CHINA CURRENCY COALITION
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HEARING BEFORE THE U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION REGARDING CHINA'S WORLD TRADE ORGANIZATION COMPLIANCE: INDUSTRIAL SUBSIDIES AND THE IMPACT ON U.S. AND WORLD MARKETS

(April 4, 2006)

Oral Presentation by David A. Hartquist
On Behalf of the China Currency Coalition

Mr. Chairman, Commissioners, good afternoon. I am David A. Hartquist of the law firm Collier Shannon Scott. Thank you for allowing me to appear before you again as counsel to the China Currency Coalition regarding China's subsidization of its undervalued currency. My remarks today will highlight the basic points in my submitted written statement.

With regard to the Commission's questions, first, it is evident that China's undervaluation of its currency is playing a significant role in a series of worrisome developments for the United States. Shutting down companies and letting go workers in critical industries, selling assets, relocating to China, and investing in China rather than in the United States while borrowing excessively to consume low-priced, dollar-denominated imports from China are not sustainable or desirable actions. This short-sightedness already has been very costly and, if allowed to continue, almost certainly will exact a greater and greater toll on the economy and security of the United States. The yuan's undervaluation has been a

driving factor underlying these dangerous trends. Commercially realistic revaluation, however accomplished, should encourage a healthier engagement by China with the United States for everyone's sake. China continues to "hide the ball," issuing false official government trade data. U.S. and IMF officials appear to continue using this phony data without challenging it.

Second, very little progress has been made on this issue over the past year. The three-percent revaluation since last July is no substitute for the forty-percent revaluation that is so desperately called for here in the China Currency Coalition's judgment. If China's system were truly market-driven, the daily trading band of +/- 0.3 percent could already have resulted in a forty-percent revaluation of the yuan as of late March.

The problem is that China's leadership evidently remains convinced that the policy of enforced undervaluation is advantageous for China. China has been very clear to the International Monetary Fund ("IMF") and the World Trade Organization ("WTO") that the Chinese government places tremendous importance on its exchange-rate regime as a means to foster economic growth and employment through exports and to encourage macroeconomic, social, and financial-sector stability in China.

Third, China's undervaluation of the yuan runs counter to obligations China has assumed at the IMF and the WTO. Most notably, the yuan's undervaluation

should be considered and treated as a prohibited export subsidy within the meaning of Articles 1, 2, and 3 of the WTO's Agreement on Subsidies and Countervailing Measures and Articles 3, 9, and 10 of the WTO's Agriculture Agreement. All the earmarks of such a subsidy are present.

Thus, in a typical export transaction, having been paid for goods sold to a customer in the United States, the exporter in China must transfer the U.S. dollars received to the Chinese government in return for yuan at the undervalued exchange rate in effect. In this sequence of events, the criteria for a prohibited export subsidy are satisfied: (a) the Chinese government provides a financial contribution of funds and services to the exporter by converting U.S. dollars into yuan and "sterilizing" the yuan to control inflation in China; (b) due to the Chinese government's controls and measures, a benefit is conferred to the extent that the exporter in China is "better off" as the result of being given more yuan than if there were no undervaluation; and (c) this subsidy is contingent upon export performance.

Lastly, what recourse does the United States have to address the yuan's undervaluation apart from further talks with China? Unfortunately, there is no way to compel China to revalue, and the IMF has no dispute-settlement mechanism or effective means at its disposal to sanction China. Moreover, while the WTO has a dispute-settlement mechanism, earlier this year the WTO's Director-General

Pascal Lamy was quoted as saying – apparently without elaboration – that to his knowledge currency manipulation does not belong to the WTO's legal order. So what is the United States to do?

The issue of exchange-rate manipulation is hybrid in nature, a monetary policy that has far-reaching effects on trade. Consequently, even as the IMF's Articles of Agreement obligate China not to manipulate exchange rates, as observed earlier there is a strong case that the yuan's undervaluation is a prohibited export subsidy under the WTO's provisions. Such a subsidy is countervailable if the subsidized imports injure or threaten to injure a domestic U.S. industry.

This legal theory is incorporated in and the centerpiece of H.R. 1498, the Chinese Currency Act of 2005, which currently has 158 co-sponsors and extensive bipartisan support. The imposition of countervailing duties to offset injury caused by imports subsidized by undervaluation of a foreign currency would be unprecedented. At the same time, this approach can be appropriately and forcefully defended as WTO-consistent, despite Mr. Lamy's general remark. Most practically, H.R. 1498 would enable U.S. industries and workers to take corrective steps against the injurious, subsidized imports and hopefully would give China and other countries engaged in currency undervaluation pause to reconsider the value and wisdom of such schemes.

Thank you.

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Introduction

Good afternoon. Thank you for inviting me to participate in this hearing on behalf of the China Currency Coalition ("CCC"). The CCC consists of U.S. industry, agriculture, and labor organizations, and its purpose is to support the economy and security of the United States by working toward and achieving as promptly as possible commercially realistic appreciation of China's undervalued yuan.

