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Testimony Before a Joint Hearing of
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The Committee on Ways and Means Subcommittee on Trade
and
The Committee on Energy and Commerce Subcommittee on Commerce, Trade, and Consumer Protection

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Introduction

Chairman Gutierrez and Ranking Member Paul, Chairman Levin and Ranking Member Herger, Chairman Rush and Ranking Member Stearns, thank you for the opportunity to participate in this important hearing.

I am here as Chief Executive Officer of the Financial Services Forum. The Forum is an association comprising the chief executive officers of 20 of the largest and most diversified financial institutions with business operations in the United States. The Forum works to promote policies that enhance savings and investment and that ensure an open, competitive, and sound global financial services marketplace. As a group, the Forum's member institutions employ more than 1.5 million people and hold combined assets of more than $12 trillion.

The Forum's members share Congress' commitment to maintaining a strong U.S. economy, enhancing savings, and opening world markets to American-made products as the most effective means of reducing America's trade deficit. Also important is for the currencies of our major trading partners to be determined by the markets.

The Importance of Market-Determined Exchange Rates

An exchange rate is just a price, the price of one currency in terms of another. As with any other commodity in a free market, the price of a currency should be determined by the interplay of supply and demand based on economic fundamentals. By reflecting investors' interest in holding assets denominated in one currency over assets denominated in another, market-determined currencies – just like standard prices in any economy – help direct scarce resources to their most productive uses. Market-determined currencies also have the benefit of serving as a correction mechanism for the global economy – as a falling currency helps stimulate demand for the products of a slumping economy, and a rising currency helps cool demand for the products of a booming economy.

As the members of these Committees know very well, two of our most important trading partners are Japan and China. As a portion of America's overall trade with the world, China is our second largest trading partner, accounting for 12 percent of total U.S. trade, while Japan is our fourth largest, accounting for about 7 percent.

In both relationships, imports into the United States have for years surpassed our exports. Last year, America's trade deficit with China rose 15 percent to $233 billion – or 28 percent of our overall trade deficit. Meanwhile, America's trade deficit with Japan rose 7 percent last year to $88.4 billion – or 11 percent of our overall trade deficit. Taken together, the deficits with China and Japan account for about 40 percent of America's overall trade deficit.

For years, the United States has worked with China toward achieving a yuan whose value is determined by market forces. Indeed, shortly after taking office, the Bush Administration committed to helping China develop the capital markets know-how and expertise necessary to end the yuan's peg to the dollar, providing massive technical assistance. And those efforts have born fruit. In July of 2005, China revalued its currency upward by 2 percent. Since mid-2006, the pace of appreciation has accelerated, averaging about 4.9 percent a month at an annualized rate, and quickening to around 5.4 percent in the first few months of 2007, as China has become more confident about the resilience of its economy. In total, the yuan has appreciated by 6.5 percent since July of 2005, and it has been estimated that by 2011 the yuan will have appreciated by a substantial 25 percent.[1] A market-determined yuan is important – for China, the United States, and the rest of the world – and the United States should continue to press China to accelerate progress. I'll have more to say about China in a moment.

Japan and the Yen

There is no question that the Japanese yen is currently trading at very low levels, recently dropping to multi-month lows against the dollar and an all-time low against the Euro. Indeed, Bank of Japan data indicate that the yen is at its weakest level in real trade-weighted terms in more than 20 years – circumstances that clearly benefit Japanese exporters.

While problematic for businesses competing with Japanese producers, there is no evidence that the yen's current trading levels are the result of currency manipulation. Indeed, as the Treasury Department reported in December, Japanese authorities have not intervened in foreign exchange markets in more than three years. Rather, the low relative value of the yen reflects economic fundamentals – namely, a fragile Japanese economy still recovering from a decade of stagnation and deflation during the 1990s, and low interest rates designed to nurture, encourage, and extend the early recovery. On April 27th, the Bank of Japan announced it would keep its short-term interest rate target at 0.5 percent, well below the U.S. fed funds rate of 5.25 percent and the Euro zone's 3.75 percent. Given such differentials and their implications for higher returns on dollar- and Euro-denominated assets, it's not at all surprising that the yen is trading at current levels.

[1] See China's Currency: Underappreciated Facts," Economist Intelligence Unit, April 10, 2007.

More importantly, we clearly cannot credibly argue to China that it should stop intervening in foreign exchange markets – buying up billions of dollars to maintain the desired value of the yuan – while at the same time urging Japan to sell its currency reserves to drive up the relative value of the yen, as some have recently suggested. Dissatisfaction with the value of the yen as determined by world markets would only signal that U.S. currency demands are unreasonable, ad hoc, self-motivated, and impossible to satisfy – undermining the credibility and legitimacy of our continuing efforts to encourage a market-determined yuan.

