By any measure, the growth of the steel industry in China has been astronomical. As recently as 1995, China produced 95 million metric tons (MT) of crude steel, almost exactly the same volume as the United States.[1] Since that time, steel production in China has more than tripled (as shown in the following data from *World Steel Dynamics*) and shows no signs of abating.

China's Annual Crude Steel Production[2]

Year	Millions of Metric Tons
2001	152
2002	182
2003	220
2004	273
2005 (estimate)	316

Based on estimated crude steel production of 316 million MT in 2005, China is projected to account for 28.3 percent of all crude steel made in the world this year.[3] Even these figures may be conservative. In May, China reportedly had crude steel output that would equate to 350 million MT on an annualized basis.[4] It is impossible to exaggerate the impact of an industry with this size and scope upon the global market – something that only magnifies the impact of the continuing market distortions that have arisen and persist in the Chinese industry.

State-owned and/or supported producers continue to dominate the Chinese industry. As of 2003, it was estimated that state-owned enterprises accounted for approximately 88 percent of China's crude steel production.[5] Based on projected Chinese steel production of 316 million MT in 2005, that would translate into roughly 278 million MT of production through state-owned enterprises, accounting for almost 25 percent of global production.[6] We urge the Committee to look closely at the conclusions of the U.S.-China Economic & Security Review Commission. Just as a healthy American steel industry and manufacturing base remain vitally important to U.S. strategic and national security goals, China's state support of its steel and other manufacturing industries must be considered in terms of its potential long-term economic and national security ramifications on the United States.

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1 World Steel Dynamics, "Global Steel Mill Product Matrix: Core Report NNNN," at 3-22 and 3-172 (March 2005) (showing U.S. production of 95.2 million MT of crude steel in 1995, compared to 95.4 million MT in China).

2 *See* World Steel Dynamics, "Global Steel Alert # 26" at 6 (March 23, 2005).

3 *See id.* (projecting total worldwide crude steel production of 1.1163 billion MT in 2005).

4 World Steel Dynamics, "Inside Track # 48" at 1 (June 15, 2005).

5 World Steel Dynamics, "China's Unstoppable Steel Industry: Core Report DDDD" at 52 (August 2003).

6 316.4 million * 88 percent = 278.4 million; 278.4 million / 1.1163 billion = 0.249 = 24.9 percent.

Building on a long history of government involvement in, and support for, its industry, the Chinese steel industry has remained a major recipient of government-directed loans from state-owned banks.[7] Indeed, steel has been the largest recipient of interest-rate subsidies among those industries targeted to receive such aid.[8] Many of the concerns voiced in other sectors about the influence of the Chinese government in its economy -- and the distortive effects that have resulted -- are prevalent in the steel sector as well. In this regard, China's government is widely viewed as "picking winners and losers" in the steel industry (through, among other things, intervention in credit market and banking transactions to direct funds to preferred entities, and by the uneven enforcement of Chinese laws). Moreover, notwithstanding professions of attempting to cool growth in the steel sector, the central government in China continues to support new steel projects and -- even if the central government had a clear policy aim of slowing steel industry investment -- this policy goal would likely be subverted at the provincial and local government levels.[9]

- Despite China's announcement that it would slow steel investment in early 2004, there still is plenty of money available for provincial development projects that create jobs . . . . The Chinese government recently approved a $2.5 billion plant expansion for Maanshan Iron & Steel Co., the country's fifth-largest steel producer, to make more steel for cars and home appliances. It also approved a $2 billion expansion for stainless-steel maker Taiyuan Iron & Steel.[10]

- Fixed asset investments by China's steel industry are up 8 percent through five months of 2005 vs. the same period last year and, in May alone, Chinese steel industry investments totaled $2.5 billion, up 24 percent from the month before.[11]

- China's largest producer, world class Baosteel, recently announced plans for a new facility in Guangdong that will have an annual output of 20 million tons.[12] To put this in context, this facility alone would constitute one of the ten largest steel companies in the world.

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7 Record of the January 30, 2004 Hearing Conducted by the U.S.-China Economic and Security Review Commission on "China's Impact on the U.S. Manufacturing Base" at 73.

8 Core Report DDDD at 53. Other targeted industries were petrochemicals, machinery, and non-ferrous metals. *Id.*

9 Indeed, even if the central government really wants to constrain steel production, it is very difficult to stop local officials from supporting new projects. *See, e.g.*, Richard McGregor, "China's steel mills face shake-out as prices fall," *Financial Times* at 10 (June 10, 2005), available at 2005 WLNR 9181694 ("One factor {in controlling Chinese steel production} will be the behaviour of the state banks, where branch managers have traditionally been more loyal to the needs of local politicians and businesses than to their Beijing headquarters.")

10 "Steel Price Plunge Predicted With Changing Role of China," *Engineering News-Record* at 13 (Jan. 24, 2005), available at 2005 WLNR 1138850.

11 "China's Steel Sector Investments Are Up 8% So Far This Year," Steel Business Briefing (June 20, 2005).

12 "China's Baosteel to build steel production facility in Guangdong," *AFX Asia Focus* (May 30, 2005).

In the context of an industry with the size and capability to alter the dynamic of world markets, the vast level of state support and market intervention in China must be of fundamental concern, both to industry participants and to governments.

B. Increasing Position of China as Major Net Exporter of Steel and Steel-Containing Products

Backed by government subsidies, China's already massive steel capacity is projected to grow significantly. One observer estimates that Chinese crude steel capacity will increase to 379 million MT in 2006 and to 405 million MT in 2007.[13] If these estimates are correct, China will have added 130 million MT of new capacity between 2004 and 2007[14] -- an *addition* of capacity that is 30 percent greater than the size of the entire U.S. industry.[15]

The implications of this state-supported capacity growth for the global system will be extremely significant. Up until the second half of last year, the growth of steel consumption in China had kept pace with or exceeded the growth in steel capacity. As recently as 2003, China's steel imports exceeded exports by 35 million MT.[16] Chinese demand for steel contributed to higher prices worldwide, helping to pull the industry out of the crisis that had begun in the late 1990s.

The explosion that is occurring in Chinese steel capacity is, however, changing this picture rapidly. By September 2004, China had become a net *exporter* of steel, and it has remained so in each successive month.[17] As a result, many observers now believe that new Chinese capacity may result in a worldwide oversupply of steel that could have severe consequences for the global steel sector:

- In the past, when China experienced a glut of inexpensive textiles and televisions, domestic manufacturers looked for markets overseas. A similar shift in steel could pose a bigger challenge, reversing fortunes for companies around the world that have been riding prices rising on Chinese demand.[18]

Indeed, the latest reports from China indicate that conditions have worsened significantly:

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13 World Steel Dynamics, "Steel Thermometer # 23" at 9 (May 27, 2005).

14 405 million MT (estimated 2007 capacity) – 275 million MT (2004 capacity) = 130 million MT.

15 *See* World Steel Dynamics, "2005: Many Questions – More Answers," at 61 (Dec. 2, 2004) (estimating U.S. crude steel production for 2004 at 98-99 million MT).

16 "Steel Thermometer #23" at 10.

17 *Id.*

18 Peter Wonacott, "Heard in China: Can Beijing Cool The Steel Boom?" *OsterDowJones Select* (May 12, 2005).

- Chinese steel buyers are in a state of panic. The sheer terror of buying "overpriced" material has destroyed any semblance of market discipline. In fact, {*World Steel Dynamics*} has coined a new word for this Chinese circumstance: "*collapsion*," reflecting two factors that are inter-related -- the domestic pricing *collap*se and the crude steel production explo*sion*.[19]

This same observer concludes, "*oversupply of steel sheet* will be perceived to be a fairly permanent feature of the Chinese steel landscape."[20] Another states that increased production from China "could produce a massive global oversupply with tens of millions of tons of Chinese steel flooding export markets."[21] According to one recent estimate that provides some perspective regarding the scale of this problem, China's steel production in 2005 will exceed Chinese demand by a volume almost as large as Germany's *total* steelmaking capacity.[22]

The problem is not just the possibility of a surge of *direct* steel exports form China to the United States, which can already be seen in tubular and other products. There is also the likelihood of steel trade *diversion* to the U.S. and North America -- as Russia, Japan, South Korea, Brazil, India and others traditional steel exporters are no longer able to sell their steel to China. In addition, there is the dimension of U.S.-China *"indirect"* steel trade (exports versus imports of cars, auto parts, machine tools, appliances and other steel-containing goods), where China already has a substantial surplus with the United States. According to data just released by AISI, the top two contributors to the U.S. indirect steel trade deficit last year were Japan, at -4.7 million net tons (NT), and China, at -3.8 million NT. While the U.S. indirect steel trade deficit with Japan remained at more or less the same high level between 1999 and 2004, the indirect deficit with China (in part, a reflection of a severely undervalued, pegged Chinese currency) grew substantially during these years, from –1.6 to –3.8 million NT.

Thus, whether the concern is (1) injurious steel import surges from China directly, (2) steel trade diversion to the U.S. and North America or (3) the use of China as a massive global export platform by steel-intensive Chinese manufacturers, these developments demand close attention from U.S. policy makers and strong actions to deter government-driven or supported capacity expansion.

C. Distortion of Markets for Key Raw Materials

In addition to its continued intervention in steel and downstream manufactured goods markets, the Chinese government has taken a number of actions that are distorting upstream markets and trade in critical raw materials. For example, last year China placed significant restrictions on the export of metallurgical coke, which is used by steel producers to reduce iron ore to iron. While coke exports have become more available in recent months, a key Chinese official

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19 "Inside Track # 48" at 1 (emphasis in original). Conditions have actually worsened since this report was issued. Just last weekend, nine leading Chinese steelmakers met in an effort to stem falling prices. So far, this effort has been unsuccessful. *See* Eric Ng, "Mainland steel prices go into free fall," *South China Morning Post* at 3 (June 29, 2005), available at 2005 WLNR 10183093.

20 *Id.* at 2 (emphasis in original).

21 "Steel gravy train dries up as stocks surge," *Metals Week* at 3 (May 23, 2005).

22 Niu Shuping, "China steel estimates surge, surplus seen," *Reuters* (June 29, 2005).

recently emphasized that China will continue to control its coke exports in the future.[23] In fact, discussing China's plans to restrain coke exports, one Chinese official explained that "{t}his means China is changing its export policy for resources of high-energy consumption products from encouragement to a neutral or restrictive attitude."[24]

Because China produced over half of all the world's coke last year,[25] its restrictions on exports have contributed to a major gap in the price that U.S. and Chinese producers pay for coke. Recent figures show that coke costs $143/MT in China, while Chinese coke for export sells for $240/MT.[26]

Similar distortions have occurred with regard to other key raw materials. For example, China is reportedly considering imposition of an export tax of 25 percent on ferromolybdenum, which steel producers use to add a critical alloying element to their product. That action has already resulted in a dramatic increase in the price of this raw material.[27] Likewise, China maintains a 40 percent export tax on ferrous scrap -- a policy that has had a major distorting effect on global markets.[28]

D. Unfair Trade and Dumping

As in other major industries, Chinese steel producers have been among the leading violators of international disciplines on unfair trade -- including most notably antidumping (AD) rules.[29] Of the 32 different products that were the subject of AD suits in fiscal years 2003 and 2004, fully half (16) involved imports from China.[30] China's demonstrated willingness to engage in unfair trade stems from the type of market distortions described above. China's distortive policies protect and prop up artificially its domestic industries, while encouraging unfair export practices. At the same time, the massive volume of imports from China seen in numerous product areas, including steel, results in material injury to the U.S. industries involved.

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23 "China will control coke exports even after canceling coke export quota," *Xinhua Economic News* (May 16, 2005).

24 *Id.*

25 *Id.*

26 "Steel Thermometer # 23" at 18.

27 *See* "Chinese intent on blocking metals' cross-border flight," *American Metal Market* at 1 (May 2, 2005); "China's Ferromolybdenum Export Price Soared 3 Times," *SinoCast* (June 14, 2005) (stating that the average export price of ferromolybdenum has increased "more than three times" since the beginning of the year.)

28 "Scrap Coalition Presses USTR on Export Barriers in NTE Submission," *Inside US Trade* (Dec. 24, 2004), available at 2004 WLNR 14632662.

29 Dumping occurs when a foreign producer sells merchandise in the United States at less than fair value – i.e., less than its cost of production or less than the price charged in a protected home market.

30 *See* U.S. International Trade Commission, *Import Injury Investigations Case Statistics* at 7-8 (Nov. 2004).

E. Other Areas of Concern

Other market distortions in China continue to have a major effect on numerous American manufacturers, not just on the steel industry. Such practices include:

Currency manipulation. Despite heavy criticism from U.S. policymakers in recent months, China continues to peg the yuan to the dollar at an artificially low, severely undervalued rate. Given that China's trade surplus with the United States has soared from $69 billion in 1999 to $162 billion in 2004,[31] one would expect the value of the yuan to have increased vis-à-vis the dollar, thereby making Chinese exports to the United States more expensive and lowering the price of U.S. shipments to China. The Chinese central government, however, refuses to allow the yuan to appreciate, even though it may now be undervalued by as much as 40 percent.[32] By manipulating its currency in this manner, China is effectively subsidizing its exports and taxing imports.[33]

Trading rights and distribution services. As part of its accession to the WTO, China promised to liberalize significantly the ability of foreign companies to import and export goods from China (known as "trading rights"), and to sell goods within China ("distribution services").[34] Nevertheless, China fell behind on these commitments during 2002 and 2003.[35] While some progress was made during 2004, this issue remains a problem. In its most recent report on China's WTO compliance, the Administration expressed disappointment that China had not yet fully implemented its commitments in this area.[36] Recent reports indicate that foreign companies continue to face obstacles to doing business in China.[37]

III. KEY POLICY PRIORITIES FOR U.S.-CHINA ECONOMIC RELATIONSHIP

Policy makers must make it a top priority to address effectively, and to eliminate, market-distorting practices in China and their negative effects on a multitude of U.S. industries. The main initiatives should include:

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31 These figures were compiled by the U.S. Census Bureau, and are available at http://www.census.gov/foreign-trade/balance/ (last visited June 15, 2005).

32 "Snow says China must move 'without delay' to change currency policies," *AP Datastream* (May 26, 2005).

33 For an analysis of the legal issues presented by China's currency policy, *see generally* Petition for Relief Under Section 301(a) of the Trade Act of 1974 filed on Behalf of the China Currency Coalition (Sept. 9, 2004), available at http://www.chinacurrencycoalition.org/petition.html (last visited June 19, 2005).