Since I last appeared before the Commission on February 3, 2005, I think it is fair to say that there has been no significant shift in the Chinese leadership's basic position on the yuan. There certainly has been some activity by China, notably the changes that were announced on July 21, 2005: the yuan's one-time revaluation of just over two percent; the replacement of the yuan's peg to the dollar with reliance upon a basket of currencies; and the institution of a daily trading band of +/- 0.3 percent. But these modifications in practice have meant only a slight appreciation of the yuan against the dollar – from 8.28 yuan prior to July 21st to 8.01 yuan per dollar as of the end of last week, or approximately 3 percent. Exactly how modest this movement over the last eight and one-half months has been can be seen when it is recognized that a truly market-driven system – even with the narrow, daily trading band – could already have resulted in a forty-percent revaluation of the yuan as of late March. The CCC continues to believe that an appreciation in the range of forty percent is desperately needed.

As far as the United States is concerned, the ineffectiveness of China's revised system should come as no surprise. China has been very clear, for example, both with the International Monetary Fund ("IMF") and with the World Trade Organization ("WTO"): China's currency policy is meant foremost to achieve for China economic growth, employment, and macroeconomic, social, and financial-sector stability. China's decision has been to permit only very slight change in the yuan/dollar exchange rate as the best way of accomplishing these goals while avoiding as much as possible depreciation of China's substantial investment in dollar-denominated debt. It is reasonable to surmise that, from China's vantage, there seems to be no reason to alter this approach in the time ahead. The desired growth is being accomplished with the assistance of the undervalued yuan, and the yuan's incremental appreciation thus far has

worked to prevent excessive losses for China's holdings in U.S. bonds. In the judgment of the CCC, however, the yuan's undervaluation is generating dangerous and increasingly damaging economic imbalances for the United States, for the global community, and for China itself.

The Undervalued Yuan's Impact on the U.S. Economy

China's direct intervention in currency exchange as well as controls over capital movements along with rigidities in the banking and financial sector prevent market forces of supply and demand from determining an equilibrium exchange rate for the yuan. As a result, the dollar's value remains artificially high and the yuan's value artificially low. Thus, the United States is losing capital investment and manufacturing capability in a variety of important industries and is seeing skilled and unskilled jobs migrate to China at an unprecedented rate. Further, as of the end of February, the China Business News reported last week, China has now overtaken Japan to become the country with the largest accumulation of foreign reserves at $853.7 billion, up from $818.9 billion as of the end of 2005.

Those U.S. companies that have not already gone out of business or relocated to China are able to export relatively little to China in the way of manufactured items. The U.S. bilateral trade deficit with China in 2005 hit a historic high of $203.8 billion. U.S. exports to third countries also are diminished by the yuan's undervaluation. To a significant degree, the loss of U.S. sales to third countries can be attributed to underselling by imports into those countries from China.

The effect on the U.S. manufacturing sector has been most severe in employment. Manufacturing employment has declined over the last five years. In February 2006, manufacturing employment was 3 million lower than in February 2001. But manufacturing in many sectors has not recovered from the recession at the turn of the century. Industrial machinery, electronic products including computers, communications equipment, electrical equipment, electric lighting, batteries, and motor vehicles and parts are some of the sectors that have not fully recovered from the recession.

Significant quantities of needed raw materials are being purchased in the United States and elsewhere, sent to China, and then made by companies in China into value-added, downstream products for export by China to the United States and elsewhere. In prior decades, these raw materials were fabricated into finished and semi-finished products in the United States.

Reduced income and revenues for U.S. workers and companies mean erosion of the U.S. tax base and greater difficulty for state and local governments particularly to fund basic, much-needed infrastructural projects.

With its ever-rising foreign reserves noted above, thanks to the undervalued yuan, the Chinese government is using foreign exchange to purchase U.S. government and quasi-government debt and is increasing the money supply in China's banking system, which in turn lends funds to Chinese businesses that are creating further excess capacity. Much of these bank loans are applied to underwrite debt or otherwise subsidize China's state-owned banks and other favored industries in China to the detriment of U.S. firms.

The situation is made worse because other Asian countries, particularly Japan, Taiwan, and Malaysia, also maintain undervalued currencies in order to compete with Chinese companies in China and global markets.

In summary, China's undervalued currency is creating current account imbalances that threaten the global financial system.

The Yuan's Undervaluation Is A Prohibited Export Subsidy That Should Be Countervailed If China Insists on Continuing to Undervalue the Yuan

In its Accession Agreement with the World Trade Organization, China unqualifiedly committed to cease all export subsidies by all levels of government by the time of accession, December 11, 2001. Despite this pledge, China has persisted in its undervaluation of the yuan. Although the precise issue has never previously arisen in dispute settlement or apparently otherwise, the China Currency Coalition submits that the yuan's undervaluation is a prohibited export subsidy in violation of Articles 1, 2, and 3 of the WTO's Agreement on Subsidies and Countervailing Measures ("the SCM Agreement") and the parallel Articles 3, 9, and 10 of the WTO's Agreement on Agriculture that build on the SCM Agreement's provisions.

