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Before the House Committee on Ways and Means

Hearing on United States-China Economic Relations and China's Role in the Global Economy

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Mr. Chairman and Members of the Committee --

The U.S.-China Economic and Security Review Commission commends the Committee for holding this important hearing and appreciates the opportunity to apprise the Committee of its work in this area. The creation of the Commission itself demonstrates Congress' growing focus on U.S.-China economic relations and the implications of this relationship for U.S. economic and national security interests.

In America, people in varying capacities – business, labor, academia, the media and government – need to better understand the almost tectonic forces now shaping the U.S.-China economic relationship. With increasing sophistication, China has become a manufacturing powerhouse. Its central and local government policies have supported development of key industrial sectors. In the 1990's, China became embedded in what has become a global supply chain for many traded products and saw its share of global trade in manufactured goods triple.

In the meantime, there is increasing unease in the U.S. over the declining share of manufacturing output and employment in our overall economy. And this is happening while China's currency – the yuan – remains pegged to the U.S. dollar at a rate set by government fiat nine years ago. What are the causes and effects here? What are the key linkages? Are there steps the U.S. should be pursuing to remedy these challenging and, in some cases, debilitating circumstances?

Our Commission is mandated by Congress to examine, among other areas, China's economic policies and the United States' trade and investment relationship with China, including assessing the qualitative and quantitative nature of the shift of United States production activities to China. This latter charge includes examining the relocation of high-technology, manufacturing and R&D facilities to China and the effect of these transfers on United States economic security, employment and the standard of living of the American people.

To facilitate its examination of these vitally important questions, the Commission held a full-day hearing on September 25, 2003, entitled: " China's Industrial, Investment and Exchange Rate Policies: Impact on the United States." Our hearing was designed to investigate the impact of China's rapid industrial growth on the U.S. economy, particularly on the U.S. manufacturing sector. We invited academic experts and representatives of business, industry and labor to provide us their perspectives on these issues. We examined whether China's governmental policies were contributing to an unfair trading advantage detrimental to U.S. economic interests. In this regard, we focused on China's policies regarding its currency valuation, stimulation of exports, industrial policies, and incentives for inward investment and research and development.

We benefited from the views of seven Members of the House and Senate who appeared at the start of our hearing. These Members – from both sides of the aisle – described their concerns, and the concerns of many of their constituents, regarding the negative impact on U.S. manufacturing of China's currency and industrial policies. Several of these Members have introduced legislation aimed at providing appropriate incentives to the Chinese Government to cease its policy of maintaining, through a firm peg to the U.S. dollar, an artificially undervalued currency. Some argued for U.S. action against other unfair Chinese trade practices such as export subsidies, dumping, intellectual property theft, and other WTO-inconsistent practices.

The Commission weighed the testimony from the hearing along with its examination of these issues over the past two years and has come to some conclusions about the dynamics at work as well as some recommendations for U.S. Government action. These findings and recommendations were transmitted to Congress along with the full record of our September 25 hearing. I am pleased to provide you here with a summary of these findings and recommendations, which the Commission hopes will be helpful to your deliberations.

China Exchange Rate Policies

Based on our examination of this issue, it appears clear that China continues to follow a policy of one-way market interventions by the government to maintain its currency at a level that economists estimate is between 15-40 percent undervalued. In this regard, China is purchasing U.S. dollars at an estimated rate of $120 billion per year to prevent appreciation of its currency against the dollar. In assessing the causes of the worsening U.S. trade deficit and loss of U.S. manufacturing jobs, clearly a broad range of factors are at work, including the lack of net new savings in the U.S. economy, the global mobility of factors of production and/or low labor costs in China. However, we believe that the artificially undervalued Chinese yuan is negatively impacting the competitiveness of U.S. manufactured goods and is contributing to a migration of world manufacturing capacity to China and to an erosion of the U.S. manufacturing base.