34 *See generally* U.S. Trade Representative, *2004 Report to Congress on China's WTO Compliance* at 11-21 (Dec. 11, 2004) (discussing China's commitments with respect to trading rights and distribution services) ("USTR 2004 Report").

35 *Id.* at 11, 14.

36 *Id.* at 14-15.

37 *See* "The Conference Board Announces a 90-Minute Global Webcast on Doing Business in China," *AP Alert – Financial* (April 28, 2005) (stating that foreign companies find that government approval procedures with respect to trading rights and distribution services "still remain complex and ambiguous").

A. Addressing Subsidies and State-Supported Capacity

First and foremost among policy priorities must be effective action to deter state-supported capacity growth in China. While market-driven capacity expansion is perfectly appropriate, the history of the global steel industry demonstrates the dangers of government-supported production. The U.S. government should be using all tools available to it to discourage further Chinese government intervention in the steel sector -- including strict trade law enforcement, bilateral and multilateral pressure on the Chinese to avoid such practices and consideration of other legal tools (such as direct WTO actions) to address Chinese government subsidies.

One obvious first step in this regard is application of the U.S. countervailing duty ("CVD") law to China -- something that has been proposed in legislation by Senators Collins and Bayh (S. 593) and Representatives English and Davis (H.R. 1216), and which has the support of the National Association of Manufacturers (NAM). [The CVD law allows the U.S. government to impose offsetting tariffs on subsidized imports that are found to cause injury to a U.S. industry.] While there is nothing in U.S. or international law prohibiting it, the U.S. Department of Commerce has long refused as a policy matter to apply CVD law to non-market economies ("NMEs") such as China.[38] Congress should act quickly to pass legislation in this area, while urging Commerce to pursue aggressively subsidy actions against China.

B. Enforcing Trade Laws and Continuing Treatment of China as a Non-Market Economy

Strict and timely enforcement of existing trade law disciplines -- especially antidumping law -- will also be key to any successful effort to discourage non-market behavior in China. In this regard, China agreed to allow other WTO Members to treat it as an NME for purposes of trade remedy laws for a period of 15 years after China's accession to the world body.[39] This represented a critical provision essential to the accurate application of U.S. law. While China has lobbied heavily to be treated as a market economy, it clearly fails to meet the legal standard involved[40] -- due among other things to the role the Chinese government continues to play in allocating resources and setting prices,[41] the large volume and significance of state-owned enterprises in China, the lack of basic labor rights and protections [42] and the artificial peg of China's currency.

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38 Jessica Wehrman, "Voinovich presses China on fair-trade issue," *Dayton Daily News* at B6 (April 18, 2005), available at 2005 WLNR 6164422.

39 *See* Protocol on the Accession of the People's Republic of China at Section 15, part of *Accession of the People's Republic of China*, WTO Doc. No. WT/L/432 (Nov. 23, 2001) (hereinafter "Protocol on the Accession").

40 U.S. law defines a "nonmarket economy country" as a country that "does not operate on market principles of cost or pricing structures, so that sales of merchandise in such country do not reflect the fair value of the merchandise." 19 U.S.C. § 1677(18)(B).

41 For an example of how China's government interferes with market prices, *see, e.g.*, "China to take measures to curb rising steel prices," *AFX Asia Focus* (April 6, 2005).

42 For a detailed discussion of labor conditions in China, *see* Section 301 Petition of American Federation of Labor and Congress of Industrial Organizations (March 16, 2004), available at

C. Denying Unwarranted Preferences to China in New Trade Agreements

The extremely competitive (and potentially disruptive) nature of the Chinese steel industry offers a perfect illustration of why China should *not* receive preferential treatment (as a so-called "developing" economy or otherwise) in new trade agreements. Demands for such treatment have occurred with regularity in WTO talks and other trade negotiating areas -- including the recent Organization for Economic Cooperation and Development (OECD) talks on a proposed Steel Subsidies Agreement (SSA). China has insisted, for example, that as a "developing country" and as a price for its participation in the talks, China should not be subject to the same restrictions on subsidies as other countries, that it should be treated as a market economy in future trade cases and that the United States should specifically agree *not* to apply any China-specific product safeguards (a right we specifically have under China's WTO accession terms).

The fact is that China's steel industry is larger than the steel industries of North America and the rest of Asia combined, and many of its steel producers are among the most competitive in the world. Ensuring that China is fully and effectively covered by all fair trade disciplines (whether under existing laws or in new agreements) should be the *first* priority -- and the United States should absolutely refuse any demands for special treatment.

D. Addressing Distortion of Raw Material Markets

If we are to ensure the healthy functioning of world markets, responding to China's intervention in key raw materials sectors should also be a priority. Indeed, as the European Union (EU) recognized last year, China's efforts to restrict coke exports have no legitimate basis under WTO rules. Accordingly, the United States should take all possible steps -- including the use of the WTO dispute settlement process, when necessary -- to force China to stop interfering in raw material markets.

E. Enforcing China-Specific Safeguard Provisions

Under the terms of its WTO accession, China agreed that, for 12 years, the U.S. and other Members could impose product-specific "safeguards" against Chinese imports -- i.e., we could impose temporary tariffs on imports causing or threatening market disruption in the United States.[43] This provision is designed to ensure that U.S. industries and workers do not suffer injury and disruption as a result of import surges from China. The provision was critical in gaining support in the United States for China's WTO accession.

Last December, a USTR report on China's WTO compliance acknowledged the importance of such China-specific mechanisms, stating that "{t}he Administration is committed to maintaining the effectiveness of those mechanisms for the benefit of affected U.S. businesses, workers, and

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http://www.aflcio.org/issuespolitics/globaleconomy/upload/china_petition.pdf (last visited on June 19, 2005).

43 *See* Protocol on the Accession at Section 16. The United States has incorporated this provision into Section 421 of the Trade Act of 1974. 19 U.S.C. § 2451.

farmers."[44] But while the U.S. International Trade Commission (ITC) has reached three separate affirmative determinations in China-specific safeguard investigations,[45] the Administration has exercised its discretion to deny relief to each of the affected industries. Such decisions risk turning this critical provision into a dead letter, as domestic industries will not pursue the complex litigation necessary to obtain China-specific safeguards if they see no realistic prospect of relief.

F. Pursuing effective Action Against Currency Manipulation

China has thus far resisted all efforts by the United States and the EU to persuade it to allow its currency to appreciate in line with market forces. Indeed, China continues to defend its currency peg.[46] Accordingly, it is clear that merely "jawboning" China over this issue will not be sufficient to deter China from pursuing a policy it believes to be in its self-interest. The U.S. government must consider practical steps -- including limiting China's access to this market if necessary -- that will bring about a real policy change in China. At a minimum, the Administration should signal that it will pursue legal action at the WTO if necessary to ensure that U.S. rights are protected.

G. Fixing International Tax Rules on Border Adjustability

Existing international rules allow countries like China (relying on value-added tax systems) to rebate taxes on exports and apply them on imports -- while the United States is denied similar border-adjustable treatment for its "direct" (i.e., income) tax system. The result is that U.S. exports to China and other major markets are essentially double-taxed, while Chinese and other foreign producers can sell here largely tax-free. This results in an enormous hit to the bottom line of every U.S. manufacturer, due to rules that have no legitimate economic or logical justification. These rules are directly contributing to our unsustainable trade deficit with China and the rest of the world, and should be fixed once and for all.

IV. CONCLUSION

Effectively addressing market-distorting practices in China will be critical not only to the health of the domestic steel industry, but also to all manufacturers in America. Such a course is also essential to maintain continued public support for the world trading system. The U.S.-China economic relationship is of paramount importance; we had better get it right. We therefore hope that the Congress and the Administration will make resolution of the issues identified above a core priority.

AISI appreciates the opportunity to comment on this vital matter, and urges the Committee to examine vigorously the issues we have raised.

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44 USTR 2004 Report at 10.

45 *See Pedestal Actuators from China*, Inv. No. TA-421-1 (Determination), USITC Pub. 3557 (Nov. 2002); *Certain Steel Wire Garment Hangers from China*, Inv. No. TA-421-2 (Determination), USITC Pub. 3575 (Feb. 2003); *Certain Ductile Iron Waterworks Fittings from China*, Inv. No. TA-421-4 (Determination), USITC Pub. 3657 (Dec. 2003).

46 "China finance: China's bank chief defends stance on renminbi," *EIU ViewsWire* (June 8, 2005).

Statement for the Record
Re: Senate Finance Committee Hearing
on
U.S.-China Economic Relations
June 23, 2005

by
Dr. Vladimir A. Masch and Professor Mark Perlman

Dr. Vladimir A. Masch
President, Pinnacle Strategy L.L.C.
94 Old Smalleytown Rd.
Warren, NJ 07059-5453
Email Vladimir@rcosoftware.com
Tel. 908-561-7820, Fax 908-251-5359

Professor Emeritus Mark Perlman
Pittsburgh University, Dept. of Economics
302 Fox Chapel Rd., Apt. 414
Pittsburgh, PA 15238-1375
Email mperlman@pitt.edu

Introduction. Mr. Chairman and members of the Committee, we are economists that propose (personally, not representing any organizations) a novel "compensated free trade" policy for the USA. This policy meets all, without any exception, economic concerns put forth on June 23 by both members of the Committee and such witnesses as Dr. Greenspan. It also can be viewed as "the third alternative" sought by Senator Schumer, vastly superior to both free trade and protectionism.

Moreover, in distinction from many "mainstream economists," we fully recognize that the trade policy of a country never ever -- and especially not in wartime -- should be based purely on economic and financial considerations. It must also be a most powerful geopolitical tool -- a weapon of diplomatic persuasion and, above all, a non-confrontational means of containment of China and other potential rivals and adversaries. Since economic and geopolitical aspects and considerations are here closely intertwined, the Committee cannot overlook the latter. It must analyze the USA trade policy in terms of a more comprehensive point of view.

The proposed system is very simple: the Congress sets an upper boundary on the aggregate trade deficit in consumer goods, and the President allocates that limit among our trading partners. A country could exceed its limit if its government paid a stipulated percentage of the excess deficit. (See a more detailed outline below.)

The existing situation and its requirements. Can we slow down the armament of China and persuade it to help us with North Korea? Can we prevent or minimize its expansionist ventures and make the 21st century an American, rather than a Chinese, century? Can we persuade France and Germany to support us in Iraq? Can we save trillions of dollars and millions of American jobs from going overseas? If we overhaul our current trade policy, we have a reasonable chance to achieve these goals. But we have no chance at all if we retain it.

Unconstrained ("orthodox") free trade brings great benefits. But it also involves most serious negative "externalities": it has brought to the USA unacceptable geopolitical and economic consequences.

The first duty of the government is to assure the security of the country and its citizens; raising their welfare is only a second-tier part of this task. In turn, welfare includes not only consumption, but also other factors, too -- such as psychological, where free trade brings strong negative connotations. To assume that consumption and growth are the most important determinants of a trade policy would be a wrong and harmful oversimplification.

In the entire history of mankind, the trade policy of a state had been used, whenever possible, as an instrument of diplomacy, of economic influence on behavior of other states. Studying 13,000 years of the history of mankind, J. Diamond establishes the existence of

friendly trade partners as one of five main challenges that define whether a society fails or succeeds (Diamond, 2005). Free trade removes any possibility of selecting such partners.

In spite of enormous trade deficit and all its implications, *the geopolitical consequences* still are more important: we are stripped of economic levers of foreign policy. We are at war now, and we also have long-term strategic interests. But at a time of war and high uncertainty, we are left with no effective economic means of persuasion, stabilization, and defense in our international relations.

The United States has the most rewarding market in the world, and access to that market is highly valued. The country also has assumed the predominant role in the war on terror, but has not been compensated for these human and financial sacrifices. In spite of all that, our current rush to free trade has led our diplomacy to beg for favors, instead of demanding cooperation from a position of strength.

We are impotent, for instance, in our belated attempts, both diplomatic and economic, to slow down the ever-increasing threat to our strategic, long-term military interests. Based on the strong growth of its industrial and technical sector (16% in 2003) and on its trade surplus, China "assimilates and replicates the Western military technology ... with stress upon war in space, the oceans, and the ether" (Helprin, 2004). As it was with Japan before WWII, China's needs in energy and raw materials should unavoidably lead to an expansionist policy. Without any doubt, sooner or later, this new superpower will try to contain and overtake the United States.

The USA has therefore an indispensable need to obtain a powerful tool to contain China and, if necessary, other potential rivals and adversaries. Containing the Soviet Union was mostly a geopolitical operation and therefore relatively easy. We have now to contain China on both geopolitical and economic front lines, which is much more difficult. Using for that purpose confrontational methods would be counterproductive (Kissinger, 2005). This predicament was enormously aggravated by admitting China to WTO: we unilaterally and irrevocably disarmed ourselves and had no means left of economic containment. The current American free trade policy continually increases our relentless decline as an economic and military power, relative to China.

If we do not succeed in obtaining a superb containment tool, the 21st century will not remain American. That tool must be:

- Comprehensive, able to be effective in regard to any political, military, and economic event, and to be equally applicable to any country of the world;
- Long-lasting and enduring, not to be overturned or nullified;
- Of changeable impact, to be intensified or weakened at our will, as necessary under the circumstances;
- Above all, non-confrontational, non-provocative, and easily explainable in realistic and believable terms of economic survival of our country.

As to *the economic consequences* of "orthodox" free trade, these are a gigantic trade deficit, the demise of our industry, and the loss of millions of jobs. We have had 28 years of trade deficits, sharply increasing lately to unsustainable levels. During the last 10 years, we transferred abroad about $3 trillion. The projected borrowing from abroad for 2005 approaches another trillion dollars. Whole sectors of industry are disappearing, and we have lost millions of jobs.

In a few years, the U.S. external debt could reach 100% of GDP, "territory never visited by any large industrial country" (Blustering, 2005), and in 2010 the annual current account deficit would reach 12% of GDP (Eichengreen, 2004). Just the interest on such debt would exceed half a trillion dollars a year. How will we pay it during a recession?

True, we have a reasonably good growth rate of the economy, but this result is achieved at too high a price: our annual trade deficit grows at least five or six time faster and, as indicated above, is unsustainable. Besides, the growth and high consumption are short-term, transitory, and will disappear at the first whiff of a recession, while debts are forever.

Note that these are the good scenarios that assume "soft landing" - long-term continuation of the existing "export financing" policies of our trade counterparts and infinite tolerance of the financial markets. Moreover, the longer we live under good scenarios, the higher is the probability of the bad ones, and the worse these "hard landing" scenarios become. They envisage an uncontrollable financial disaster, triggered at any moment by any unfavorable event, big or small, from a terrorist act to a misunderstood statement of a prominent official. Because the current trade situation threatens to weaken or bankrupt many companies that have survived even the Great Depression (Jones, 2005), that is, the very foundation of the American industry, the crisis scenarios may be catastrophic.