Incidentally, it's worth noting that the U.S. dollar itself is currently trading near record lows against the Euro and at levels against the British pound not seen in nearly a quarter century.

China and the Yuan

Turning to China, in recent years the discussion in Washington regarding the U.S.-China economic relationship has focused in large part on China's currency policy. Many policymakers assert that an undervalued yuan makes cheap Chinese exports even cheaper, giving Chinese producers an unfair advantage over American companies and contributing to the U.S. trade deficit with China.

As I stated a few moments ago, a market-determined yuan is important – for the United States and for China. Foreign exchange market intervention by the People's Bank of China – buying dollars with yuan – has boosted liquidity in China's economy, thwarting government efforts to scale back excessive bank lending and fixed investment. Speculative money flowing into China in anticipation of a revaluation is also undermining government objectives. Finally, allowing the yuan to more fully float according to market forces would free the PBOC to pursue monetary policies that advance China's macroeconomic goals. For these reasons – as well as the priority of a more fair and transparent trade relationship – U.S. policymakers should continue to press China to accelerate progress toward a market-determined yuan.

Chinese authorities have repeatedly argued – reasoning generally acknowledged by most foreign analysts, including Treasury Secretary Paulson – that an immediate shift to a market-determined yuan is not possible given the underdeveloped state of China's capital markets. More specifically, China's banks, securities firms, and other businesses currently lack the expertise to develop and trade derivatives and other structured instruments used to hedge the risk associated with greater currency volatility. This reality is one of many reasons why financial sector modernization in China – accelerated by great foreign participation – is so important. Sophisticated derivative products and hedging techniques provided by foreign financial services firms would enable China to move more quickly toward a free-floating yuan whose value is determined by market forces based on economic fundamentals.

But even as we continue to press China to accelerate progress on the yuan, we should not allow the currency issue to overshadow the broader potential of the U.S.-China economic relationship. Indeed, the short term effect of a significant appreciation in the yuan would likely be to make the trade deficit *worse*. Because a higher-valued yuan would mean higher prices for imported Chinese goods, and because the process of finding cheaper alternatives to more expensive Chinese goods takes time, the trade deficit would likely get worse before getting better – a phenomenon economists call the J-curve effect.

Of far greater significance to the policy goals of maintaining strong U.S. economic growth and job creation is expanding access to China for American businesses and helping to activate China's 1.3 billion potential consumers – a fifth of the world's population. A simple example demonstrates the enormous potential of greater spending by Chinese consumers:

Last year, the United States exported to Japan goods and services worth $60 billion – approximately the same amount exported to China ($55 billion). But China's population of 1.3 billion is ten times Japan's population of 127 million. If U.S. exports are expressed in relation to population, the U.S. sold the equivalent of $472 worth of goods and services to every citizen of Japan last year, but only about $40 worth of goods and services to every Chinese citizen.

If China's citizens were to eventually consume American-made goods and services at the same rate that Japan's citizens did last year, the United States would export more than $600 billion worth of goods and services to China, 11 times what America exported to China last year, an amount equivalent to 5 percent of America's GDP, and more than twice what we imported from China last year – replacing the trade deficit with a significant surplus.

But in order to mobilize its 1.3 billion consumers, China needs a more open, competitive, and effective financial system. Chinese households historically save as much as half of their income, as compared to single-digit savings rates in the United States and Europe. This pronounced propensity to save is related to the fact that most Chinese depend on their families and private savings to pay for retirement, healthcare, and the economic consequences of accidents or disasters. Activating the Chinese consumer requires the availability of financial products and services – personal loans, credit cards, mortgages, pensions, insurance and retirement products – that will reduce the need for such "precautionary" savings and facilitate consumption.

The fastest way for China to develop the modern financial system it needs to achieve more sustainable economic growth, allow for a more flexible currency, and increase consumer consumption is to import it – that is, by opening its financial sector to greater participation by foreign financial services firms. Foreign institutions bring world-class expertise and best practices with regard to products and services, technology, credit analysis, risk management, internal controls, and corporate governance. In addition, the forces of competition brought by foreign institutions would accelerate the development of modern financial techniques and methodologies by China's financial institutions.

By providing the financial products and services that China's citizens and businesses need to save, invest, insure against risk, raise standards of living, and consume at higher levels, foreign financial institutions – including U.S. providers – would help create what every U.S. manufacturer and service provider wants – an unleashed Asian tiger hungry for U.S. products.

Thank you very much for the opportunity to appear at this unique joint hearing.