Section 3004 of the Omnibus Trade and Competitiveness Act of 1988 (22 U.S.C. Sec. 5304) requires annual reports from the Department of Treasury on foreign countries' exchange rate policies and requires the Secretary to enter into negotiations on an expedited basis with countries found to be manipulating their currencies to gain an unfair competitive trade advantage. Past reports from the Treasury on China have sidestepped this conclusion, which appears now to be inescapable. *The Commission believes it is clear that China, in violation of both its IMF and WTO obligations, is in fact manipulating its currency for trade advantage and therefore finds it imperative that the Treasury immediately and forcefully enter into negotiations with the Chinese Government to resolve this matter*. China's continued maintenance of an undervalued exchange rate with the U.S. dollar will continue to promote major distortions in the flow of trade and investment, to the detriment of American companies and workers, and therefore requires decisive action by Washington.

Given these findings, the Commission recommends the following:

Recommendation: The Treasury Department should make a determination in its foreign country exchange rate report to Congress that China is engaged in manipulating the rate of exchange between its currency and the U.S. dollar to gain an unfair competitive trade advantage and immediately enter into formal negotiations with the Chinese government over this matter. Should these efforts prove ineffective, the Commission urges the Congressional leadership to use its legislative powers to force action by the U.S. and Chinese Governments to address this unfair and mercantilist trade practice. For the near future, continued vigorous development of such legislative initiatives as were outlined by Members of Congress during our hearing, linking China's performance on its exchange rate policies to its continued full access to the U.S. market, appears essential to ensure the appropriate level of effort by both governments to this matter.

China's Investment and Industrial Policies

China has attracted a total of over $400 billion of foreign direct investment (FDI), most of it in the last six years. This compares with $1.3 trillion for the U.S., $497 billion for the U.K., $482 billion for Belgium-Luxemburg, and $480 billion for Germany. As FDI flows to China are now expanding by over $50 billion per year, China will soon have accumulated the second largest stock of FDI in the world.

China's undervalued currency is just one of several factors behind that country's success in attracting massive inflows of FDI, particularly into its manufacturing sector. China's industrial policies have also played a significant role. In this regard, we have learned that:

- China has pursued industrial policies that have catalyzed its growth as a manufacturing powerhouse, particularly in increasingly higher-technology production. The Chinese Government has designated a number of "pillar industries," particularly in the high-tech area, for which it provides preferential benefits for domestic development and foreign investment.

- Manufacturers in China are supported through a wide range of national industrial policies, which include: tariffs; limitations on foreign firms' access to domestic marketing channels; requirements for technology transfer by foreign investors; government selection of partners for major international joint ventures; preferential loans from state banks; privileged access to listings on national and international stock markets; tax relief; privileged access to land; and direct support for R&D from the government budget.

Some of these industrial practices fall outside the parameters of China's World Trade Organization (WTO) commitments, however others appear to violate China's stated WTO obligations. The U.S. Government needs to engage more forcefully with the Chinese Government where they appear to violate China's WTO commitments. The Congress needs to be regularly briefed on progress toward removing these barriers so as to keep the pressure on our trade regulators and enforcers to hold China to its commitments.

Recommendation: The United States Trade Representative and the Department of Commerce should identify whether any of China's industrial policies are inconsistent with its WTO obligations and engage with the Chinese Government to mitigate those that are significantly impacting U.S. market access. Appropriate Congressional Committees should be fully briefed on the actions the agencies are taking to resolve these issues.

With trade and investment flows rapidly growing between the U.S. and China, it has become increasingly difficult for interested parties to have a clear understanding of all the dynamics at work. In order to fashion effective government policy, a better picture of the trade and investment relationship is needed.