Even if an industry sector wins because of buying cheaper components, outsourcing, and the offshore exodus of the US factories, the country as a whole loses. Trade between U.S. companies and their foreign affiliates accounts for about one-third of the total trade deficit (Blustein, 2005). The computer hardware industry, with an export surplus in the beginning of the 1990s, now contributes $25 billion to the country's trade deficit (Bernstein, 2004; Engardio and Roberts, 2004). In the area of highly advanced technology products (ATP), United States trade has gone from a surplus of $30 billion in 1998 to a deficit of $27 billion in 2003 (Stein, 2004). In 2004, this deficit increased to $37 billion. Now we mostly sell to China scrap metal, recyclable paper, lumber and other commodities.

The trade deficit with China (expected to top $200 billion in 2005) is especially worrisome. Congress is considering now the Senate Bill # 295, imposing tariffs on goods of that country. But the bill treats the symptoms, rather than the disease -- and only a small part of lesser symptoms, too. It is too narrow, addressing neither the geopolitical issues, nor the possibility of retaliation and a trade war, nor the predatory trade tricks other than "pegging" the currency, nor the structural crumbling of the total global market. The measure will not provide much relief. The bill may be counterproductive, too, leading to harmful destabilization of the Chinese currency and economy, without substantial positive effects for the USA. Finally, it is temporary, and it will be overturned by WTO. Chinese are patient people, and they will sit these tariffs out with a scornful smile.

Such measures are very far from sufficient; they only distract us from what is necessary. The whole global market system is broken. We need a permanent, comprehensive, and theoretically sound change of the trade policy and overhaul of that market, rather than a temporary, partial, and ineffective return to tariffs.

True, in some periods, such as after WWII, free trade may indeed have been beneficial for the USA from every point of view. During those periods, meeting the theoretical conditions did not matter. But the 21st century, full of troubles and uncertainty, is not one of these periods, and it will not be for many decades. Therefore let us consider the theoretical justification of free trade: "There is nothing more practical than a good theory."

The Emperor Has No Clothes. To summarize, it is our nation that pays for globalization. Free trade was supposed to pay for it. But the theory that free trade benefits every participating country is not applicable in the real world. The "law of comparative advantage," which is supposed to justify that assumption, works only under utopian conditions of no trade deficits, no capital movement, full employment, no excess capacity, a static economy, no technical progress, homogeneous workforce, and no uncertainty. Exchange rates, wages, and prices must be "appropriate" (that is, no great disparity in wages between the countries) and completely flexible (no minimum wage, either). The displaced workers should be re-employed by another industry immediately (hence no unemployment), without any training or transition or relocation cost -- otherwise, the "comparative advantage" would disappear. (Even worse -

– comparative advantage disappears if a country can undersell us in all products and has sufficient resources to manufacture them.) We can go on and on.

Every economist should know these conditions: almost all of them are listed even in the introductory textbooks, such as Samuelson (1976, 668, 671, 680) or Samuelson and Nordhaus (1998, 696, 704). In addition, Samuelson (2004) has shown that the law is invalid for a dynamic economy with technical progress. Instead, exaggerated, baseless, and wrong statements about the validity of that "law" in the real world are regularly presented as eternal and universal truths. This myth has obtained the status of being infallible and immaculate. But the emperor has no theoretical clothes.

Besides, the free trade advocates keep mum about several "factor price equalization theorems" which prove that, even under full employment, wages in all trading countries would be equalized at a sufficiently low level. Under a persistent unemployment, it will be much worse. (The average Chinese wage is around $135 per month, for 14 to 16 hours of work a day, seven days a week, under very harsh sweatshop conditions; some factories pay $50 to $80 per month. The average American wage is about $135 per day. China needs up to 20 million new jobs per year. What jobs and salary levels should be sacrificed to meet that requirement -- let alone similar large-scale requirements of India and the former Soviet bloc?)

By the end of the 1920s, John Maynard Keynes completely rejected the "law of comparative advantage," considering it invalid and irrelevant in the real world, that had unemployment and deficits (Milberg, 2002; Irwin, 1996, 189-206). Many preeminent economists were of the same point of view. Karl Marx was for free trade -- but only because he considered it destructive (Marx, 1982, 213).

The Keynes's dislike of dogmas was shared by Friedrich Hayek, who stated that "Probably nothing has done so much harm to the liberal cause as the wooden insistence of some liberals on certain rough rules of thumb, above all the principle of laissez faire." He implied that -- since only two imperfect alternatives were available, protectionism and free trade -- after choosing free trade, "the temptation to present it as a rule which knew no exceptions was too strong to be resisted" (Hayek, 1994, 21).

The supporters of free trade suppress extremely important principle formulated by John Stuart Mill (1848), that forever changed economics: economic laws are relevant only for production, where we allocate limited resources to deal with nature's constraints. The distribution of goods and wealth obeys no laws but those set by society. The economists have no say here, except for providing auxiliary analyses. After Mill, again and again, we unfailingly come to a conclusion that "Economic science could evaluate how certain courses of action differed in terms of achieving a desired end, but economic science could not judge those ends themselves." (Irwin, 1996, 186). The very fixation on purely economic goals of consumption and growth, mentioned above, is a serious violation of that principle.

The principle directly involves the end results of trade: even if a country as a whole gains from free trade, it still has winners and losers. To solve the arising difficulties, Mill (1825) proposed "the compensation principle": winners compensate losers. But the difficulties proved to be insoluble even in theory (Irwin, 1996, 183-188, 219), let alone in practical implementation of the principle. Since the winners do not voluntarily share their gains with the losers, society has to intervene. Societal determination should extend into the very decision about what form of trade to engage in -- even more so because, if a theory supporting free trade assumes full employment, it counts only consumption gains, but not job displacement losses, both material and psychological.

Myths and distortions could have been tolerated earlier, but now, with the current trillion-dollar annual stakes, they must be stopped. We can unshakably rely on only one axiomatic canon: any absolute dogma is a bad bedfellow for the economy, be it sleeping on the left or on the right side of the bed. The Soviet Union and free trade are good examples. A Russian

proverb says, "Make a fool pray, and he will get bumps on his forehead." (This is not about prayer – this is about fools.) Unfortunately, in the free trade case, it is the American economy that gets bumps.

The Proposed System. We cannot and should not completely back out of free trade. But its scope must be limited to the lower (micro) level of international trade. At the macro level, the undesirable side effects of free trade should be constrained by forbidding excessive trade deficits. Balancing the trade deficit at a reasonable level should be a prerequisite for free trade.

Deficit constraints should be aimed at both stability of the global market and the equitable sharing of the burden of economic adjustment between surplus and deficit countries. Keynes was against "the misplaced notion that the deficit country should bear the entire burden of adjustment" and therefore against devaluation of that country's currency, especially under fixed currency rates (Milberg, 2002, 242), which include "pegging". If our trading partners want to create jobs at our expense, especially by predatory trading, then let that country pay for the privilege.

This is an extremely important and undeservedly suppressed consideration, and the proposed "compensated free trade" system implements this view of Keynes and others, which, throughout the centuries, was implemented through tariffs.

The proposed system also represents a generalization of the "free market at the micro level, state policies at the macro level" approach of Keynes, Samuelson, and others, expanded from a single country with a "closed" economy to the global economy -- resulting in a comprehensive, orderly, consistent, and theoretically valid system of organizing the global market for our times.

This proposal can also be understood as a simple embodiment of common sense: it is equivalent to the behavior of parents, who do not deny the freedom of purchase choice to their kids, but still wisely set a limit on their overall spending.

This is how the proposed system would work:

- The United States sets an upper bound of the allowed annual trade deficit in consumer goods (and undesirable capital goods) for each country or group of countries.

- A country may exceed its limit if its government pays a stipulated percentage (up to the full amount) of the excess deficit.

- Congress sets annual limits on the overall trade deficit in consumer goods. (For instance, at the start of the system Congress approves year-by-year mandatory reductions of the deficit, to be applied until its size is acceptable.) It also sets the rules of trade, such as forbidding transshipping of goods between countries and similar techniques, aimed to bypassing the deficit limits, or demanding a Congress approval for any substantial increase of the deficit limit for a country.

- The President of the United States allocates the allowed deficit and stipulated percentage for each of our trading counterparts. (The deficit is added to our expected export to form an upper limit on imports from a country. It is adjusted by that country's tariffs, if any, on our goods; see Item 10 below.)

- Both the number and zeal of customs inspectors dedicated to accepting goods from a country would depend directly on that country's relevant behavior. (For instance, if a country does not pony up, all its Pacific imports could have to pass through one customs inspector located in San Francisco.)

To raise the money for deficit payments, our trade counterparts may use either export taxes (Lau and Stiglitz, 2005) or export certificate auctions (similar to the types described in Buffet, 2003 or Daly and Cobb, 1991). They may also pay from their financial reserves. But it would not require the appreciation of Chinese and other currencies, which might reward speculators and de-stabilize these economies.

In distinction from "soft" import limiting measures such as tariffs, which may or may not achieve their goal, the proposed system will assure meeting its trade deficit objectives.

The system uses the American separation of powers to limit the arbitrariness of the deficit limits: Congress sets the overall limits, while the President allocates them among our trading partners. That approach also decreases the capability of lobbyists to manipulate the system in their interests.

The proposed overhauling of our current trade policy probably is the only feasible way to eliminate the fallout of admitting China to WTO in a comprehensive, constructive, enduring and (extremely important) non-confrontational manner. Applying the system to sustain the financial well-being of the country is reasonable and non-provocative. It provides perhaps the sole reasonable chance to make the 21st century an American, rather than a Chinese, century. We might have no chance at all to achieve that goal if we retain the current policy.

As Hayek (1994) implied (see above), the liberals selected "orthodox" free trade because only two alternatives, free trade and protectionism, were available. The proposed "compensated free trade" system would be the third alternative, a compromise in many ways highly superior to the two extremes. It switches from trade to finance, thus escaping Lilliputian clutches of both WTO and the many trade agreements, entered into by many administrations. It differs from the "orthodox" free trade by imposing a macro control over that anarchic and shock-generating activity. And it differs from protectionism by: (a) offering a "compensated bypass" of any fixed import quotas ("We can take any of your exports, just pay for the privilege"), and (b) thus replacing our import tariffs by the export tariffs or their equivalents, self-imposed by the exporters (see above).

The proposed system can be implemented, even given the constraints imposed by ideological commitment of both free traders and deficit hawks. Both can remain true to their principles, while the system, as an exceptionally good compromise, provides "wins" for both sides and a victory for the country. The war grants a more than sufficient cause for a much needed overhaul of a utopian and harmful orthodoxy. And it is high time for it. A later action may not suffice.

The System Objectives. This system will be a versatile instrument, designed to achieve four geopolitical and 16 economic objectives. It also has another large advantage: as a measure saving millions of jobs and trillions of dollars, it probably will be very popular politically.

A. *Geopolitical Objectives*

(1) The system will provide a comprehensive, constructive, enduring and (extremely important) perhaps the least confrontational way to contain the excessive economic and military development of China. The containment can be gradual, measured, and targeted against specific actions. It will stop our financing the growth of the gigantic, modern, and potentially hostile armed forces of that country.

(2) To win the war on terror, we need the cooperation of all countries. This system would be a powerful tool of persuasion. We can stop begging for favors and start demanding what support is due to our country for its human and economic sacrifices on world's behalf.

(3) Our "less deserving" trade counterparts, such as predatory traders, will have much tighter deficit limits than our allies and other "deserving" countries, such as the developing countries we want to help. This will re-direct our imports toward the "deserving" countries.

(4) The proposal may replace in part our current system of direct foreign aid and World Bank or IMF loans and grants to developing countries by increasing instead their allowed deficits. A new factory may bring more benefits than badly designed and corruption-prone grants and loans.

B. *Economic and Financial Objectives*

(5) The system will reduce our trade deficit and the current account deficit.

(6) Most importantly, it will implement the principle of sharing the burden of trade adjustment between surplus and deficit countries. Moreover, in distinction from tariffs, which might be set too high, the system will allocate these costs fairly and automatically, at a level compatible with the given deficit limit of each country.

(7) Most importantly, the system is very flexible. Most of its control parameters (country bounds and percentages) are easily changeable. Every year, it would hone the terms and limits anew, in light of current needs and events, both geopolitical and economic. In short, it is a superb risk management tool, reducing our need for knowledge about the future.

(8) The system will provide macro constraints to prevent and absorb economic shocks. In accordance with the risk management feature (of Item 7 above), we can move into deficit reduction gradually, testing the consequences as we proceed. To a certain degree, we will be able to control the market process at the macro level, instead of being its helpless plaything, while fully retaining free trade at the lower micro level of individual enterprises.

(9) The system will change the behavior of predatory trading countries that now use dirty tricks costing us hundreds of billions (such as pegging their currencies to the dollar at an undervalued rate, intervening in the currency markets, dumping, counterfeiting goods, violating patents, or subsidizing their export production}. Currently they are sure of their impunity because we have no effective weapons. Complaints to the WTO are lengthy and difficult, while WTO bureaucrats often have their own biases and agendas. The very emergence of the proposed system, where misbehaving could be punished, would have an immediate and strong effect, much stronger than the import tariffs currently being proposed in Congress and elsewhere.

(10) In distinction from such tariffs, we can protect our strategically important and socially desirable industries without fear of a trade war through retaliatory tariffs or quotas on American goods, since these tariffs and quotas would automatically lower the allowed upper bound of imports. (For instance, let our exports to a country equal $100B and we allow it to have a deficit of $20B. The upper limit on imports from that country thus equals $120B. If the country imposes a tariff of $5B on American goods, our revenues would decrease to $95B. The limit on imports would then automatically decrease to $95B + $20B = 115B.)

(11) We can protect a large number of our domestic companies from bankruptcy by eliminating the unfair "China price" (as they are called in industry) terms of competition, when "... [imported] finished goods ... cost less than the costs of the U. S. firms' raw materials" (Encardio and Roberts, 2004; Jones, 2005). In case of complaints to WTO about fettering free trade, we would easily neutralize any such

complaint by showing that nobody impedes it. ("Sure, sell till you drop. It is about the deficit, stupid.")

