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China's Role in the Origins of and Response to the Global Recession

I would like to thank the Commission for inviting me to speak today on the origins of the current financial and economic crisis and the role that China has played. I am particularly pleased to be included on a panel with such distinctive and knowledgeable scholars on China's financial institutions. For my part, I come here from a very different background of trade and have observed the emergence of the current crisis through observations on a somewhat different set of statistics, mostly trade..

I read with interest the plethora of dignitaries proclaiming in Davos that the United States was, without doubt, the cause of the current financial crisis. Clearly, the United States has played a major role in the evolving financial crisis but I think there is a broader explanation of the causes of the current crisis, an explanation that recognizes the global nature of our economies and the critical linkages that exist. This explanation also looks at the economic dislocations in a much longer time frame which in my view indicates that systemic and secular factors must be addressed if long-term stable growth is to be achieved.

During the time that I served as Assistant USTR for Asia and Pacific beginning in 1992 and later as Assistant USTR for China, I observed a number of trends in Asian trade and currency alignments. In 1994, China unified its exchange rate and depreciated the currency by about 50% against the U.S dollar and, with only a slight modification, maintained that peg until 2005. In doing so, China instituted instability within the foreign exchange markets, particularly in Asia. We on the trade side noted that trading relationships with the rest of Asia improved while at the same time noting our deteriorating trade relationship with China. During this period, jobs moved from other parts of Asia to China as China became the manufacturing and assembly hub of Asia.

The economic and financial dislocations from China's depreciation of the Yuan was one of the major contributing factors in the Asian Financial Crisis. That crisis resulted in Asian economies depreciating their currencies so that they were aligned with the Renmenbi and, as a result of the peg, with the U.S. dollar. Following the Asian Financial Crisis, the Asian economies had a stronger link to the United States via their exchange rates, nearly all essentially linked or pegged to the U.S. dollar. The surplus savings of Asia were now available to be tapped by the U.S. capital markets.

Two significant developments set the stage for the evolving drama that has turned into a tragedy. First, China acceded to the WTO making unilateral concessions to other WTO members by

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opening markets and eliminating market regulations that restricted trade. The China accession to the WTO further enhanced the linkages between China and the rest of Asia, solidifying the China hub at the center of Asia. Second, the United States legislated major tax cuts that reversed the emerging government surplus into a deficit thus requiring the United States to import savings from abroad to finance those deficits. The War in Iraq further exacerbated the government deficit which required that more savings from China needed to be imported to finance government institutions. Without those savings, the United States would have had to have higher interest rates in order to finance those deficits, thus crowding out the private sector access to capital. In short, China and parts of Asia provided the necessary savings to finance the U.S. government and as well as the expansion of the U.S. capital market.

The extent of the savings gaps can be seen in both in China's current account and in its accumulation of foreign exchange reserves. Figure 1 shows China's current account surplus and figure 2 shows China's foreign exchange reserves. Both show dramatic increases since 2001 when China acceded to the WTO. In the case of China's foreign exchange reserves, China has purchased government securities mostly in the form of U.S. dollar denominated securities. Consequently, in the current financial crisis, the value of China's reserves have not depreciated although the return on those assets has decreased. The increase in China's current account balance and in foreign exchange reserves is directly attributed to China undervalued currency. At almost \$2 trillion, China has more foreign exchange reserves than any other country, eclipsing even Japan.

While the undervalued exchange rate creates problems in the trading sector, the real policy problem is that China manipulates its exchange rate. China manipulation to maintain an undervalued currency is effectively a policy to subsidize its exports, subsidize foreign direct investment, and to tax China's imports. An undervalued exchange rate is the cornerstone of its export led growth strategy. Beginning in July 2005, China appreciated the Yuan and instituted an exchange rate mechanism based on a basket of currencies. The exact composition of the basket is still unknown. Even then, China only allowed the exchange rate to appreciate modestly over time. Figure 3 shows the increasing bilateral deficit with China and figures 4 and 5 show how China's exchange rate has appreciated in nominal terms since 2005 and in real terms since 2000.

Because of the negative impact the currency has on the current account, it is no wonder that critics challenge U.S. trade policy, specifically China's accession to the WTO. When China joined the WTO in 2001, it made unilateral concessions to open its markets by reducing and, in some cases, eliminating its tariffs and its non-tariff barriers and to bring its domestic laws into conformity with WTO rules. Expectations were raised that these unilateral concessions might reduce the bilateral trade deficit with China or, if not, at least significantly reduce the growth rate of the deficit. U.S. exports to China increased faster than to any other country. However, they increased faster to China because they increased from a very low rate. Out exports to the EU rose by 70% more in absolute terms and to Canada by 40% and neither of those countries made any concessions to the United States.

