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.

The Director-General's comment additionally appears not to take into account relevant portions of Article XV, notably Article XV:4, of the General Agreement on Tariffs and Trade ("GATT"), the gist of which is that member states shall not, by exchange action, "frustrate" the intent of the GATT and shall not, by trade action, "frustrate" the intent of the IMF's Articles of Agreement. An addendum to Article XV:4 elaborates on and gives a couple of examples of what is intended by use of the word, "frustrate." More exactly, this addendum notes that infringements of the letter of any of the GATT's Articles by exchange action shall not be viewed as a violation of the GATT if, in practice, there is "no appreciable departure from the intent of the Article." Also pertinent, Article XV:9(a) of the GATT holds that nothing in the GATT shall preclude a member state's use of exchange controls or exchange restrictions in accordance with the IMF's Articles of Agreement.

The purpose of Article XV generally may be said to be the harmonious working in tandem of the IMF's Articles of Agreement with the GATT and the WTO's other agreements. What is deemed by one organization as consistent with its charter should not be found violative of the other organization's charter if at all possible and *vice versa*. Toward this end, Article XV:2 of the GATT stipulates in pertinent part that in all cases in which the WTO is called upon to consider problems concerning monetary reserves, balances of payments or foreign exchange arrangements, the WTO's Member States shall consult fully with the IMF and shall accept the IMF's determination of whether action by a member state in exchange matters is in accordance with the IMF's Articles of Agreement.

It is apparent that the drafters of the GATT and the IMF's Articles of Agreement recognized that trade action and exchange action can overlap and that coordination on such occasions is desirable. As Professor Lowenfeld observes at page 501 n.5 of his book, "International Economic Law," there was an acute awareness on the part of the United States and other countries after World War II that the 1930s had seen frequent resort to many monetary devices, including use of exchange controls and competitive currency depreciation, that had undercut recovery in international trade.

Over the years, there has indeed been a need for international monetary-trade coordination, for example, with issues concerning restrictions on imports due to problems with balance of payments. On the other hand, there has been little or no discussion or occasion of relevance calling for coordination on issues of currency manipulation or undervaluation.

In November 1996, consistent with this historical background, the IMF and the WTO entered into an agreement (the Fund-WTO Cooperation Agreement, dated November 25, 1996) acknowledging the increasing linkages between the various aspects of economic policymaking and designed to facilitate linkages between the IMF and WTO. More precisely, paragraph 8 of this agreement provides that the IMF shall inform in writing the relevant WTO body (including dispute settlement panels) that is considering exchange measures within the Fund's jurisdiction whether such measures are consistent with the IMF's Articles of Agreement. Paragraph 9 of this agreement also directs that the WTO's Director-General and the IMF's Managing Director shall ensure cooperation between the staffs of their two institutions and shall agree on appropriate procedures toward that end, including access to databases and exchanges of views on

jurisdictional and policy issues. Article 10 of the Agreement obligates the staffs of the WTO and the IMF to consult with each other on issues of possible inconsistency between measures under discussion with a common member under the WTO's and IMF's agreements.

What might all of these provisions mean for the yuan's enforced undervaluation? The answer to this question depends in good part on whether this situation is viewed purely as a trade matter or purely as a monetary matter or as a hybrid of the two. If, as the China Currency Coalition believes should be the case, the yuan's undervaluation is considered to be a hybrid by virtue of being a measure that is both financial and trade in nature with serious effects on international trade, it remains to be seen if and how effectively the WTO and the IMF might collaborate with each other under the terms of their 1996 agreement to cooperate.

In sorting through this situation, it will perhaps also be helpful to keep in mind the earlier comment that currency undervaluation that is a prohibited export subsidy in the WTO's eyes is not necessarily currency manipulation as well under the IMF's guidelines in Article IV(1)(iii) of its Articles of Agreement and its 1977 Surveillance Decision. For instance, currency manipulation as defined by the IMF entails manipulation of exchange rates or the international monetary system "in order to" prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members. The IMF's element of intent for currency manipulation is not present in the WTO's agreements on prohibited export subsidies. As discussed earlier, a prohibited export subsidy under Articles 1, 2, and 3 of the SCM Agreement exists if there is a governmental financial contribution, a benefit results, and the subsidy is contingent upon export performance.

Seen from this vantage, especially given that the IMF has no dispute settlement mechanism and, as a practical matter, no other effective means at its disposal to sanction China, even if the IMF were to continue to be reluctant to find currency manipulation by China recognition of the yuan's undervaluation as a prohibited export subsidy would – in a hopefully significant way – assist U.S. companies and workers in a WTO–consistent manner to weather the storm, hold China accountable for its unwillingness to let the yuan appreciate expeditiously, and possibly impress upon China that there are rules of law to be honored and logical costs and consequences to be borne if those rules are wrongly disregarded.

Under this approach, any dispute settlement that went forward at the WTO could involve consultation with the IMF on the question of measuring the amount of the yuan's undervaluation or, expressed within the framework of Article 1.1(b) of the SCM Agreement, the amount of the benefit of the prohibited export subsidy. As the IMF's 2005 Article IV Consultation – Staff Report commented at page 14, "Although it is difficult to reach firm conclusions about its extent, the continued strengthening of the external balance points to increased undervaluation of the renminbi, adding to the urgency of making a move." Although these words were written on July 8, 2005, before China's July 21st revaluation of 2.1 percent, their sentiment is even more valid today given China's substantially greater amassment of foreign reserves now than as of last July.

Finally, the China Currency Coalition submits that the best remedy to address the yuan's undervaluation is to amend the U.S. countervailing duty law so as to implement the SCM Agreement's provisions in a WTO-consistent manner and treat undervaluation of the yuan or any

other currency as a prohibited export subsidy. H.R. 1498, the Ryan-Hunter bill, with 158 co-sponsors and bipartisan support, adopts this strategy. If a U.S. domestic industry were found to be materially injured or threatened with material injury by reason of imports so subsidized, countervailing duties would be imposed to offset that injury. If China chose to take the United States to dispute settlement at the WTO, it could do so. On the other hand, if China decided to react by allowing the yuan promptly to appreciate in accordance with market forces, so much the better. If other countries like Japan, Taiwan, and Malaysia followed suit, better still.

Thank you for inviting me to appear before you today.