(12) In Items 10 and 11, the system will crush the major argument of American industries that sell finished goods on the American market but use in their production the imports of raw materials or semi-finished goods, that more costly imports make them to abandon the USA production and cut the USA jobs -- like the argument of steel users, that their workers outnumber "40-to-1" the workers in the steel industry. Under the proposed system, considering the export tax or similar surcharges, the import to the USA of finished goods will be more costly than production in the USA. (E.g., suppose that the imported raw material costs $30 per unit of finished product, while the other production costs -- both in the USA and in the alternative country -- equal $70 per unit. With an export tax of 20 percent on raw material only, the total cost per unit equals $30 + $70 + $6 = $106. If the industry wants to transfer the whole production abroad, the export tax would apply to the total amount of $100 and, instead of $6, would equal $20.)

(13) The system will save American jobs in many ways, such as reducing dumping and other means of unfair competition, reducing the volume and raising the prices of imports (thus re-directing consumers toward "made in America" goods), and protecting our industries.

(14) The system will stop our financing of the creation of Godzilla-strength competitors.

(15) Most importantly, by increasing the export prices of our trading partners, the system will automatically change the often-harmful behavior of American enterprises without any intrusion or control of their profit-seeking motivation. (For example, Wall-Mart would be able to continue its pursuit of profit, without hurting the American economy and without additional government control and interference.)

(16) The system would provide an additional incentive for the central banks of our trading counterparts to purchase dollars, since the dollar devaluation would automatically reduce the quantity of goods they could export to the USA, while the dollar appreciation would increase that quantity.

(17) The system will impose a proper financial discipline on domestic consumption. To some discomfort of our consumers, the system will limit our excessive consumption to the desired level. It will impose the deficit limits only on consumer and undesirable capital goods, thus reducing the consumption of "butter" to what we can afford after producing the necessary "guns" and making worthwhile investments.

(18) Higher prices of imported consumer goods may have any of the three possible outcomes or their combinations: (a) the population will buy less and thus increase private savings; (b) the payments for excess imports will decrease the external deficit; or (c) the population will buy domestic goods and thus increase the domestic employment. All three outcomes are beneficial to the USA.

(19) The system will reduce the unsustainable rates of growth of some parts of the world economy, which threaten the environment and put excessive pressure on the supply and prices of oil and other commodities. This will help to conserve valuable global resources.

(20) As long as the trade policy is not corrected, our trade deficit and debt position will worsen at an ever-increasing rate. In turn, that will provoke an increasing pressure toward protectionism, as already demonstrated by Senate Bill #295

submitted by 14 senators. Similar measures are to come in the House. The proposed macro constraints may be our best chance to retain free trade at its proper micro level with the minimal necessary modifications.

But what about the negatives? Five major negatives of the proposed system are possible: (a) raising our inflation and interest rates and decreasing our growth – countered, however, by better growth because of reduced competition; (b) reducing the purchasing power of the American consumers; (c) reducing profitability of American enterprises and other multinationals that use the low wage countries as sources of profit; (d) decreasing the rate of growth of our trade partners and of global GDP; (e) triggering an economic and financial meltdown.

Unfortunately, the same five phenomena will also unavoidably happen under any other future scenario, such as the dollar depreciation, irrespective of whether we have done anything or not to bring our deficits to a sustainable level, but without the advantages of this system. It is better to deal with such phenomena when we at least have a powerful weapon for fighting them, rather than otherwise. And "Addictions must be broken, the sooner the better" (Krugman, 2005).

Besides, some of these consequences may be desirable: compare (d) with Item 19. Most importantly, (c) is unavoidable if we want to reduce the deficit: as mentioned above, a substantial part of it is caused by imports of multinationals and other companies that have taken the US factories abroad.

Conclusions. We may draw 12 main conclusions from this statement.

(1) Granting access to lucrative American markets can be a powerful weapon in our diplomacy, in the war on terror, and in containing China in a non-confrontational way. Not using it cannot be morally justified. Also, the trade policy should reflect a complex interaction of military, geopolitical, economic, and financial factors and considerations. The proposed system provides that weapon and meets that requirement.

(2) The proposed system is the only way to save both free trade and globalization -- with modified rules. He who pays for globalization sets the rules.

(3) Over the long run, but starting immediately and on an impressive scale, the proposed system should save millions of American jobs and trillions of dollars of deficits and debt. Even the first year financial savings should be no less than an 11-digit dollar amount.

(4) Free trade is only as good as its set of constraints. "Compensated free trade" uses macro constraints that impede only harmful trade, while allowing free trade at the micro level.

(5) What is good for Wal-Mart may now be bad for the country. The proposed system would eliminate the dangerous dissonance between the larger criteria of the country as a whole and the local profit criteria of individual enterprises.

(6) If the USA wishes to extricate itself from the quicksand of trade deficit, the proposed system or something similar is absolutely necessary; changing currency rates or setting up import tariffs would not be even remotely sufficient. The proposed system is the simplest and most natural approach. It also implements the view of Keynes and others that the deficit country should not bear the entire burden of adjustment. As well, it generalizes the theoretically correct approach of Keynes, Samuelson, and others "free market at the micro level, state policies at the macro level" from one country with a "closed" economy to the global economy.

(7) This proposal does not urge any specific timing or size of deficits cuts. It merely provides an effective and versatile tool for helping to solve complicated multifaceted problems of the USA government.

(8) The very existence of that tool should stop predatory practices used by a number of our trade partners.

(10) The "compensated free trade" system can be supported by both sides of the theoretical and practical aisles: both committed free traders and committed deficit hawks can remain true to their principles, while the system, as an exceptionally good compromise, provides a "win-win-win" solution: "wins" for both sides and a victory for the country. If a reason is still needed for a much-needed overhaul of a harmful orthodoxy, the war grants a more than sufficient cause.

(11) The orthodox theory of free trade is abstract and utopian. It becomes invalid and irrelevant under a multitude of real world conditions, such as a persistent unemployment or unbalanced trade. Obviously, the cumulative impact of all these conditions makes this conclusion much stronger. The theory can be safely applied in practice only in a modified form, and the proposal allows doing that with minimal modifications, leaving free trade intact at the micro level.

(12) Both protectionism and orthodox free trade are outdated, and the latter is very dangerous: it involves most serious negative "externalities", both geopolitical and economic. "Compensated free trade" is a highly superior third alternative, a logical response to the conditions and needs of the twenty-first century, at a time of war and uncertainty.

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Senate Committee on Finance
Editorial and Document Section
Rm. SD-203
Dirksen Senate Office Bldg.
Washington, DC 20510-6200

Re: Comments for the Record in the June 24, 2005, Committee on Finance Hearing on U.S.-China Economic Relations

On behalf of the U.S. retail industry, the National Retail Federation submits this written statement for the record in the U.S. Senate Committee on Finance hearing on June 24, 2005, regarding U.S.-China Economic Relations.

The **National Retail Federation** (NRF) is the world's largest retail trade association, with membership that comprises all retail formats and channels of distribution including department, specialty, discount, catalog, Internet, independent stores, chain restaurants, and grocery stores, as well as the industry's key trading partners of retail goods and services. NRF represents an industry with more than 1.4 million U.S. retail establishments, more than 23 million employees - about one in five American workers - and 2004 sales of $4.1 trillion. As the industry umbrella group, NRF also represents more than 100 state, national and international retail associations.

1. **Introduction**

For most Americans, the most visible sign of the rapid growth in trade between the United States and China is when they visit their local stores. It is readily apparent to any shopper that China has become a large supplier of a wide range of consumer products sold in the United States, including clothing, shoes, toys, consumer electronics, housewares, furniture, etc. Indeed, the retail industry represents a sizable segment of the U.S. importing sector and accounts for a large portion of total number of imported products from China.

Some view this situation with alarm and point to the amount of Chinese goods in American stores as evidence of the demise in American manufacturing and loss of manufacturing jobs. Some even blame what they see as "greedy" retailers for this situation, and accuse retailers of being only interested in exploiting coolie labor in China to get the lowest priced goods at the expense of U.S. manufacturers and workers.

Liberty Place
325 7th Street NW, Suite 1100
Washington, DC 20004
800.NRF.HOW2 (800.673.4692)
202.783.7971 fax 202.737.2849
www.nrf.com

This disturbingly widespread view demonstrates a fundamental lack of understanding about the retail industry and, more generally about how the U.S. and global economies work.

Trade in textiles and apparel has become a central issue in this debate as China has rapidly become a major supplier of clothing to the U.S. market. Therefore, NRF's comments will focus on these products in attempting to explain generally why retailers choose to import from China and what appropriate policy options are for those inclined to think that Congress must intervene in this situation in some way. In discussing policy options, these comments will discuss the retail industry's position with respect to two legislative proposals that have received most attention – S. 295, which would impose a duty of 27.5 percent on all imports from China if the Chinese Government fails to revalue its currency; and S. 593 ("Stopping Overseas Subsidies (SOS) Act"), which would subject China and other non-market economy countries to U.S. countervailing duty law.

2. **Why are Retailers Doing More Business In China?**

Like any other business in the United States, retailers face the daily challenge of creating value for their customers and shareholders. Retailers must also grow their sales and their businesses in an industry marked by cutthroat competition, an average profit margin of 2 percent, and downward pressure on prices as U.S. consumers spend increasingly less of their discretionary income on basic consumer products, especially clothing.

To meet these challenges, retailers must offer customers a fresh selection of products – goods they want to buy at prices they are willing and able to pay. Retailers seek out the best sources for products that meet those requirements. Sometimes that source is a U.S. producer. But often the best source is a foreign supplier because some products are only available from foreign sources, and other products are not available from U.S. producers in the quantities, time frame, or at the quality and price available from foreign suppliers.

In deciding where to source the goods they sell, the key consideration for most retailers is not necessarily price, but rather finding suppliers that provide superior customer service, <u>and retailers are willing to pay a premium for it</u>. Under the current, just-in-time, "full-package" production and supply system for textiles and apparel, superior customer service means suppliers must make the retailer's needs the top priority, provide consistently high quality, speed-to-market and on-time delivery, and assist the retailer along every step in product development, from concept to market.

While there are U.S. textile companies providing good customer service, decades of protectionism through quotas and other barriers limiting foreign competition have had an unfortunate impact on the business ethic of many in the textile industry. Retailers frequently complain that too many U.S. textile

companies treat them – their customers – as "the enemy," and view their business relationship with the retailer as an entitlement, rather than something that they must earn.

Meanwhile, Chinese suppliers, often owned by Hong Kong and Taiwanese companies with decades of experience competing for business in the U.S. market, have learned that the formula for success is treating the customer as "number one." China also has other key advantages over even lower-cost countries – a workforce that sets the standard for skill and productivity, modern factories and infrastructure built by massive foreign investment, easy access to raw materials through integrated textile and apparel production, competitive prices, consistently high quality, innovation, flexibility in executing orders, and "speed to market" (*i.e.*, the ability to get goods to the customer quickly).

Although many in the U.S. textile industry blame Chinese "cheating" and "unfair" prices for lost jobs and bankruptcies, suppliers who are unable, or unwilling to serve their customers' needs will lose out to their competition regardless of price or how much new technology they may have invested in.

3. **Is China Destroying the U.S. Textile Industry?**

Many textile companies, their Washington lobbyists, and the textile and apparel union, UNITE-HERE, continue to blame competitiveness problems in their industry on competition from China. Contending that imports from China are devastating their industry, they have become a driving force in advocating extreme, protectionist measures to block access of Chinese goods to the U.S. market, and have supported every single piece of legislation designed to do such. But is this view about the impact of trade with China really accurate, and are the policy options they seek to advance their goals either warranted to advisable?

Due to changes in the U.S. economy, imports as a whole have grown steadily over the past 40 years so that, by value, over 70 percent of all clothing sold in the United States is now sewn outside the United States. Import penetration is even higher when calculated by volume – over 90 percent. Accordingly, any increase in apparel imports from China will largely come at the expense of other foreign suppliers, not U.S. production, and will not change the total import level.

While China's share of global production is growing, a look at import mix and the apparel market shows that China is not the core problem the U.S. textile industry claims it is:

- Total U.S. apparel imports have risen only marginally over the past four years from $69 billion in 2000 to $76 billion in 2004 reflecting slight sales growth in the U.S. market (2.5% per year average);
- China accounts for at most 10% of the total U.S. market for apparel by value;

- Events in the apparel market have no impact on 83 percent of U.S. textile industry shipments, which are non-apparel related products where sales and profits have grown;
- China accounts for only 1% of the U.S. market for textile products (yarns and fabrics) – Canada, Mexico, the EU, and Korea account for 63%;
- China accounts for only 10% of the total U.S. market for made-ups;
- Imports account for only 3.7% of the total U.S. market for carpets and rugs and 13.5% of the total U.S. market for curtains and linens;
- China is a growing export market for the U.S. textile industry – in 2003, 8% of the total value of textile and apparel products imported from China contained U.S. content (cotton $737m; MMF $130m, yarn $55m, fabric $31m).

In addition, for retailers, the risks of putting all their orders in China are becoming too high for the following reasons;

- U.S. manufacturers will continue to file trade cases targeting Chinese goods;
- With most imports from China coming through the West Coast, particularly LA/Long Beach, growing port congestion and labor strife in 2002 that resulted in a shutdown of the West Coast ports created were wake-up calls for retailers;
- During the SARS scare in 2003, retailers were unable to send their sourcing and design staffs to China for over a month;
- China is experiencing a serious energy crisis, which is causing blackouts and factory closures;
- Due to the huge influx of foreign direct investment, labor costs along coastal China are rising;
- In response, the Chinese Government is pushing investment inland, which has a backward infrastructure, creating higher costs and potential delays in shipments.

As a result, retail orders in China have increased only 12 to 20 percent, and retailers are actively seeking alternative places to source product in places like India, Pakistan, and Central America.

4. The Position of the U.S. Retail Industry Regarding Legislation (S. 295) on China Currency Policy

The U.S. textile industry and other manufacturers have seized on the alleged undervaluation of the Chinese currency as a core reason for their competitiveness problems. As a result, textile producers and some other U.S. manufacturers are strong supporters of legislation (S. 295) introduced on February 3, 2005, by Senators Charles Schumer (D-NY) and Lindsey Graham (R-SC) that would impose a 27.5 percent duty on all imports from China unless the Chinese Government revalues its currency, the Yuan or Renminbi. On April

7, 2005, Schumer offered the bill as an amendment to the foreign affairs authorization bill. After a motion to kill the amendment failed overwhelmingly, Senate Leadership convinced Schumer to pull the amendment in return for a commitment for a Senate vote on the measure before the August recess as a stand-alone bill. That agreement has been since modified so that the vote would be no later than the end of this session of Congress.