The problem for China, as for many other countries, is that the need to create jobs has forced them to adopt export led growth strategies based on an undervalued currency. While these

policies can have dramatic and positive effects over fairly long periods of time, eventually the policies fail. China has to create millions of jobs every year in order to absorb new labor entering the jobs market in China. The export led growth strategy was effective in increasing employment but now the financial crisis is having an adverse economic impact on China's employment, as it is around the globe.

The undervalued currency is still serving China well since those reserves have not decreased but probably have increased, although at a lower rate. While China's exports have decline, so too have imports so that China's foreign exchange reserves are still increasing. The current financial crisis probably has resulted in less foreign exchange reserves flowing into China via the capital account.

What China Needs to Do

The economic and financial crisis presents a set of unprecedented opportunities to initiate programs that otherwise policy makers would avoid. Obviously, current policies in China have contributed to the current financial crisis and steps need to be taken to reverse the effects of those policies. In particular, the current crisis presents an opportunity for China to play a global economic leadership role by restructuring its development programs in ways that will generate greater growth of its domestic economy as well as the global economy.

First, China needs to continue and even accelerate the rate of appreciation of its currency. The undervalued currency is the cornerstone of its export led growth strategy and it simply exports its savings to the United States rather than using those funds for domestic investment. If China is unprepared to make those steps, then the United States and other countries should consider initiating, in a progressive manner, stronger actions against China's beggar-thy-neighbor policies.

Critics argue that any serious action by the United States on China's manipulated currency would jeopardize China's holding of U.S. financial assets. First, China has already been broadening the composition of its foreign exchange reserves so that would not be a new development only a newer trend. Second, China has already been appreciating its currency although at an anemic rate. Thus appreciation of its currency is not the issue only, once again, the rate of appreciation. Third, critics argue that assertive action by the United States would anger China forcing them to see U.S. dollar denominated assets faster. However, such action would only serve to depreciate the dollar further and, due to the informal peg, depreciate the Yuan further thus increasing its foreign exchange reserves.

Second, China needs to dismantle the internal obstacles to trade within China -- China needs to open China to China. The marketplace is riddled with barriers. The combination of provincial restrictions in the form of tolls, shakedowns, out right prohibitions on using the roads, labor problems in loading and unloading freight and the lack of an adequate road/rail infrastructure make it difficult for Chinese and foreign companies to establish an efficient nationwide distribution system. According to some estimates, these barriers can add about 16 percent to the cost of the product compared to roughly four percent in developed countries. China has made some progress in this area since it acceded to the WTO but China's recovery program offers an

