U.S. TREASURY DEPARTMENT OFFICE OF PUBLIC AFFAIRS

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TESTIMONY OF TREASURY DEPUTY ASSISTANT SECRETARY MARK SOBEL ON CURRENCY MANIPULATION AND ITS AFFECT ON U.S. BUSINESSES AND WORKERS BEFORE THE COMMITTEE ON WAYS AND MEANS SUBCOMMITTEE ON TRADE; COMMITTEE ON FINANCIAL SERVICES SUBCOMMITTEE ON DOMESTIC AND INTERNATIONAL MONETARY POLICY, TRADE AND TECHNOLOGY; AND COMMITTEE ON ENERGY AND COMMERCE SUBCOMMITTEE ON COMMERCE, TRADE AND CONSUMER PROTECTION

Thank you Chairman Levin, Chairman Gutierrez, Chairman Rush, Representative Herger, Representative Paul and Representative Stearns and members of the sub-committees, for the opportunity to appear today to discuss this important issue.

Treasury's Assessment of Exchange Rate Policies

As you know, twice a year the Department of the Treasury issues a Report to Congress on International and Exchange Rate Policies. This report, often called the "Foreign Exchange Report," is required by the Omnibus Trade and Competitiveness Act of 1988 (the "Act"). The report reviews economic and policy developments of important world economies and other economies with which the United States has a large trading relationship. The Act states that "the Secretary of the Treasury shall analyze on an annual basis the exchange rate policies of foreign countries, in consultation with the International Monetary Fund, and consider whether countries manipulate the rate of exchange between their currency and the United States dollar for purposes of preventing effective balance of payments adjustments or gaining unfair competitive advantage in international trade."

Treasury takes the preparation of this report very seriously. We know that it is read closely by members of Congress as well as the financial community, the general public, and foreign governments. We make every effort to ensure that we produce an accurate yet comprehensive report that incorporates analysis reflecting the realities of today's international monetary and financial systems. In developing our assessments, Treasury undertakes a careful review of major trading partners' exchange rate regimes and policies, the evolution of their external balance of payments positions, their accumulation of foreign exchange reserves, macroeconomic developments within their economies, and their responses to these developments in terms of monetary and financial developments and financial and exchange restrictions.

Treasury has made a concerted effort in recent years to broaden and improve the coverage and analytical rigor of the report. We have done so because of changing global circumstances since 1988, including profound technological change and globalization, which have enabled many more economies today to become systemically important from an economic and financial perspective. In addition, global capital flows have increased greatly since 1988. The interdependence of the United States with the world economy has increased, heightening our sensitivity to the impact of developments overseas.

In recent reports, therefore, Treasury has strengthened our coverage and analysis of global economic developments and the evolution of the U.S. balance of payments position by including a discussion of perspectives on interpreting U.S. current account developments and international capital flows. In this regard, we have discussed the shared international strategy for global adjustment and noted that given the large U.S. current account deficit, the counterpart to that deficit is inevitably to be found in large surpluses elsewhere in the world. We also have provided more extensive descriptions of macroeconomic and financial developments in many of the key countries of particular interest to the public.

Further, Treasury has also included a series of appendices on critical international monetary policy issues. In this regard, we began including a special appendix in which many variables and indicators are analyzed on a systematic basis to develop a better understanding of the currency policies of key countries. In this light, and given the inherent difficulties in defining currency manipulation for the purposes of preventing effective balance of payments adjustments or gaining unfair competitive advantage in international trade, we have examined a range of indicators that economists would typically look at when dealing with currency manipulation questions. We have analyzed a range of different combinations of indicators and weights in order to shed light on the judgments that we are asked to make. The numerical examples illustrate the sensitivity of the rankings to the weighting scheme chosen and also highlight the fact that, for an array of differing reasons, many countries throughout the world have large external surpluses.

Treasury also has made a special effort in the report, through additional appendices, to discuss important related topics. Recognizing that the International Monetary Fund allows members to choose their own exchange rate regime, we have discussed at length the advantages and disadvantages of various exchange rate regimes and, more specifically, fixed versus flexible exchange rates. In light of the vast accumulation of foreign exchange reserves by some countries, especially emerging markets, we have discussed the costs and benefits of reserve accumulation and some of the "rules of thumb" on what are thought to be prudent levels of reserves. And in light of the considerable attention being given to misaligned exchange rates, we have discussed some of the methodological problems involved in estimating equilibrium or fair value exchange rates.