The U.S. retail industry supports the ultimate goal of allowing the Chinese currency to float and have the market determine its proper value. In the shorter term, we believe that the current peg of the Chinese currency is unsustainable and should be adjusted, whether by modifying the current peg or pegging the currency to a basket of currencies rather than just to the U.S. dollar. We have also communicated our industry's views on the issue to Chinese Government officials.

That said, however, the U.S. retail industry strongly opposes the Schumer/Graham bill for several following reasons. First, it is a sledgehammer approach to a complex foreign and economic policy issue that is being addressed by the Administration through sensible diplomacy and the tools available through U.S. law. It would also be a gross violation of international trade rules that would expose the United States to billions of dollars in possible trade retaliation. As such it seriously threatens to undermine U.S.-China political and economic relations at a time when the United States needs to work with China in addressing serious global issues, from how to deal with a nuclear-armed North Korea to advancing the global trade negotiations at the World Trade Organization.

Second, the Schumer/Graham bill would inflict serious damage on the U.S. economy in several ways:

- By imposing a new 27.5 percent federal sales tax on many consumer products, it would severely suppress consumer spending, upon which the health and growth of the U.S. economy depends.
- Economists, including Federal Reserve Chairman, Alan Greenspan, are of the opinion that the bill would result in an immediate and substantial increase in U.S. interest rates, particularly if China were forced to sell off or stop buying billions of dollars in U.S. treasury bonds, which would further suppress consumer spending, particularly in the U.S. housing market.
- With many American companies heavily invested in China, the investment firm of Morgan Stanley has estimated that imposition of a 27.5 percent tax on Chinese goods would reduce profits from Standard & Poor's 500 companies by more than $50 billion, or as much as 8 percent of their total earnings.[1]

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[1] *If U.S. Presses China on Yuan, A Delicate Scale could Tip*, The Wall Street Journal (June 29, 2005), p. C1.

- The impact on corporate earnings would result in a major decline in the stock market, which would have serious consequences for pension funds and investment accounts upon which millions of Americans depend for their retirement income.
- The decline in consumer spending would also lead to a serious decrease in state sales tax revenues, thereby severely impacting state budget deficits.

Third, it is clear that the Schumer/Graham bill would do nothing to lower the U.S. trade deficit, but would merely shift trade to other foreign countries, mostly in Asia. This view has been confirmed by sourcing executives from many retail companies. It is also the view of Federal Reserve Chairman, Alan Greenspan, who also correctly observed, that a bilateral merchandise trade deficit with a particular country (as opposed to the global current account balance) is not a particularly meaningful economic measurement, and its importance should, therefore, not be overblown.

Fourth, because the Schumer/Graham bill would merely shift trade to other foreign countries, it would clearly have no impact in terms of protecting American jobs from Chinese imports. In fact, the legislation would likely have the opposite effect. It would hurt the U.S. retail industry, which accounts for one-fifth of U.S. employment, and American retail jobs that depend on trade with China. In addition, it would also lead to job losses for U.S. manufacturers and farmers who must import components for the goods they produce.

Finally, some advocates of the Schumer/Graham bill view it as a useful threat against China while contending that there is no chance it will ever become law. As a threat, Schumer/Graham is the trade equivalent of nuclear deterrent known as mutually-assured destruction. Under the circumstances, one must ask whether there is any logic to threatening China, or any other country for that matter, by figuratively pointing a gun to our own heads. Indeed, threats are only credible if one is truly serious about pulling the metaphorical trigger, something most Members of Congress, who appreciate the risks in this particular case, are clearly unwilling to do. Given that fact, it makes sense for Congress to focus on a sensible policy debate, rather than embarking on reckless, ill-considered, and self-destructive legislation of this sort.

5. **Position of the U.S. Retail Industry Regarding Legislation (S. 593) to Subject China to the U.S. Countervailing Duty Law**

Another piece of China legislation that has garnered support from the U.S. textile industry and other manufacturers is a bill (S. 593), introduced on March 10, 2005, by Senator Susan Collins (R-ME), that would subject China to the U.S. countervailing duty ("CVD") law.

Although not specifically prohibited from doing so, current practice by the U.S. Department of Commerce is not to apply countervailing duty law to non-market economy ("NME") countries like China under the theory that state control makes it impossible to identify specific subsidies.

As a counterbalance, however, China does fall under the U.S. antidumping law, in which offsetting duties are imposed when U.S. producers of a "like product" are found to be injured by dumped imports (*i.e.,* goods sold at less than the price in the home market or less than the cost of production). As an NME country, China is subject to a much more stringent methodology in calculating dumping margins than market-economy countries. In particular, Chinese companies must demonstrate that their costs are at market rates (*i.e.,* not subsidized), or they will be deemed to be dumping and, therefore, subject to the country-wide dumping rate – often in excess of 100 percent – calculated using prices in a surrogate market economy country, such as India. In effect, the NME methodology already sweeps in any subsidies a Chinese company may be receiving.

This analysis is substantiated by a report issued by the Government Accountability Office (GAO) on June 17, which examined the applicability of U.S. countervailing duty (CVD) law to China and other non-market economy (NME) countries. The GAO report questioned whether the CVD law would provide U.S. producers a higher level of protection than is already applied under the U.S. antidumping (AD) law, given that countervailing duties tend to be lower than antidumping duties and the prohibition against double-counting subsidy benefits in AD and CVD cases. Finally, the report noted substantial practical problems with identifying countervailable subsidies in an NME economy and calculating appropriate CVD levels, although third-country surrogate countries could be used.

NRF agrees with the GAO analysis. Our concern and opposition to the Collins legislation comes down to three issues. First, the World Trade Organization (WTO) subsidies code governs the definition of a countervailable subsidy, which must meet one of two criteria. A countervailing duty may be imposed if a subsidy is an export subsidy, in which receipt is conditioned on exportation of the product in question, or it is a domestic subsidy which confers a specific, rather than general benefit. The Collins bill, especially when combined with other legislation that would define Chinese currency practices as a countervailable export subsidy, could run afoul of WTO rules under the subsides code by targeting practices that would not otherwise meet the definition of a countervailable subsidy.

Second, we are concerned about the filing of frivolous CDV cases that would substantially increase the cost and uncertainty of doing business in China, with no appreciable benefit other than for harassment.

Finally, we are concerned about the possible use of third-country surrogates to calculate prices in a CVD case against an NME country. In the antidumping context, this practice, at best, results in artificially inflated dumping margins, and, at worst, is totally arbitrary.

6. **What Are Appropriate Policy Options?**

Even though the World Bank estimates that the increase in trade following China's accession to the World Trade Organization has added $75 billion to global income, some still believe trade with China is bad for the U.S. economy, security, and jobs. Under the guise of "fair trade" and leveling the proverbial playing field, some Washington policy makers believe that limiting imports from China is necessary to protect U.S. manufacturers and jobs and correct the bilateral trade deficit. However, this approach raises the fundamental question whether it is a wise or effective strategy in dealing with issues on China.

Over the past twenty-five years, the United States has achieved an extraordinarily high level of import penetration for many types of consumer products. In the case of clothing the import penetration ratio is over 70% by value and 90% by volume. In the process the United States has shed a million textile and apparel jobs, notwithstanding the fact that textiles and apparel have been and remain the most protected sectors in U.S. manufacturing. Therefore, if the objective is to protect manufacturing jobs, history proves that limiting imports, from China or any other country, through quotas, increased duties, or other trade barriers is a manifest failure. The reason is simply because job losses in U.S. manufacturing, and particularly in the textile industry, have been and will continue to be driven by factors other than trade.

Moreover, decades of protectionism have also been a dismal failure as a means to make the U.S. industry more competitive. In the case of the U.S. textile industry, protectionism has hindered innovation, advances in productivity, and delayed needed restructuring in the industry, while imposing a huge cost on American consumers, taxpayers, and the economy as a whole.

Finally, with China a dominant supplier of many basic consumer products, it is curious why would anyone think that a reasonable policy to address our issues with the Chinese is to impose a huge, regressive sales tax on American consumers – like the Schumer/Graham legislation – and punish U.S. companies and their workers who depend on trade with China.

A more effective approach is to focus on domestic policies that hinder the competitiveness of U.S. manufacturing in areas such as health care and tax policy. In addition, manufacturers, including in the textile industry should be given help in developing new export markets, including China, and create for retailers viable sourcing alternatives to China. This goal can be best achieved by supporting: (1) negotiations at the WTO that will eliminate high tariffs and other trade barriers on consumer goods – particularly textiles and apparel – globally on a reciprocal basis; and (2) free trade agreements with flexible and commercially-viable rules of origin – particularly for textiles and apparel – that will provide the

incentives retailers and apparel manufacturers need to expand trade and investment in countries other than China.

Policy makers should encourage, rather than attempt to hinder rationalization and consolidation in manufacturing, including the textile industry. This process may lead to job losses, but will ensure that the jobs that remain or are created will be better, higher paying, and higher skilled, and companies will be stronger and more competitive globally.

Respectfully Submitted,

Erik O. Autor

Vice President, Int'l Trade Counsel

National Retail Federation

Written Statement of Terence P. Stewart, Esq.
Managing Partner, Stewart and Stewart

This statement presents an overview of some of the major economic and trade issues affecting the economic relations of the United States and China. Following the introduction and data about the US-China trade balance, the statement (a) reviews China's WTO compliance over the three years of its membership, (b) outlines the major trade remedies that the US should employ to insure a more level playing field, (c) examines the increasingly important exchange rate issue, (d) comments briefly on the range of issues concerning protection of intellectual property, and (e) identifies some issues where China has had difficulty bringing itself into WTO compliance and which present potential opportunities for a WTO challenge that would assist in bringing about compliance in fact.[1]

A. Introduction

China has made tremendous strides in meeting its WTO obligations, but it still has a long way to go. While not all parts of China's government appear to be committed to full compliance, China has made extensive and good faith efforts to address the complex challenges it faces in bringing its economy into full accord with WTO rules. On many issues, China has worked reasonably well in a bilateral fashion to address problems, and the US and other trading partners have worked hard to provide China with technical, and other, assistance to permit China to achieve what it appears to generally desire – a trading system in compliance with WTO rules. Nonetheless, given the large trade deficit and continuing WTO compliance problems in particular areas, it is critical that the US use all of the tools available in the WTO and in US trade laws to help China move toward meeting its obligations both to the US and the world trading community generally.

B. US-China Trade Balance

The economic relations of the US and China have grown significantly over the last 25 years.

- China has become the third largest trading partner of the US, after Canada and Mexico.
- The US is China's second largest trading partner overall.
- The US imports more merchandise from China than from any other country except Canada.
- China exports more merchandise to the US than to any other country.
- China is the fifth largest destination for US exports (after Canada, Mexico, Japan, and the UK).
- The US is the sixth largest supplier of imports to China.
- Given current trends, China is likely to become the US' primary source of imports by 2006.

However, the most significant fact about US-China trade relations is that it is seriously imbalanced. Since 1985, the US trade deficit with China has steadily increased. In 2004, the deficit reached $162 billion, the largest bilateral trade deficit ever recorded. And, in the first 4 months of 2005, the Census Bureau reports that the trade deficit with China reached $56.7 billion, outpacing the trend for the same period in 2004 ($42.2 billion). That is a 34 percent increase in the US deficit with China so far in 2005 and if the trend continues it will top $200 billion this year.[2]

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[1] The statement is largely derived from a report prepared by the Law Offices of Stewart and Stewart for the U.S.-China Economic and Security Review Commission in January 2005 and from testimony provided by Terence P. Stewart to that body on February 3, 2005. Copies of these documents are available at the Commission's website: www.uscc.gov/researchpapers/2005/05_01_21_china_inthe_wto.pdf; www.uscc.gov/hearings/2005hearings/written_testimonies/05_02_3_4wrts/stewart_terence_wrts.pdf.

[2] *See* www.census.gov/foreign-trade/balance/c5700.html#2005.

US-China Trade Balance US$ (billion)

Year		Year		Year		Year	
2004	- 162.0	1999	- 68.7	1994	- 29.5	1989	- 6.2
2003	- 124.1	1998	- 56.9	1993	- 22.8	1988	- 3.5
2002	- 103.1	1997	- 49.7	1992	- 18.3	1987	- 2.8
2001	- 83.1	1996	- 39.5	1991	- 12.7	1986	- 1.7
2000	- 83.8	1995	- 33.8	1990	- 10.4	1985	- 0.6

U.S. Trade with China

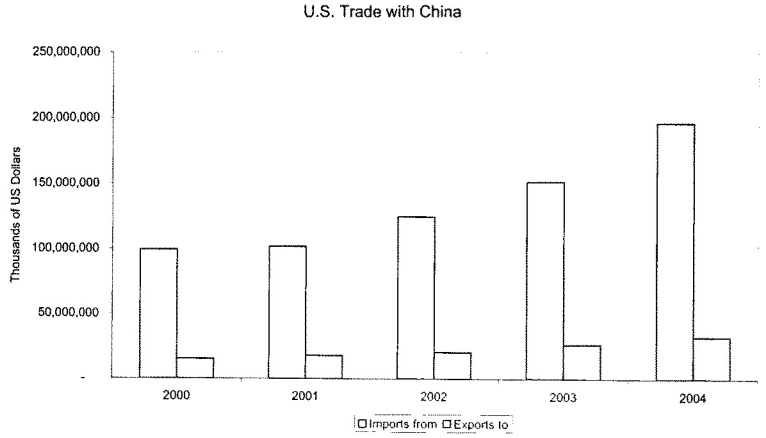
Data are in Millions of US $s.

US Imports from:	2000	2001	2002	2003	2004	% Change 2000-04
World	1,218,022	1,140,999	1,161,366	1,257,121	1,469,864	20.7%
All Other	1,118,004	1,038,721	1,036,173	1,104,685	1,273,165	13.9%
China	**100,018**	**102,278**	**125,193**	**152,436**	**196,699**	**96.7%**
China % World	8.2%	9.0%	10.8%	12.1%	13.4%	5.2%

US Domestic Exports to:	2000	2001	2002	2003	2004	% Change 2000-04
World	781,918	729,100	693,103	724,771	819,052	4.7%
All Other	765,733	709,918	670,975	696,403	784,331	2.4%
China	**16,185**	**19,182**	**22,128**	**28,368**	**34,721**	**114.5%**
China % World	2.1%	2.6%	3.2%	3.9%	4.2%	2.2%

Trade Balance	2000	2001	2002	2003	2004	% Change 2000-04
World	(436,104)	(411,899)	(468,263)	(532,350)	(650,812)	49.2%
All Other	(352,271)	(328,803)	(365,198)	(408,282)	(488,834)	38.8%
China	**(83,833)**	**(83,096)**	**(103,065)**	**(124,068)**	**(161,978)**	**93.2%**
China % World	19.2%	20.2%	22.0%	23.3%	24.9%	5.7%

Source: Bureau of Census import and export statistics. Imports are imports for consumption, f.a.s. basis. Exports are dometic exports, f.a.s. basis.



