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# Written Statement to the U.S. – China Commission
# February 3, 2005

I would like to thank the U.S.-China Economic and Security Review Commission for its invitation to participate in its public hearing on February 4, 2005. It is with regret that I am unable to attend due to previous travel commitments. However, I would like to take this opportunity to submit a statement to the Commission for its consideration.

China's rapid economic growth and increasing integration into the world trading system and international financial system is a real opportunity for the United States and the world. China's growth has been an important source of support for global economic growth. Indeed, over the past 3 years, the United States and China together have accounted for half of world growth.

China's economy has changed tremendously since its decision 25 years ago to shift towards market-oriented economic reforms. At that time China was almost autarkic, with very little trade with the outside world and essentially no foreign investment. Since that shift in policies, China's economy has grown by an average of 9.5 percent per year. China's trade has grown much faster, and now represents over 70% of China's total GDP. China is now the third-largest trading economy, after the United States and Germany.

Opening up the Chinese economy to international trade and foreign investment was a critical factor in helping China achieve faster rates of growth. Chinese exports have grown rapidly, but so have their imports – both for investments in domestic infrastructure and to provide goods demanded by a population with rising incomes. Accession to the WTO was an important step for China's reformers, both to assure access to foreign markets, but also to assure continued market-oriented reforms domestically.

China's integration into the world trading system and membership in the WTO also carries responsibilities. China's WTO accession three years ago marked a commitment to liberalize trade and to abide by the rules of the international trading system. The Administration has been firm on its insistence that China live up to those commitments.

The Administration strongly believes that the world economy and international trading system work best with free trade, with the free flow of capital and with currency values set in open, competitive markets. The G7 group of major industrial nations have also consistently emphasized in their communiqués that flexibility in exchange rates is desirable for major countries to promote smooth and widespread adjustments in the international financial system.

China's fixed exchange rate regime may have been appropriate at an earlier stage of its development, and China's willingness to withstand large downward pressures during the Asian crisis in the late 1990's did help maintain international financial stability. But now that China has a much larger economy, its engagement in international trade has increased enormously, cross-border capital flows are increasing, and structural changes have greatly expanded the role of the market, a fixed exchange rate system is no longer appropriate and China should move towards a more flexible exchange regime now. Greater exchange rate flexibility would allow faster transmission of international price signals and better adjustment to global imbalances.

Treasury has emphasized that exchange rate flexibility is also firmly in China's interest. Flexibility avoids the buildup of imbalances and the emergence of one-way bets that have made fixed exchange rate systems problematic in so many countries. Greater exchange rate flexibility also greatly enhances the independence and effectiveness of monetary policy. Treasury has stressed that a market-based, flexible exchange rate would allow China greater scope to use monetary policy to reduce the risks of repeating economic cycles of booms and busts; to enjoy the benefits, while mitigating the risks, of a more open capital account; and to improve the allocation of resources and the quality of financial intermediation in the Chinese economy. The U.S. has argued that it is better to undertake an orderly exit from the peg as soon as possible rather than face a disorderly abandonment of the peg (in either direction), which could have potentially disruptive consequences for both China's real economy and the international economy.

China's leadership has clearly stated that they intend to move to a flexible market-based exchange rate. Following the U.S.-China Joint Economic Committee (JEC) meetings hosted by Treasury in September 2004, China "reaffirmed its commitment to further advance reform and to push ahead firmly and steadily to a market-based flexible exchange rate." Chinese Premier Wen has stated publicly that China will gradually make the exchange rate more flexible. China's central bank governor stated that China will quicken the development of its foreign exchange market, and push ahead with reform of the exchange rate regime. Chinese central bank governor Zhou also said recently that "rigid exchange rates amid imbalances in international revenues and expenditures present huge risks."

To bring about a flexible exchange rate regime in China, the Bush Administration adopted a financial diplomacy strategy that features candid senior-level discussions, multilateral support from other countries, and technical engagement to identify and overcome Chinese obstacles to a flexible currency.

Dialogue at the most senior levels has entailed frequent and substantive representations and consultations on exchange rate and financial markets issues. The JEC, held in Washington last September, in which Secretary Snow, Chairman Greenspan, and the Chinese finance minister and central bank governor participated, covered a broad range of economic policy, financial sector and capital markets issues with exchange rates as the central focus. Following several meetings late last year during the G-20 and G-7 forums, Secretary Snow will discuss China's economy and exchange rate with Finance Minister Jin and Governor Zhou this week when the G-7 Ministers meet in London. These are only a small part of the discussions that have taken place between senior officials of our two countries. These discussions are an extremely effective channel for identifying ways

Treasury can help China's financial and monetary leaders on the path to a flexible currency regime.

The United States is actively assisting China to address the impediments to greater exchange rate flexibility that China perceives. In collaboration with China's central bank governor, Secretary Snow launched a technical cooperation program that led to three constructive sessions in 2004 that focused on the mechanics of a flexible currency regime. In February, sessions in Beijing dealt with assessing and supervising currency risk in banking systems and developing financial instruments to manage that risk. In June, Treasury provided extensive training in Beijing on banking supervision, credit analysis, international accounting standards, and resolution of non-performing loans. In September, Chinese officials came to Washington to discuss foreign reserve management and supervision and regulation of a currency futures market. The technical cooperation program will continue this year with focus on more practical aspects of exchange rate flexibility.

Treasury has also mobilized our trading partners in a multilateral effort to encourage China to move to a flexible exchange rate. This effort includes the G-7 and the G-20, as well as the Asia-Pacific Economic Cooperation (APEC) forum. These multilateral meetings have achieved a broad consensus on calling for flexible exchange rate regimes in large economies like China's.

The Chinese authorities are taking steps to bring about a move towards a flexible exchange rate. China has reduced barriers to capital flows to deepen markets involving foreign currency transactions. China is committed to bank reform and is working to strengthen domestic banks, bank supervision and regulatory structures, and to prepare these institutions for exchange rate flexibility. Late last year, China's central bank eliminated a ceiling on bank lending rates, which will give greater scope to pricing credit risks. In addition, China's banking regulator will focus this year on banks' capital adequacy ratios, the accuracy of non-performing loan classifications, and whether banks have sufficient provision coverage. China is also making progress in developing financial products and systems to support foreign exchange trading and hedging of currency risk. In this effort, twenty-four foreign banks and financial institutions have received approval to conduct foreign exchange derivatives business. China is also working to provide domestic and foreign banks with an on-shore foreign exchange trading platform for non-renminbi currency pairs. These systems and financial products will allow China's domestic banks and regulators to gain more experience with international foreign exchange trading, risk management techniques, and oversight of these markets and instruments.

The Administration will continue to pursue diligently the financial diplomacy strategy outlined above. Treasury will continue to engage with China on exchange rate policy, banking sector reform, capital market development, and further opening of financial services in China. We firmly believe that this approach, working in cooperation with the Chinese to bring about exchange rate flexibility as soon as possible, is the most effective way to achieve our common goal.