Under Articles 1, 2, and 3 of the SCM Agreement, a measure must satisfy three criteria in order to be considered a prohibited export subsidy. In essence, there must be a governmental financial contribution (Article 1.1(a)(1)), a benefit must thereby be conferred (Article 1.1(b)), and such a subsidy must be specific by virtue of being contingent in law or in fact upon export performance (Articles 1.2, 2.3, and 3.1(a)). The yuan's enforced undervaluation by the Chinese government meets each of these criteria.

In a typical export transaction, having been paid for goods sold to a customer in the United States, the exporter in China must transfer the U.S. dollars received to the Chinese government in return for yuan at the undervalued exchange rate in effect.

In this sequence of events, the Chinese government first provides a financial contribution of funds to the exporter by means of the service of converting U.S. dollars into yuan.

Second, a benefit is conferred by this governmental financial contribution that is equal to the difference between what the yuan would be worth if its value were set by the market and its artificially low value as the result of China's undervaluation of the yuan. With the yuan undervalued by approximately forty percent, therefore, for each U.S. dollar earned by sale of goods to the United States the Chinese exporter will receive eight yuan rather than five yuan. As this illustration demonstrates, the exporter in China is "better off" as the result of being given more yuan than if there were no undervaluation.

Third, and lastly, this subsidy is contingent upon export performance. Only after the exporter has been paid in U.S. dollars for the goods that have been exported to the United States is the exporter required to convert those proceeds into yuan.

The setting forth in these straightforward terms of why the yuan's undervaluation should be seen as a prohibited export subsidy is not intended to overlook various underlying and, in some instances, arguably contrary points that add complexity to the analysis. At least a few should be mentioned at this juncture, therefore, and there are likely others that might be advanced. Also importantly, due to incomplete transparency by China, not all facts and details are known about exactly how China's system functions. At the same time, however, in the China Currency Coalition's opinion the evidence that is available is more than adequate to support the conclusion that the yuan's enforced undervaluation is a prohibited export subsidy.

For instance, with respect to the criterion that there be a governmental financial contribution under Article 1.1(a)(1) of the SCM Agreement, such a finding can rest on one or more of several grounds. As suggested above, the Chinese government's exchange of yuan in return for U.S. dollars can properly be viewed as "a government practice {that} involves a direct transfer of funds," in line with Article 1.1(a)(1)(i). The yuan's undervaluation might also be considered a governmental provision of services under Article 1.1(a)(1)(iii), inasmuch as the Chinese government both exchanges the yuan for U.S. dollars and then "sterilizes" the issued yuan in order to avoid inflation and loss of value by the yuan within China. These services by China are financial contributions integral to the yuan's undervaluation. Further, to the extent that the Chinese government entrusts or directs private bodies to conduct the exchanges and "sterilizations" of yuan, that activity likewise can reasonably be seen as a governmental financial contribution under Article 1.1(a)(1)(iv).

With respect to whether the subsidy due to the yuan's undervaluation is contingent, in law or in fact, upon export performance, and so is "specific" under Articles 1.2, 2.3, and 3.1(a) of the SCM Agreement, it is evident that this subsidy in fact is tied to actual or anticipated exportation or export earnings within the meaning of the SCM Agreement's Article 3.1(a) n.4. It is also possible that Chinese law and regulations might expressly provide that this subsidy is contingent upon exportation, but China's failure to date to report its subsidies to the WTO and lack of transparency are impediments to ascertaining the actual circumstances in this regard. Another aspect as to whether this subsidy is specific concerns its availability also to those persons and entities in China that have obtained U.S. dollars by means other than through the export of goods or services to the United States. A similar argument was made by the United States unsuccessfully in dispute settlements involving U.S. cotton subsidies and tax treatment for foreign sales corporations, but successfully by Canada in a dispute settlement pertaining to dairy products. As long as it can be established that there is a clear distinction between the eligible domestic recipients and the eligible exporters and different conditions for each group to receive the subsidy, the prerequisite of specificity for a prohibited export subsidy should be met.

From a broader standpoint, there is the question of whether responsibility and authority over exchange-rate problems lies with the IMF or the WTO or is shared by these two international organizations. Opinions vary. Earlier this year, the WTO's Director-General was quoted as saying that to his knowledge currency manipulation does not belong to the WTO's legal order. This remark, however, does not seem to consider that prohibited export subsidies fall within the bailiwick of the WTO and that undervaluation of a currency like the yuan can be a prohibited export subsidy under the WTO's provisions without necessarily comprising "currency manipulation" within the IMF's definition of that term.