The ever-growing trade deficit with China is not sustainable and requires urgent attention. The trade deficit flows from many factors that are not market-driven, such as WTO compliance problems, currency issues, and intellectual property violations, among others. The US needs to take forceful and effective action to shrink the trade deficit with China, to bring the trade flows between the US and China into a realistic balance, and to work to improve respect in China for the rule of law.

C. Overview of China's WTO Compliance

After three years in the WTO, China has met WTO commitments in numerous areas. Even so, in many areas, China has not yet achieved full compliance with its WTO obligations. In the following areas, for example, the US Trade Representative's 2004 WTO compliance report pointed out the following issues of concern to both the US government and the US manufacturing and services sectors.

- Intellectual property rights: Although China has undertaken major efforts to revise its IPR laws and regulations, piracy remains rampant and enforcement of IP rights is seriously inadequate.
- Trading and distribution rights: Although China implemented its commitment to full trading rights ahead of schedule, concerns remained regarding distribution rights in that China had not issued specific rules clarifying how distribution rights would be acquired. In early 2005, China has been slow to approve applications for distribution rights and the process has suffered from lack of transparency.
- Services: In many sectors, China met the "letter" of its commitments to liberalize trade but frustrated the "spirit" by imposing new and burdensome licensing and operating restrictions, such as high capital requirements and prudential rule requirements that exceeded international norms.
- Agriculture: US exporters experienced continuing problems with market access and transparency of regulations.
- Industrial policies: In a number of areas, China has continued to use policies that effectively limit or impose conditions on market access, or give preferential treatment, such as the following:
  - discriminatory VAT policies
  - national treatment not provided to medicine price controls and drug reimbursement
  - preferential import duties to certain products (particularly from Russia)
  - discriminatory application of SPS measures
  - disparate standards testing of foreign products compared to domestic products
  - lack of transparency for proposed technical regulations and conformity assessment procedures
  - development of unique standards for products in spite of existing international standards
  - inconsistent application of the China Compulsory Certification (CCC) mark
  - investment laws and regulations that continue to "encourage" technology transfer
  - auto industrial policy discourages auto parts imports and encourages use of domestic technology
  - government procurement policy mandates Chinese-produced software to the extent possible

D. Overview of Trade Remedies Available Respecting Chinese Imports

1. China-Specific Safeguards

When China acceded to the WTO in December 2001, its trade regime was not fully consistent with WTO rules. As a condition of granting China early entry into the WTO, China agreed that, for certain periods of time following accession, other WTO Members would be able to use two China-specific trade remedies if imports from China caused market disruption or injury to another Member's domestic industries.

a. China Product-Specific Safeguard (Section 421)

Article 16 of China's Protocol of Accession established a general "product-specific special safeguard" measure with respect to Chinese goods. This measure permits WTO Members, for 12 years following China's accession (*i.e.*, until December 11, 2013), to take action to curtail surges of imports of Chinese goods that cause or threaten to cause "market disruption" to a domestic industry producing similar goods. This product-specific safeguard, unique to China, is applicable to any type of product (both industrial and agricultural goods).

The China product-specific safeguard was enacted into US law as Section 421 of the Trade Act of 1974 (19 U.S.C. § 2451). The rationale of Section 421 is that US industries should not lose jobs due to competition from Chinese imports at a time when China is adjusting to its WTO obligations. Congress wanted this measure to be applied vigorously to address import surges from China, and noted that if the ITC made an affirmative determination on market disruption, there would be a "presumption" in favor of providing relief. But Section 421 has not been administered as Congress intended.

The ITC has conducted only 5 Section 421 investigations so far: (1) pedestal actuators, (2) steel wire garment hangers, (3) brake drums and rotors, (4) ductile iron waterworks fittings (DIWF), and (5) innersprings. The last active investigation was completed more than one year ago, in March 2004. In 3 of the 5 investigations, the ITC made affirmative injury determinations and recommended relief, but the President nevertheless chose to deny relief to the affected domestic industry. Given this track record, and the strong lobbying by China to discourage the President from granting relief in these cases, domestic industries have been discouraged from filing new petitions. As a result, Section 421 so far has, unfortunately, been an ineffective trade remedy. Expectations of its utility as a measure to provide relief to US industries injured from a surge in Chinese imports have not been realized.

b. China Textile Safeguard

In May 2005, the US imposed textile safeguards on Chinese imports covering 13 product categories. Thus, after a shaky start, the textile safeguard trade remedy is being used and initial cases suggest it may be effective within the parameters of the provisions.

Paragraph 242 of the Working Party Report to China's WTO accession permits WTO Members to impose, until December 31, 2008, safeguard measures restraining Chinese textile imports if they are "threatening to impede orderly development of trade in these products" due to "market disruption." In the US, the Committee to Implement Textile Agreements (CITA) conducts investigations and imposes safeguards on Chinese textile imports. If a safeguard measure is imposed on a particular textile category, CITA may restrain Chinese exports of that product to 7.5 percent growth.

The US textile industry's efforts to use the textile safeguard mechanism to respond to surges of Chinese imports were initially slowed by delay and legal actions, but have achieved some degree of success of late.

- Initial delay and initial safeguards: Because CITA did not issue procedural rules until May 2003, the domestic industry did not file initial petitions until July 2003 and CITA did not impose the first textile safeguards on three product categories until December 23, 2003.
- Safeguard: US sock producers filed a safeguard petition in June 2004. CITA imposed a safeguard on October 29, 2004.
- Legal action: In October and November 2004, anticipating the end of global textile quotas on January 1, 2005, a domestic textile industry coalition filed a series of textile safeguard petitions covering a variety of products that were based on the "threat" of increased imports rather than actual increased imports. When CITA accepted the new threat-based petitions, retailer and importer groups filed suit in the US Court of International Trade (CIT). They claimed that CITA lacked authority to consider threat-based petitions and asked the court to enjoin CITA from

granting relief. On December 30, 2004, the CIT granted the motion for a preliminary injunction and issued an order enjoining CITA from proceeding on the threat-based safeguard requests during the pendency of the court action. The Court of Appeals for the Federal Circuit stayed the CIT's injunction on April 27, 2005 and CITA resumed consideration of the threat-based safeguard requests.

- Recent petitions filed and safeguards imposed: In April 2005, CITA self-initiated China textile safeguard investigations on three product categories based on preliminary import data from the first quarter of 2005, and domestic industry coalitions filed 7 safeguard petitions covering 14 product categories. In May 2005, the domestic industry coalition filed another safeguard petition on 2 product categories, and CITA imposed safeguards covering 13 product categories.

2. Antidumping Duty Law -- Under-Collection of Dumping Duties on Chinese Imports

Antidumping law applies to imports from China as well as other countries. However, in recent years, it has become apparent that, due to significant undercollection of dumping duties by US Customs and Border Protection (CBP) on Chinese imports, US industries that successfully petitioned for antidumping duty relief from Chinese imports have not received the full benefits of antidumping duty orders to which they are entitled under US law.

CBP reported in its FY 2003 annual report on the Continued Dumping and Subsidy Offset Act (CDSOA) (March 2004) that it had failed to collect $130 million of antidumping and countervailing duties, $103 million of which related to antidumping duties on Chinese imports, including such products as crawfish, paint brushes, iron castings, roller bearings, silicon metal, brake rotors, garlic and honey. While the undercollection of duties stems from multiple and complex reasons, contributing causes include:

- Failure by importers to post adequate cash deposits or bonds on entries,
- CBP allowing importers to post a continuous entry bond instead of requiring a single entry bond as required by a Treasury Decision,
- CBP allowing importers to post continuous entry bonds that are too low to cover eventual dumping liability,
- Cash deposits posted on estimated duties are lower than finally-determined duties and the importer fails to pay the difference due to bankruptcy or disappearance, and
- In the case of "new shipper" reviews, a "loophole" that allows importers to post a bond, rather than cash deposits, on estimated dumping duties.

Although CBP has proposed a series of reforms to address this problem (*e.g.*, ensuring that surety bond companies can cover defaults; requiring different bonding requirements where continuous bonds are used; and closely monitoring continuous entry bonds), CBP's FY 2004 CDSOA Report showed that it had failed to collect $260 million in antidumping and countervailing duties in 2004, $224 million of which related to antidumping duties owed on Chinese imports.

Only as a result of the CDSOA annual reports has the magnitude of the duty undercollection problem, which largely stems from Chinese product imports, been identified. It is critical that the full amount of duties owed be collected. Effective actions by Congress, CBP, and Commerce are needed to ensure the proper functioning of US antidumping law with respect to Chinese products.

3. Countervailing Duty Law -- Non-Application of CVD Law to Imports from China

Since 1984, the US Commerce Department has not applied countervailing duty (CVD) law to non-market economy (NME) countries, such as China. Commerce reasoned that subsidization is a market economy phenomenon and could not exist in an NME where "markets" do not exist. As a result of this policy, US industries cannot petition for the imposition of countervailing duties when injured by reason of Chinese imports benefiting from government subsidies.

Commerce's approach is not mandated by the CVD statute. Rather, Commerce established its policy in an administrative determination. Therefore, given a reasonable basis, the policy could be reversed or changed by administrative action. Indeed, the US position is bizarre at the present time in light of the heavy emphasis the US placed on eliminating or limiting subsidies as part of China's accession process to the WTO. The US policy begs the question: If subsidies cannot exist in China, why did the US insist time and time again during China's accession process that such subsidies had to be eliminated, reduced, identified and/or reported?

Indeed, the US' continuing concern over Chinese subsidies belies the premise of Commerce's policy that subsidies cannot exist in a NME. For example, in the most recent Transitional Review Mechanism conducted at the WTO, the US both inquired about and identified a large number of Chinese subsidy programs that appeared to constitute either prohibited or actionable subsidies under the WTO Agreement on Subsidies and Countervailing Measures. In one submission in the TRM process, the US asked China to explain whether it provided subsidies with respect to certain products or industries, or continued to maintain certain subsidy programs:

- Semiconductors – whether China grants VAT rebates on semiconductor exports?
- Copper – whether China grants VAT rebates on imports of copper scrap or on exports of copper-based, semi-fabricated or finished products?
- Subsidies to State-Owned Enterprises Running at a Loss – whether China has eliminated these subsidies as promised in the accession agreement?
- Non-Performing Loans – asked China to explain its injection of US$45 billion into the Bank of China and the China Construction Bank; asked China to explain its debt forgiveness as part of the Northeast Revitalization Programme.
- Price Controls – whether certain price control programs provide subsidies?

In another TRM submission, the US identified a number of programs and practices that appeared to constitute prohibited subsidies, as well as other programs that appeared to constitute actionable subsidies. These were:

- **Subsidies Contingent Upon Export Performance**
  - Honourable Enterprises – preferential benefits
  - Export-Contingent Tax Reduction for Foreign-Invested Enterprises (FIEs) in Special Zones
  - Income Tax Refund for Foreign Investors Investing in Export-Oriented Businesses
  - Special Steel for Processing Exports Policy
  - Export-Contingent Income Tax Reduction for FIEs or Tax Allowance for FIEs
  - Export Subsidies for High-Technology Products
  - Customs Duty and VAT Refund on Imported Capital Equipment Used for Production of Products for Exports
  - Government Assistance to Increase Fabric Exports
  - Tax Incentives for Dehydrated Garlic Exports
  - Guangdong Grants Provided for Export Performance
  - Low Interest Loans for Processors of Agricultural Products in Henan Province
- **Subsidies Contingent Upon the Use of Domestic Over Imported Goods**
  - VAT Rebate on Purchases of Domestic Equipment by FIEs
  - Enterprise Income Tax Reduction for Purchase of Domestically-Made Machinery and Equipment
- **Other Programs**
  - Assistance provided to Forest Products
  - Assumption of Interest on Loans for Technology Upgrades

- Assistance for Capacity Expansion in the Soda Ash Industry
- Assistance provided to the Textile Industry
- Chendu Assistance to the Semiconductor Industry
- Reduction in VAT for Sino-Russian Border Trade
- Subsidies listed in Annex 5A of China's Protocol of Accession

In sum, Commerce's policy should be changed. This could be accomplished by Congress amending the countervailing duty law to expressly provide that CVD law applies to non-market economy countries. A number of bills (*e.g.*, H.R. 1216; S. 593) have been introduced in both the House and Senate to make such a change. Alternatively, Commerce has the discretion to change its present policy on its own. Given that Commerce's policy is not required by statute, it is reasonably likely that a discretionary change in policy would be upheld by the courts, as long as Commerce supported the change with reasoned analysis.[3]

E. Exchange Rate Policy

For ten years, China has maintained a fixed exchange rate for its currency of 8.28 RMB to the US dollar. Despite US efforts to persuade China to move toward a flexible, market-based exchange rate and some indications both publicly and at senior levels that it would do so, China's exchange rate has not changed.

Many economists estimate that China's currency is undervalued by as much as 40 percent or more. This means that Chinese goods compete domestically and internationally at prices that are artificially low, hurting US producers in the US market, as well as in the Chinese and third country markets. Moreover, it is argued that China's pegged exchange rate effectively imposes a tax on US exports while at the same time it grants a subsidy to China's exports, a harmful combination that has resulted in the loss of US manufacturing jobs.

A number of attempts have been, or are being, made to address this problem. For example, Senators Schumer and Graham's bill (S. 295) would impose a 27.5% additional duty on Chinese imports unless the President certifies to Congress that China is no longer manipulating its exchange rate and that its currency is at or near its fair market value. In addition, two Section 301 petitions were filed in 2004 with the US Trade Representative seeking US action regarding China's exchange rate policy, but USTR rejected both petitions.

Various bases for a WTO challenge to China's exchange rate policy have been proposed. The primary grounds for challenging China's exchange rate policy are that China's undervalued currency (1) constitutes a prohibited export subsidy within the meaning of GATT Articles VI and XVI, and the WTO Agreements on Agriculture and Subsidies and Countervailing Measures, (2) violates GATT Article XV:4, and (3) violates China's obligations under the International Monetary Fund's Articles of Agreement. However, while these potential grounds have *prima facie* merit, it is unlikely that the current Administration, which rejected similar arguments in the Section 301 petitions, would initiate a WTO challenge on these grounds.