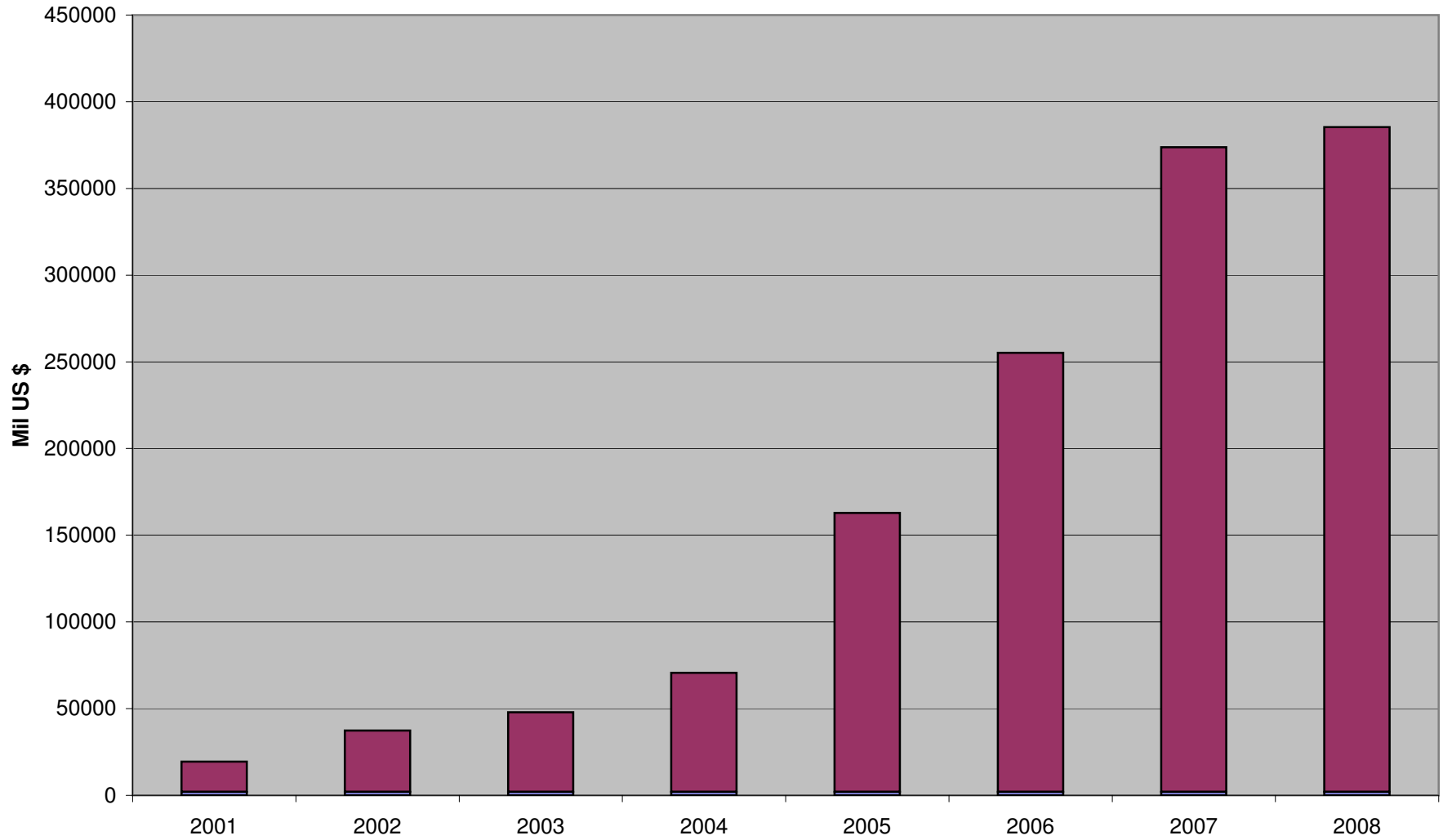
excellent opportunity to address some of the more costly infrastructure impediments. A more open China will develop geographically isolated parts of China to economic growth thus expanding the Chinese domestic economy.

For the United States, we are already seeing that of all the sectors that have performed the best during this recessionary period, the export sector has been the strongest. Stable long-term economic growth will require that the export sector lead the way and to do that other countries will have to adopt policies that will create the conditions for more stable growth. A continuation of the current beggar-thy-neighbor policies where currency undervaluation is the key component of export led growth will only contribute to further instability in financial and commercial markets.

Conclusion

Since the mid 1990s, government officials have proclaimed that China's growing trade surplus with the United States was unsustainable. Nevertheless, the deficit continued to more than double every five years as China transferred its vast savings to the United States via the pegged exchange rate. The current crisis demonstrates that the current account imbalances were indeed unsustainable. And while the United States on track to set its house in order, the stability of the global system requires that other countries similarly use this opportunity to alter their economic policies.

**Figure 1: China's Current Account Balance's
(2008 ESTIMATED)**



Year	Mil US \$
2001	212165
2002	289407
2003	403251
2004	609932
2005	818872
2006	1066344
2007	1528249
2008	1946030