Treasury staff also prepares informal papers, known as Occasional Papers (available at: www.treasury.gov/offices/international-affairs/occasional-paper-series/) on a number of other key international monetary policy issues. These staff papers are not statements of Administration or Treasury policy, but they shed light on these important issues. The question of currency misalignment was discussed in detail in a recent Treasury Occasional Paper (www.treasury.gov/offices/international-affairs/occasional-paper-series/docs/ExchangeRateModels.pdf). That paper reviewed many of the concepts of exchange rate equilibrium in use as well as many of the models used to estimate the over or under valuation of a currency. An important finding of the paper is the wide variance of views that exist with respect to misalignment, as well as the sensitivity of the results to various modeling assumptions. In fact, in some cases, depending on the price deflators used, currencies were found to be overvalued using one deflator but undervalued using another deflator. Another main message of the study is that, although the range of estimates can and often do vary considerably, it is possible to draw certain inferences about misalignment provided the results are drawn from a variety of models and the results are largely similar in magnitude and direction. This information must, however, be supplemented with assessments of other reasons why exchange rates, during relevant periods of time, might deviate from perceived equilibrium values.

Treasury reported to Congress, in March 2005, on the procedures and inherent difficulties involved in making designations pursuant to the Act. That report, entitled, “Report to the Committees on Appropriations on Clarification of Statutory Provisions Addressing Currency Manipulation,” established that to identify exchange rate manipulation, standard macroeconomic and microeconomic analysis needed to be supplemented with certain indicators, including but not limited to: (1) measures of undervaluation; (2) protracted large scale intervention in one direction; (3) rapid foreign exchange reserve accumulation; (4) capital controls and payments restrictions; and *(5)* trade and current account balances. We have since incorporated much of this in one of the aforementioned appendices where I indicated the outcomes largely depend on weights assigned and combinations of indicators used. As since noted in Treasury’s November 2005 Report, there is no mechanistic or formulaic approach in determining manipulation; a complete assessment requires additional analysis of the interactions among economic variables, specific factors affecting economies, and current policy formulation and implementation.

The March 2005 report also noted the role of “intent” in rendering judgments about designations pursuant to the Act. The language of the Act states that currency manipulation must be undertaken “for purposes of preventing effective balance of payments adjustments or gaining unfair competitive advantage in international trade.” “Intent” of the country in question is a consideration as it is inherent in the language of the act. Determining intent behind the policy can be difficult to assess.

The methodology Treasury uses in examining the foreign exchange policies of foreign economies was also the subject of a review by the Government Accountability Office (GAO) in April 2005. The GAO report[1] concluded that Treasury has complied with the requirements in the 1988 Trade Act. The GAO report made no recommendations, but did note that currency “manipulation” is a complex issue that it involves both country-specific and broader international economic factors. The report also considered the views of outside experts on whether the renminbi was undervalued, finding that the views varied widely, with many experts maintaining a view that the currency is significantly undervalued while others contending that undervaluation was not substantial or that estimating it was not possible. According to the GAO, even among experts who believe that China’s currency to be undervalued, there was no consensus on how and when China should move to a more flexible exchange rate regime or whether capital account liberalization should be a part of that move.

Another key element of Treasury’s strategy to ensure that countries pursue appropriate exchange rate policies is to encourage the International Monetary Fund (IMF), the world’s only multilateral institution with a mandate for exchange rates, to improve its work on foreign exchange surveillance. Exchange rate manipulation to gain competitive advantage is inconsistent with the treaty obligations of the 185 member countries of the IMF. Treasury strongly supports IMF Managing Director Rodrigo de Rato’s effort to update the IMF’s thirty-year old operational rules for exchange rate surveillance.

We take very seriously our responsibilities to ensure that the Report to Congress on International Economic and Exchange Rate Policy is of high quality, topical, and thorough. We have been careful to

[1] GAO-05-351; International Trade “Treasury Assessments Have Not Found Currency Manipulation, but Concerns about Exchange Rates Continue,” April 2005.

be very clear about how we approach the issue of designations pursuant to the Act and our reasoning in specific cases.

China

As the exchange rate policy of China is of interest to the committee members, I will address it in more detail.