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[3] Recently, the US Government Accountability Office (GAO) addressed the issue of CVD law and China. *See* U.S.-CHINA TRADE: COMMERCE FACES PRACTICAL AND LEGAL CHALLENGES IN APPLYING COUNTERVAILING DUTIES, GAO-05-474 (June 2005). The report concluded that CVD law could be applied to China if Commerce (1) reclassified China as a market economy, (2) treated individual Chinese industries as "market-oriented," (3) reversed its policy of not applying CVD law to NME countries, or (4) Congress authorized application of CVD law to NME countries such as China. The GAO noted that WTO rules do not preclude any of these options. With respect to the third option, however, the GAO noted that, absent congressional authorization, a change in policy could be challenged in court, with uncertain results. The GAO report recommended that Commerce clarify its ability to measure Chinese subsidies and the methodologies it might use. Further, the GAO recommended that, if Congress authorized use of CVD law against China, it should consider enacting legislation specifically implementing China's accession commitment regarding the use of third-country information in CVD actions.

Separately, another potential way to address the exchange rate problem would be to modify US antidumping law and/or countervailing duty law to permit currency manipulation to be treated as a form of dumping or subsidization consistent with the original GATT notes (*i.e.*, *Ad Note* to GATT Article VI:2 and VI:3). This approach is reflected in the recently introduced Ryan-Duncan bill (H.R. 1498).

F. Protection of Intellectual Property Rights

One of the most serious and persistent issues facing US companies vis-à-vis China is how to protect their intellectual property rights (IPR). Notwithstanding that China has modified its IP laws and improved its IP legal regime to comply with the letter of its WTO obligations, China has failed to adequately enforce IP rights. Intellectual property piracy and counterfeiting has been, and continues to be, endemic in China and has caused grave harm to US businesses. The rate of piracy is enormous. It is estimated that, for certain types of products, piracy has reached about 90 percent over the last 15 years. The World Customs Organization has estimated that global counterfeiting amounts to more than $500 billion annually with the majority of that originating in China.[4] USTR's 2004 WTO compliance report estimated that US businesses lost between $2.5 billion and $3.8 billion annually due to piracy of copyrighted materials alone.

At the April 2004 JCCT meeting, IPR issues were made one of the highest priorities in US-China trade relations. At that meeting, China committed that it would undertake a series of actions to significantly reduce IPR infringement throughout the country. In December 2004, as it pledged, China issued a long-awaited judicial interpretation (Judicial Interpretations on Several Issues Regarding Application of Law in Criminal Intellectual Property Rights Cases) that was expected to bolster China's IP criminal enforcement abilities and efforts. To the disappointment of many observers, however, the new interpretation appears to be inadequate as an enforcement tool because, among other things, it maintains violation thresholds which offer loopholes for potential counterfeiters.

In USTR's Special 301 "out-of-cycle" review on China's IPR enforcement efforts, the comments submitted by industry groups and private sector organizations illustrated that IPR violations abound in virtually all industries. China needs to urgently address its many IPR enforcement shortfalls, such as the lack of deterrent penalties, the lack of transparency, insufficient resources for police investigations, and the reluctance of regional governments to enforce IPR.

The US should continue its efforts to highlight the necessity and importance of China improving its IPR enforcement. The US also should work with other WTO Members (*e.g.*, EC, Japan, and others) to provide China with effective training and technical assistance and to coordinate increased pressure on China to make the legal modifications necessary to improve IPR enforcement. Should these efforts not prove effective, the US should then seriously consider bringing the IPR enforcement issue to WTO dispute settlement.

G. Potential WTO Dispute Settlement Cases

As of the end of 2004, China completed three full years as a WTO member. During that period, while China has made impressive efforts to fulfill its WTO commitments, those efforts are far from complete and have not always been satisfactory. So far, only one WTO dispute settlement case has been filed against China – in March 2004, the US filed a case concerning China's discriminatory VAT policies.

After three years, however, the US should give serious consideration to filing dispute settlement cases at the WTO on a number of outstanding issues where China is not fully in compliance with its obligations

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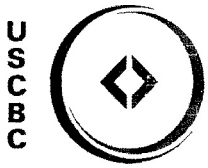
[4] *See* Fakes!, Business Week, February 7, 2005.

and commitments. If used prudently, WTO dispute settlement cases can be a means to induce and encourage China to come into full WTO compliance.

Based on issues of concern identified in USTR's 2004 WTO compliance report, and to the extent they remain unresolved, there are a number of potential areas where China's non-compliance could be considered as potential topics for WTO dispute settlement cases. These potential areas include the following:

- Customs Valuation: US exporters have encountered valuation problems at Chinese ports. These problems include: (1) valuation based on reference pricing instead of transaction value; (2) addition of royalties and license fees to the dutiable value of imported software; (3) non-uniform valuation by ports of particular digital products; and (4) valuation of high-value electronic media to be used to produce multiple copies of products (*e.g.*, DVDs) based on the estimated value of the future copies instead of the value of the carrier medium itself.
- Export Quotas on Fluorspar: China has imposed export restrictions on fluorspar in the form of quotas and license fees on fluorspar exports, but does not restrict domestic users of fluorspar.
- Nondiscrimination: (1) US pharmaceutical manufacturers have experienced national treatment problems regarding price controls on medicines and drug reimbursement. (2) China has discriminated in applying SPS measures. (3) With respect to fertilizer, China has exempted all phosphate fertilizers except DAP (type of fertilizer the US exports to China) from a 13% VAT.
- Consumption Taxes: The effective consumption tax rate on imported products (*e.g.*, spirits/alcoholic beverages, tobacco, cosmetics and skin/hair care preparations, jewelry, fireworks, rubber, motorcycles and automobiles) is substantially higher than the rate applied to domestic products because China uses different tax bases to compute consumption taxes for domestic and imported products.
- Standards Testing: In some sectors, foreign products are tested in specially designated laboratories that are separate from those laboratories used to test domestic products. Such disparate testing can lead to uneven treatment.
- Conformity Assessment Procedures: Despite national treatment commitments, China has accredited 68 Chinese enterprises to test for and certify the CCC mark, but has not accredited any foreign-invested conformity assessment bodies.
- Auto Industrial Policy: China's new auto industrial policy contains discriminatory provisions that discourage the importation of auto parts and encourage the use of domestic technology.
- Sanitary and Phytosanitary: (1) China applies certain non-science-based standards (*e.g.*, zero tolerance for pathogens) to imports of raw poultry and meat that are not applied to similar domestic products. This violates national treatment and has hampered imports of US products. (2) China imposes overly restrictive standards on food additives that block imports of many US processed food products.
- Financial Services – Insurance: China has been issuing concurrent branch approvals (more than one at a time) for Chinese insurers, but only approving branches of foreign firms consecutively (one at a time).
- Express Delivery Services: In July-November 2003, China circulated draft amendments to the postal services law, which (a) gave China Post a monopoly on letters under 500 grams (a horizontal commitment violation as it restricted the existing scope of activities), and (b) failed to establish an independent regulator. At the April 2004 JCCT, China indicated that it would resolve the weight restriction problem, but the July 2004 draft amendment still contained a weight restriction (reduced to 350 grams).



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THE US-CHINA BUSINESS COUNCIL

美 中 贸 易 全 国 委 员 会

TRADE WITH CHINA: OPPORTUNITIES AND CHALLENGES

Submission of the US-China Business Council

Senate Committee on Finance
June 23, 2005

For 60 years, America has championed open markets with the knowledge that ever expanding trade furthers prosperity both at home and abroad. The promise of new markets and the competition brought by international trade has helped make American businesses, entrepreneurs, and workers among the most dynamic, innovative, and efficient in the world.

Trade, however, is not a guarantee. To succeed, American companies and workers must constantly make technological breakthroughs and develop more effective methods of production and sales. This is an enormous challenge, but by perpetually rejuvenating our companies and improving the resourcefulness of our workers, trade makes America stronger.

Recognizing this, American leadership brought China into the international trading system—yielding both far-reaching opportunities and immediate challenges. Much of the discussion in Washington and throughout the country is currently focused on the challenges: inadequate protection of intellectual property rights, China's currency policies, and the bilateral trade deficit. These are all issues that American business and government should work together with China to solve. Every day, the US-China Business Council assists its approximately 250 member companies surmount the barriers to competing in China.

The opportunities, however, far outweigh the challenges in America's trade relationship with China. Therefore, before addressing the challenges, it is helpful to remind ourselves of the many ways in which we are already benefiting from trade with China.

THE REALITIES OF TRADE WITH CHINA

It goes without saying that the United States imports many goods from China. These imports present a competitive challenge to some sectors of our economy and can cause financial pain to some American workers.

But we must not lose sight of the fact that the imports we buy from China also affect our economy in positive ways. Low-cost imports from China help keep the cost of living down and help allow the American economy to grow without experiencing high rates of inflation. The relative absence of inflationary pressures has enabled the Federal Reserve to keep interest rates low—giving American households and small businesses easier access to financing for new

BEIJING USA HEAD OFFICE 1818 N Street, NW Suite 200 Washington, DC 20036
Tel: 202-429-0340 Fax: 202-775-2476 Email: info@uschina.org www.uschina.org SHANGHAI

homes, higher education, and new business loans and investments. These are real gains, and just as we cannot ignore the financial injury imports bring to some, we must acknowledge the benefits imports have for many others.

Moreover, while China is currently presenting new challenges to some manufacturers, it must be pointed out that China is the latest in a long line of rising lower-cost economies that have challenged the American economy over the past few decades. Manufacturing's share of the US economy has fallen from 32 percent in 1960 to 22 percent in 1980 to 14 percent in 2002—indicating that recent job losses in the manufacturing sector are due to longer-term trends and not simply China's entry into the world economy over the past few years. Policies designed to make American manufacturers more competitive in the face of this challenge are important and must be pursued. However, restrictions on trade with China will not create more manufacturing jobs.

Less well known is how much American companies export to China. In 2004, China passed Germany to become America's fifth-largest export market. If our exports to Hong Kong are included (reflecting the fact that most of our exports to Hong Kong end up in the mainland), China passed the United Kingdom to become our fourth-largest export market last year—and will likely pass Japan to become our third-largest market by the end of this year. In fact, America's three largest export markets at the end of 2005 will likely be Canada and Mexico—our two geographically closest trading partners, with whom we have a free trade agreement—and then China (See Figure 1).

Our exports to China have, in recent years, grown considerably faster than exports to any other major market. Over the past five years, American exports to China have grown 114 percent. The second fastest growing major market for US exports was Belgium, at 21 percent. Our exports to Canada have grown just 6 percent during that time and our exports to Mexico and Japan have declined 1 percent and 17 percent respectively (See Figure 2).

China is of particular importance to America's farmers. China accounted for 35 percent of American soybean exports and 30 percent of cotton exports in 2004, making it the largest market for American exports of those products. Last year, China was the second-largest overseas market for American wheat.

Exports like these mean jobs. As we contemplate what steps may be in order to ensure that American companies are able to take advantage of the opportunities presented by China's market reforms and to guarantee that China's government fully implements its trading commitments, we must remember that the stakes are high. We cannot afford to take ill-considered actions that would mean the loss of many export-dependent jobs.

THE NATURE OF TRADE WITH CHINA

Our trade deficit with China must be understood in its proper context as part of global trade and investment patterns. Critics of trade with China often refer to the fact that one quarter of our 2004 trade deficit was with China. This is true, but the story does not end with one number. Trade with China is but one part of America's large global trade deficit. Furthermore, much of

the growth in our trade deficit with China is the result of a massive economic reorganization underway in East Asia, where economies that have been developed as export platforms focused primarily on the US market are transforming into an integrated Asian economy centered on China.

Between 1994 and 2004, according to official US trade data, our trade deficit with China grew by $130 billion; our deficit with the rest of the world increased by $370 billion—nearly three times as much. Only $60 billion of the increase was from members of the Organization of Petroleum Exporting Countries, so oil prices are not major cause of this trade deficit growth. Our trade deficit with the richest 15 countries of the European Union jumped by more than $90 billion, from just over $11 billion in 1994 to approximately $105 billion in 2004. Our combined trade deficit with Canada and Mexico grew by $100 billion, from $13 billion in 1994 to $113 billion in 2004. Chinese trade policies cannot explain these large, across-the-board imbalances. Rather, something fundamental about the way the United States interacts with a changing global economy is responsible.

Moreover, recent increases in imports from China are, to a significant extent, the result of Asian economic integration. In 2004, which was typical of previous years, approximately $50 billion of the $60 billion of foreign direct investment going into China came from other Asian economies, according to research commissioned by the China Business Forum. This investment represents a shift in productive capacity to China from Asian economies that have long had trade surpluses with the United States. Trade patterns have mirrored investment flows: Most major East Asian economies have seen their exports to China grow substantially faster than their exports to the United States, as they export production inputs to China for final assembly and re-export to America. Indicative of this shift, as China's share of the US trade deficit increased over the past decade from 19 percent to 25 percent, the combined share of other East Asian economies plummeted from 63 percent to 21 percent (See Figure 3). What we once bought from various Asian countries, we now buy from China.

Increases in imports from China, much of which are the result of this Asian economic integration, therefore are not the only, or even principal, cause of recent growth in the global US trade deficit. Rather, growth in the US trade deficit appears to be across the board, with most of the deficit increase in the past 10 years coming from our non-Asian partners.

IMPLEMENTATION OF CHINA'S WTO COMMITMENTS

China's World Trade Organization (WTO) entry agreement was good for the United States. We gave up nothing, as China by and large already enjoyed full access to our market; in contrast, China agreed to take meaningful market-opening measures that benefit American companies. Since China's WTO entry in December 2001, its average tariff rate dropped from 15.3 percent to 9.4 percent; tariffs on information technology imports were reduced to zero; nearly all import quotas and licenses have been eliminated; and restrictions on foreign banks, insurance companies, freight and courier services, packaging, and distribution and trading services have been eliminated or reduced. These are just some of the many ways in which China has opened its markets to American businesses.

The steps China has taken to implement its WTO commitments have led to real results for US companies selling to China. Our exports to China since its WTO entry three years ago are up 81 percent, versus 34 percent growth in the three years prior to China's entry. As American firms have more time to realize these benefits, and as China is required to implement more commitments, we expect US exports of goods and services to continue to grow.

Nevertheless, it is imperative that the US government and business community continue to work toward China's complete implementation of WTO rules. China's progress in market openings, while satisfactory in many sectors, has been inadequate in a number of areas. These shortcomings have created impediments to US companies seeking to export to or do business in China. As we press China for full implementation of its WTO commitments, the goal of our engagement must be complete access for US companies to the Chinese market and the elimination of Chinese trade policies that are incompatible with WTO rules. In short, we must work to ensure a level playing field.