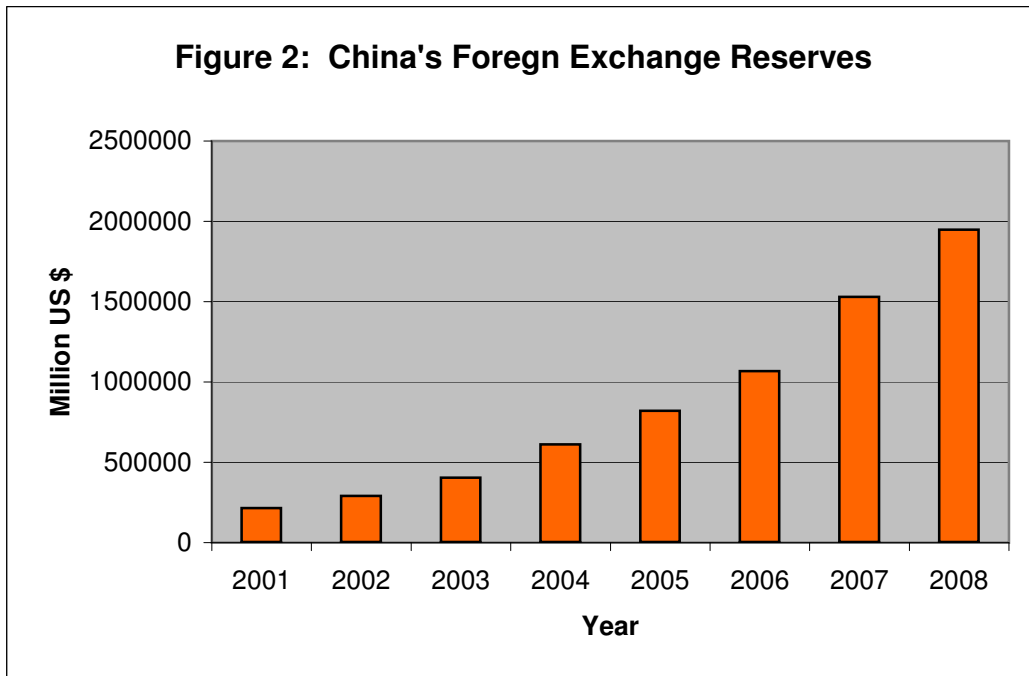


Figure 3: U.S. Trade Deficit (In Goods) with China
Annual 1986-2008

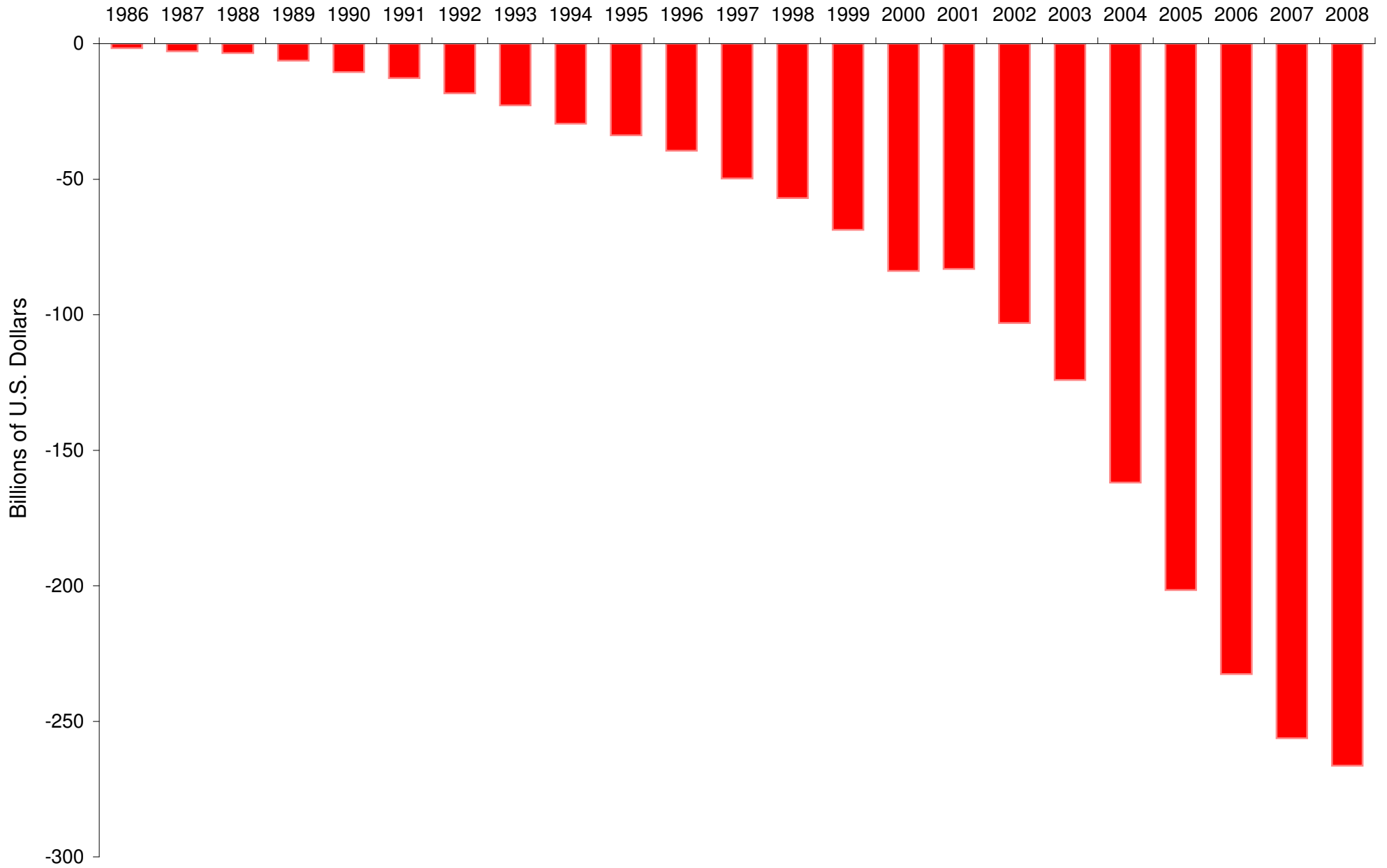
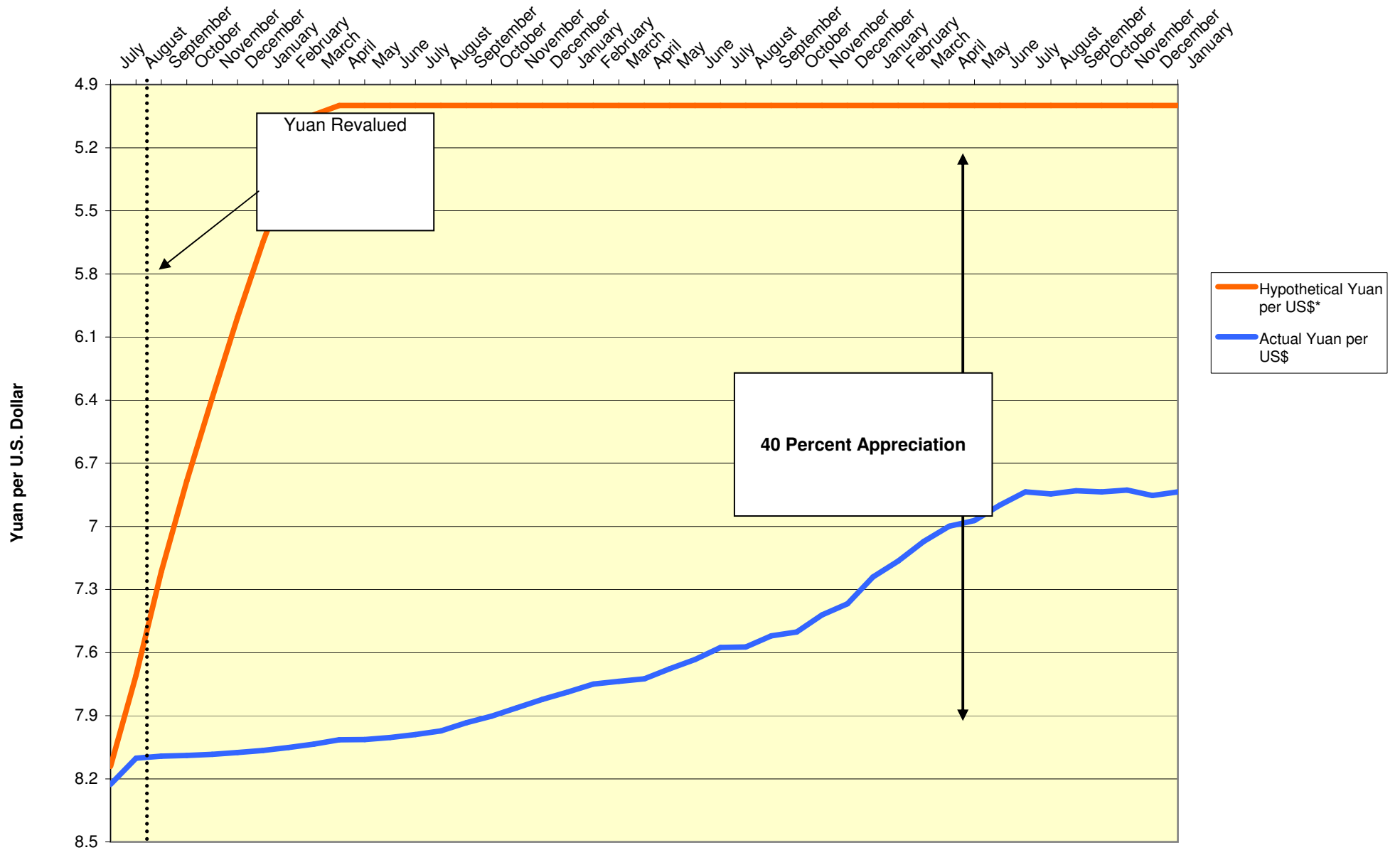


Figure 4: U.S. Dollar Exchange Rate for the Yuan
 Monthly, July 2005 - January 2009



* Hypothetical value of the Yuan derived by assuming full 0.3% maximum daily appreciation against the US\$, as announced by the People's Bank of China on July 21, 2005.