China's currency policy is an important issue in the economic relationship between our two countries. Although China abandoned its fixed exchange rate in July 2005 and the RMB has now appreciated against the U.S. dollar by a bit more than 7 percent, China does not yet have the currency policy we want it to have and that it needs. Secretary Paulson has stated that a major objective of his as Treasury Secretary will be to press the Chinese government to advance toward the goal of an RMB for which the value is freely set in a competitive marketplace, based on economic fundamentals. The Secretary and Treasury staff meets frequently with Chinese counterparts to press this issue.

The Secretary has laid out several key steps China must take to advance toward this goal, including: widening the band on daily exchange rate movement; reducing intervention; developing its capital market; and setting clear monetary policy targets to avoid inflation and increase confidence in the value of the Chinese RMB. These reforms will allow China to develop the market infrastructure it needs for a freely floating currency; we are committed to working towards those reforms. Although China has embraced currency flexibility as a policy goal, Chinese authorities are not moving quickly enough for the United States or the rest of the global community. And they are not moving quickly enough for China's own good. While we agree on China's broad reform agenda, China's leaders believe there is risk in moving too quickly. Secretary Paulson has told his Chinese counterparts repeatedly that the greater risk is in China moving too slowly. The Secretary will again emphasize this message during the upcoming meeting of the Strategic Economic Dialogue to take place here in Washington later this month. We hope that Chinese leaders at that time will have the benefit of meeting with Members of Congress to discuss the U.S.-China economic relationship.

Treasury's foreign exchange report clearly states that China's cautious approach to exchange rate reform exacerbates distortions in its domestic economy and impedes the adjustment of international imbalances. With respect to determining whether or not China manipulates its currency as defined in the legislation, Treasury must take into consideration the intent of Chinese authorities. In the December 2006 Foreign Exchange Report, after careful analysis of China's economic and currency policies, Treasury did not find that China's policies are designed for the purposes of gaining unfair competitive advantage or preventing effective balance of payments adjustments. Treasury will continue to carefully analyze China's policies as we prepare future Reports.

While China's currency policy is critical to the United States and to China, currency movement alone will not significantly reduce China's trade surplus nor eliminate the distortions in the Chinese economy. China's trade surpluses are rooted in the structure of the Chinese economy and are not solely the result of currency policy. China needs to restructure its economy so that household consumption, rather than exports and excess investment, powers growth. Reform of China's financial system is also critically important for the rebalancing process, by providing Chinese households the means to insure themselves against major risks and finance expenditures like education. Better financial services will also help address many of the reasons why Chinese households save so much and can spend so little of their incomes. Vibrant domestic consumption is key to the welfare of the Chinese population and is the only way that China can grow without generating huge trade surpluses.

To be a responsible international stakeholder in the global economy, China needs to take swift and effective action to remedy these imbalances. This is both for the global economy and for China's own sake. Currency flexibility will enhance the ability of China's economic policy makers to use monetary policy to steer China's economy towards steady and sustained growth. Rebalancing the structure of economic activity in China will help to alleviate global economic imbalances and will ensure that China's future growth can be sustained without generating huge trade imbalances.

Japan

The Department of the Treasury closely monitors Japan's foreign exchange policy, which is reported on extensively in each Foreign Exchange Report.

The value of the yen is determined in open, competitive global markets, responding to the forces of supply and demand. Global trading in the yen-dollar market is extremely large, reflecting the importance of Japan in world trade and the global financial system. Since 2001, the yen-dollar exchange rate has fluctuated in the range of 105 to 135 yen to the dollar, and stands today at about 120 yen to the dollar. While Japan has previously intervened in the foreign exchange market, there is currently no intervention and Japan has not intervened since March 2004.

In real, price adjusted terms, the yen is at its lowest value since the early 1980s. The yen's real effective value is the result of a protracted period of deflation in the Japanese economy that coincided with rising prices in the United States and other trading partners of Japan. Japan's long deflationary episode reflects the drawn-out difficulties of Japan's adjustment to the bursting of the asset price bubble in the early 1990s.

Japan's economy is recovering. The recovery has been underway for several years, but it has not been brisk and it has not yet gathered steam. One of the most important contributions Japan could make to the global economy, and to U.S. firms and workers, would be to resume sustainable and robust domestic demand growth and exit completely from deflation.

We discuss foreign exchange issues with Japan and the other G7 partners regularly. Japan has joined repeated G7 statements supporting foreign exchange flexibility.

Thank you.