Recommendation: The Commission believes it is essential that U.S. policymakers have a clearer, more comprehensive, and timely picture of global investment and R&D flows to China, particularly in the manufacturing sector. The Commission's 2002 Report to Congress urged Congress to consider establishing an enhanced, mandated corporate reporting system to capture better this information by requiring firms to report "their initial investments in China; any technology transfer, offset, or R&D cooperation agreed to as part of the investment; the shift of production capacity and job relocations resulting from the investment, both from within the United States to overseas and from one overseas location to another; and contracting relationships with Chinese firms." We believe the need for such a system has only increased in urgency since our 2002 Report and again urge Congress to consider taking such action.

Impact on U.S. Economy

In his September 15, 2003 remarks to the Detroit Economic Club, Commerce Secretary Don Evans stated that *"the President believes that our economic and national security require a stable, robust manufacturing sector that produces sophisticated and strategically significant goods here, in the United States."* Manufacturing employs 14 percent of the American workforce, but has accounted for nearly 90 percent of all the job losses since total U.S. employment peaked in March 2001. Over 2.7 million American factory jobs have been lost over the past three years, roughly one in every six manufacturing jobs.

We are awaiting the release of the President's Manufacturing Initiative and look forward in particular to reviewing its proposals for dealing with the China-specific challenges. *It is our opinion that China's undervalued currency and government investment strategies are having a deleterious effect on the* *competitiveness of U.S. manufactured goods and contributing to a migration of world manufacturing capacity to China, with a concurrent erosion of the U.S. manufacturing base*.

Recommendation: The Commission believes that the President's pending Manufacturing Initiative should include provisions that strengthen the competitiveness of U.S.-based manufacturers in light of the growing shift of production to China, especially high-tech and R&D. The Initiative should address de facto Chinese Government subsidies, including those not covered under the WTO, such as tax incentives, preferential access to credit, capital, and materials, and investment conditions requiring technology transfers.

Engaging forcefully with China over its currency valuation, over its WTO non-compliant practices, and over practices that, even if outside the strictures of the WTO agreement, are operating to inappropriately disadvantage U.S. exporters is not a "get tough" policy attempting to hold China to a higher standard than other trading partners. It is a necessary and appropriate U.S. response to hold a major trading partner to the spirit and letter of the commitments it agreed to in the interest of forging a mutually beneficial economic relationship.

When China joined the WTO, part of the bargain was that it agreed to be subject to three China-specific safeguard provisions that lowered the threshold for bringing WTO trade disputes against China: a non-market economy methodology in anti-dumping cases, a product-specific safeguard that allows WTO members to restrain Chinese imports that disrupt their domestic markets, and a textile safeguard. These provisions were pursued in recognition of the fact that China did not meet the standards of a market economy and are an important means to maintain a level playing field for China's trading partners. As we recommended in our 2002 Report to Congress, we urge USTR and the Commerce Department to make aggressive use of these safeguards to minimize the potentially severe dislocations to our economy during China's transition into the WTO.

In the coming months, the Commission will hold hearings on a number of issues pertinent to the Committee's work. In December we will examine how China's emergence as an economic power is impacting other nations in Asia and how this affects U.S. interests in the region. We also plan to hold a hearing in the near future on China's WTO compliance record where we will review the official reports of China's compliance – those issued by USTR and the WTO – as well as the effectiveness of the WTO's Transitional Review Mechanism in addressing any noncompliance problems and compare these efforts with assessments offered by industry, labor and other key stakeholders. We also intend to carefully examine the Administration's Manufacturing Initiative once it is released and how it addresses the concerns we have outlined above.

Later next year, the Commission will hold hearings on U.S. science and technology transfers to China and Chinese fundraising in the U.S. capital markets. The fruit of all this work will be embodied in our next Annual Report for the Congress due out next Spring.

It is the hope of the Commission that our work will help inform your deliberations and contribute to the fashioning of legislation by the Congress which will illuminate the dynamics of the U.S.-China economic relationship, better identify unfair Chinese trade practices, and steer Chinese economic practice into more sustainable and fairer channels. Thank you again for this opportunity to provide our views on the issues before you.