We are encouraged that Secretary of Commerce Carlos Gutierrez, US Trade Representative Rob Portman, and Chinese Vice Premier Wu Yi are set to discuss many of the key issues that challenge American companies at the Joint Commission on Commerce and Trade meeting on July 11. We are confident that frank discussions, combined with the robust enforcement of our existing trade laws and a willingness to challenge unacceptable practices in the WTO when necessary, will yield results in many of the areas that strain our trading relationship with China.

China's protection of intellectual property rights (IPR) is a major concern for American companies. American companies lose sales not only in China to competitors who sell pirated goods, but also in third countries to exports of those counterfeited products around the globe. China has made some progress in increasing criminal liabilities for those who are found to be producing pirated goods, but much remains to be done to enforce those rules and to bring China into line with international IPR standards. Although IPR problems cannot be solved overnight, China can take a number of steps to accelerate progress in combating piracy. These include:

- Significantly increasing the resources devoted to enforcement activities;
- Criminalizing the export of pirated products and establishing targets for a meaningful reduction in counterfeit exports;
- Increasing the number of criminal cases and demonstrating the results to deter counterfeiters;
- Increasing administrative penalties for counterfeiting;
- Bringing China's copyright protections into compliance with the WTO Agreement on Trade-Related Aspects of IPR;
- Favorably resolving a number of high profile IPR cases involving American companies to signal publicly China's commitment to IPR protection; and
- Adding a substantial number of American brands to the list of well-known trademarks, which are granted greater protections.

We need to work with China to establish a better "roadmap" that will bring clarity and transparency to measuring progress in IPR protection and to make this a joint issue of

importance. After all, protection of IPR is in China's own interest to ensure it develops innovative capabilities and can sustain long-term economic growth.

American companies exporting to and operating in China also need China to implement fully its obligation to grant foreign firms distribution rights. These rights are critical for American companies that want to make their products available to Chinese customers. Currently, American firms applying for distribution rights face a confusing and time-consuming process. Many companies find their applications stalled at one of the many levels of required government approval. These delays have a tangible and negative effect on American exports to China. China needs to clarify remaining questions holding up approvals and clear the backlog of applications.

Certain non-tariff barriers to trade also diminish American exports to China. Most notable are:

- Discriminatory technical, safety, and agricultural standards that effectively give Chinese firms an unfair advantage;
- Delays in issuing rules governing direct selling that would allow American firms to participate fully in this segment of the market;
- Proposed government procurement regulations for software—and in the future perhaps other products—that could severely limit the ability of American firms to sell to China's government—by far the largest buyer of legitimate software in China; and
- Extremely low limits on the numbers of foreign films and other media products allowed to enter China.

In each of these areas, China's policies run counter to either the letter or the spirit of its WTO obligations. Furthermore, these barriers affect sectors that are central to America's competitive strengths. The US government must engage China and insist that it adopt nondiscriminatory standards in a transparent manner, abandon or substantially alter the flawed software procurement rules, enact direct selling rules that reflect internationally accepted norms, and significantly boost the number of foreign films allowed into the country.

THE NEED FOR FINANCIAL REFORMS

On perhaps the most fundamental level, China should be urged to move forward in adopting far-reaching financial and capital market reforms. The current system for capital allocation in China provides some Chinese producers with a systemic unfair advantage. Reforms to ensure that banks are responsible for their balance sheets and that loans are given to firms based on business criteria will help make the Chinese economy more accountable to market pressures. The United States should remind China that the US standard for granting market economy status—a top trade concern for China's government—requires China to undertake major banking, financial service, currency, and other capital market reforms. As in so many other instances, these reforms are in China's own interest.

We look forward to the continued opening of China's financial services sector and the removal of remaining restrictions on American banks operating in China by December 2006. The ability of American financial service providers to compete for the business of private Chinese firms and

individuals will do much to bring about a more efficient, transparent, and fair allocation of capital. We encourage the Chinese government not to waver in its WTO implementation efforts and call on the US government to ensure that America's financial firms receive the access to China's market they are due.

SCHUMER-GRAHAM CURRENCY LEGISLATION

One issue that looms large over today's hearing is legislation to impose tariffs of 27.5 percent on all imports from China unless Beijing revalues its currency by a similar amount.

We share the legislation's goal of China's adoption of a market-determined exchange rate. Most observers understand that a fully convertible, truly market-determined exchange rate cannot be implemented until China adopts further financial reforms, but that interim steps to introduce a more flexible exchange rate are both appropriate and necessary. We support the extensive efforts of the Treasury Department, other executive branch agencies, Congress, and our G7 partners to impress upon China the importance of implementing a more flexible exchange rate policy. Chinese officials themselves have acknowledged that a market-determined exchange rate is in China's best interests. Tariffs and threats of tariffs, however, will not bring us closer to the goal of China's movement toward a flexible exchange rate. In addition, if adopted, the tariffs would not bring manufacturing jobs back to the United States. Instead, they would serve as a tax on American consumers and could increase our trade deficit. We find little to support in that formula.

Although political and popular opinion appears convinced that China's currency is significantly undervalued, economists remain divided on the true value of the yuan. Some economists say it is not undervalued at all. These academic disagreements highlight a fundamental point: only the market can tell us the true value of China's currency.

Regardless of whether a revaluation of almost 30 percent would lead to a significant reduction in the US trade deficit—something which many economists doubt—tariffs of the same amount would certainly not reduce US imports by much, if at all. Should we impose these tariffs, Americans would buy from other Asian and Latin American countries what we buy today from China. The costs of production in these countries are somewhat higher than in China but still much lower than in the United States. Our trade deficit would therefore remain high or even increase, since our imports would be slightly more expensive. At the same time, our significant exports to China would be threatened by retaliatory tariffs, which China would certainly levy against our products in response to the enactment of this bill.

Furthermore, the threat of tariffs is not likely to make China's leaders more inclined to take an interim step toward a market-determined exchange rate. Timetables, such as that included in S. 295, make a meaningful interim step toward exchange rate flexibility all the more difficult—and therefore unlikely—for China to take. Destabilizing "hot money" inflows to China, which are already substantial, would further increase if speculators believed that China would revalue its exchange rate within an established period of time. The capital losses that would result from an

exchange rate change under these circumstances could lead China to resist further reforms to its exchange rate system.

Also, we cannot levy discriminatory tariffs in blatant violation of central WTO principles as we simultaneously press China to embrace the rules of the world trading system. Our ability to entice China to move forward with market reforms would be lost entirely, and our credibility in driving the Doha agenda of multilateral trade liberalization would be undermined dramatically. We will be much more likely to achieve the outcomes we desire if we work within the rules of global trade.

CONCLUSION

In conclusion, the US-China Business Council is very much aware that the benefits and costs of international trade do not affect all Americans evenly. We recognize that some sectors of our economy struggle with the challenges brought by trade with China and the rest of the world. We must remember, however, that our large global trade deficit is not caused solely or, perhaps, even primarily by Chinese policies.

In addition, the benefits of trade, in the form of substantial exports, a lower cost of living, and less inflation, are large and clearly outweigh the challenges. Business and government should work to guarantee that all Americans have the opportunity to enjoy these benefits. Part of this work requires us to press China to abide by its international trade agreements and to enforce our trade remedy laws to ensure a level playing field. Jeopardizing the US economy by imposing tariffs is not an acceptable way to inform China that it must change some of its polices. Rather, we should focus on policies, such as reducing our large fiscal deficit and enhancing the competitiveness of our economy, to correct a trade deficit that has grown remarkably with all regions—not just with China

Figure 1

US Top 15 Export Markets In 2004 ($ billions)

China & Hong Kong Listed Separately

- Canada $187.7
- Mexico $110.8
- Japan $54.4
- United Kingdom $36.0
- **China $34.7**
- Germany $31.4
- Korea $26.3
- Netherlands $24.3
- Taiwan $21.7
- France $21.2
- Singapore $19.6
- Belgium $16.9
- Hong Kong $15.8
- Australia $14.2
- Brazil $13.9

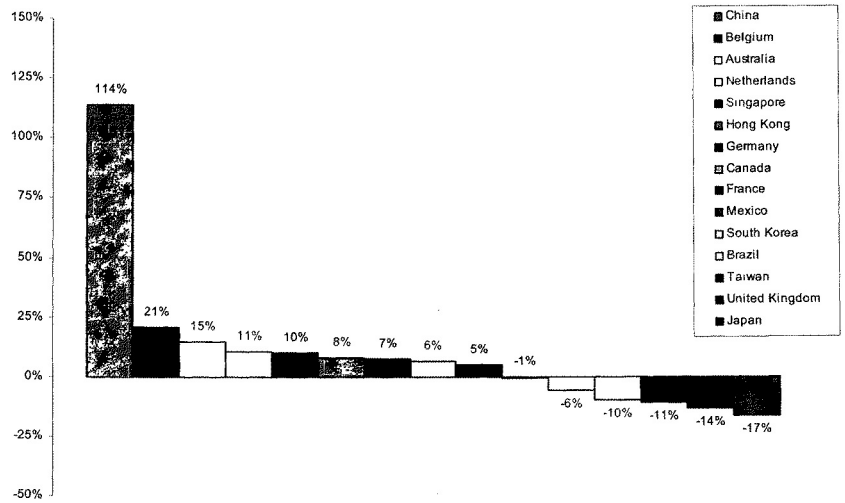
China & Hong Kong Combined

- Canada $187.7
- Mexico $110.8
- Japan $54.4
- **China & Hong Kong $50.5**
- United Kingdom $36.0
- Germany $31.4
- Korea $26.3
- Netherlands $24.3
- Taiwan $21.7
- France $21.2
- Singapore $19.6
- Belgium $16.9
- Australia $14.2
- Brazil $13.9

Source: US Dept of Commerce, US Dept of Treasury, US ITC

Figure 2

Growth in US Exports to Our Top 15 Markets*, 2000 - 2004

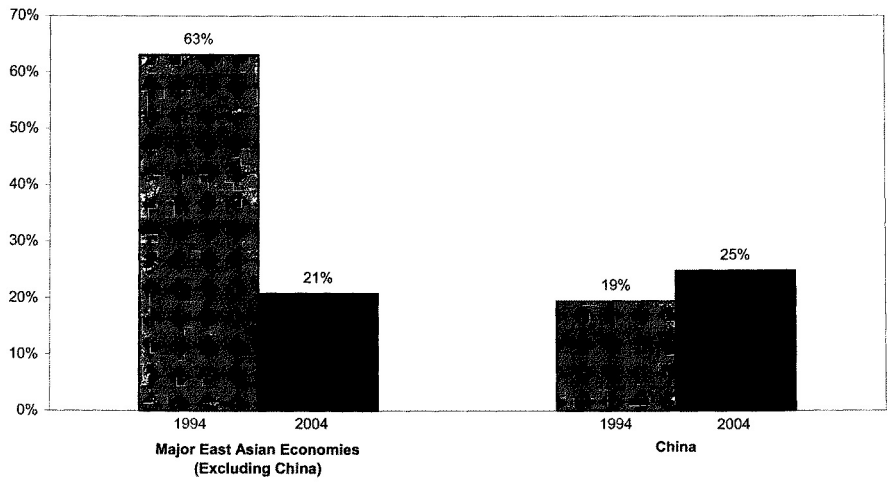


** Based on value of exports*

Source: US Dept of Commerce, US Dept of Treasury, US ITC

Figure 3

Asia's and China's Share of US Trade Deficit



Source: US Dept of Commerce, US Dept of Treasury, US ITC

AN INTRODUCTION TO THE US-CHINA BUSINESS COUNCIL

The United States-China Business Council, Inc. is a private, non-profit, non-partisan, member-supported organization. It is the principal organization of US corporations engaged in business relations with the People's Republic of China. Founded in 1973 as the National Council for US-China Trade, the Council originally served the early efforts of United States business in China in the absence of formal diplomatic relations between the two nations. With the massive growth of US-China economic engagement since the end of the 1970s, the Council has continued to assist firms entering the field for the first time, but increasingly the bulk of its work has served the interests and needs of US firms with well-established commercial relationships in China. Headquartered in Washington, DC, the Council also serves its corporate members from field offices in Beijing and Shanghai.

The Council provides extensive, tailored Business Advisory Services on a wide range of business interests and concerns to individual member companies. Its meetings and programs, in the United States, China and Hong Kong, provide both broad-gauge and highly business-relevant information, and offer companies the chance to share ideas and experiences as well.

The Council continues to play a central role in analysis and advocacy of key policy issues of significance not only to US businesses but also to the future of US-China relations. The Council's activities in support of government policies conducive to expanded US-China commercial and economic ties include educational meetings with Members of Congress and Congressional staff, and frequent testimony on behalf of the US business community in Congressional or other venues. The Council also works to enhance media and public understanding of complex issues in US-China relations, appearing frequently on major broadcasts and providing accurate statistical and analytical information to media representatives.

The Council's numerous publications include the leading US periodical on China trade, *The China Business Review*, the members' weekly electronic newsletter, *China Market Intelligence*, and numerous focused studies on topics of current business interest.

The Council serves as a valued and economical complement to the intensive in-house efforts that US companies devote to business development in China. Council membership in 2005 currently stands at approximately 250 firms, and continues to strengthen in response both to China's economic growth and to the many challenges and complexities US firms face in the Chinese environment. Among the Council's members are many of the largest and best known US corporations, but smaller companies and service firms make up a substantial portion of the overall membership as well.

The Council is governed by a Board of Directors composed of distinguished corporate leaders. The Council's current chairman is Michael L. Eskew, Chairman and Chief Executive Officer of UPS. Since November 1, 2004, the Council's president has been John Frisbie.

The US-China Business Council has long served as a respected host for senior visitors from China and from the United States government. In recent years, the Council has been honored to receive His Excellency President Hu Jintao; Premier Wen Jiabao; former President Jiang Zemin; former Premier Zhu Rongji; and other distinguished Chinese guests from central and provincial government entities. Recent American public figures to meet with Council members have included Commerce Secretary Carlos M. Gutierrez; former US Trade Representative Robert B. Zoellick; former US Ambassador to China Clark "Sandy" Randt; key figures from the United States Congress; and numerous specialists on US-China affairs from various agencies of the Executive Branch of government.

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USA HEAD OFFICE 1818 N Street, NW Suite 200 Washington, DC 20036
BEIJING Tel: 202-429-0340 Fax: 202-775-2476 Email: info@uschina.org **www**.uschina.org **SHANGHAI**