U.S.–CHINA TIES: REASSESSING THE ECONOMIC RELATIONSHIP

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TUESDAY, OCTOBER 21, 2003

HOUSE OF REPRESENTATIVES,
COMMITTEE ON INTERNATIONAL RELATIONS,
Washington, DC.

The Committee met, pursuant to call, at 2:10, p.m., in Room 2172, Rayburn House Office Building, Hon. Henry J. Hyde (Chairman of the Committee) presiding.

Chairman HYDE. The Committee will come to order. I take great pleasure in convening this hearing on the United States-China economic relations in the context of the ongoing Asia Pacific Economic Cooperation Leader Summit in Bangkok.

President Bush will have the unique opportunity to advance both our security and our trade interests in the Asian region as a whole, and with China in particular. As many of my colleagues are well aware, our view of China has swung nearly full circle, from strategic partner to strategic competitor, from collaborator to antagonist, over the course of the past 2 decades.

But, in the aftermath of September 11th, our relationship has shifted course once again in a more positive direction.

China has played a constructive role in building consensus inside the U.N. Security Council in the deliberations over Iraq and the passage of key resolutions supporting the reconstruction of that country.

Its mediation efforts in regard to North Korea have, over the past few months, been of invaluable assistance to our diplomats as they try to ease tensions in northeast Asia and reduce the threat posed by the development of weapons of mass destruction.

Where trade and security concerns intersect in safeguarding international commercial traffic, we look forward to China's constructive role in the proliferations security initiative, the container security initiative, and other anti-terrorist counter-proliferation measures put in place by the Bush Administration.

On the trade front, the pace of globalization and the dynamism of the Chinese economy are reflected in the fact that, last year, China attracted more foreign direct investment than any other country in the world, including the United States.

This year, Chinese imports are expected to surpass $380 billion, making China the third largest importer after the United States and Germany. It is rapidly becoming a major importer of industrial goods, and it has now surpassed Japan as the world's leading source for information products and high-tech hardware.

There are however, increasing storm clouds on the horizon in our bilateral economic relationship. China's overvalued currency and our ballooning trade deficits are getting increased attention in Congress.

Many United States policy makers and business and labor representatives believe that China's currency is undervalued when compared with the dollar by as much as 15 to 40 percent, making Chinese exports into this country cheaper and our exports more expensive than they would be if exchange rates were determined by market forces.

They point out that the undervalued currency has contributed to our trade deficit with China, which has grown sharply from $30 billion in 1994 to $103 billion last year to an estimated $130 billion this year, which has hurt United States production and employment in several U.S. manufacturing sectors.

The National Association of Manufacturers also reports that several industries, including tool-and-die and metal forming, are competing against Chinese products sold at prices so low they don't even cover the cost of raw materials and shipping. These and other charges of export subsidies, particularly in the Chinese steel industry, need further investigation by appropriate government agencies.

China's rapid emergence as a major force in the world economy is all the more remarkable in light of its very high tariff barriers on industrial products, higher on average than those maintained by India.

After 18 months of membership in the World Trade Organization (WTO), China still retains a number of trade barriers in contravention of that body's key principles.

According to a 2003 *White Paper* written by the American Chamber of Commerce in China and the American Chamber of Commerce in Shanghai, has complied with its WTO obligations in lowering tariffs and changing hundreds of laws and thousands of government regulations. However, there has been little progress in implementing World Trade Organization commitments in the key areas of financial services, agriculture, and distribution and trading rights.

A recent Heritage Foundation background, *The APEC Forum: Time to Make a Difference*, reached a similar conclusion that China is not fulfilling its WTO accession commitment.

It notes that there are substantial barriers to United States agricultural exports, rampant piracy of intellectual property, forced transfer of technology from firms launching joint ventures in China, and capital markets largely insulated from free-market pressures, with China largely ignoring its commitments to allow foreign banks to compete in its financial services market.

To be sure, China can point to a number of extenuating circumstances affecting its ability to meet its international trade commitments. The SARS epidemic, for example, created short-term economic disruption inside the government and in many companies in the first half of this year.

There have been changes as well in the leadership of the Chinese Communist Party and of the national government, including the establishment of a new ministry of commerce with authority over domestic and foreign trade.

It should be said that a number of large United States firms are now profitably operating in China and exporting globally, including into the U.S. market. Nevertheless, there is a growing need to address problems in our relationship before they reach crisis stage. Some of the possible remedies should include the following steps:

First, the APEC ministers should ensure that all members respect and fully meet their WTO commitments and redouble their efforts to conclude a successful Doha Trade Round.

Second, China needs to take decisive and immediate steps to meet its existing commitments as a member of the World Trade Organization. Failure to implement its commitments could not only jeopardize our bilateral relationship, but could also affect our future support for the global trading body as a whole.

Third, the United States and China must develop a plan to ensure that market forces more fully dictate the relative value of our currencies.

Fourth, the U.S. Commerce Department's International Trade Administration, together with all other appropriate United States and Chinese agencies, should develop an action plan to increase the growth rate of United States exports to China, particularly from small and medium-sized companies.

Fifth and finally, an interagency task force should review all aspects of our trade and commercial relationship with China to ensure that China is taking adequate steps to meet its WTO commitments and other obligations under United States trade laws.

On a wide range of security and political issues, the United States and China are working effectively, side by side, to frame a common position to global and regional threats. We cannot afford to do any less when it comes to putting our trade and commercial ties on a long-term, sustainable basis.

[The prepared statement of Mr. Hyde follows:]

PREPARED STATEMENT OF THE HONORABLE HENRY J. HYDE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF ILLINOIS, AND CHAIRMAN, COMMITTEE ON INTERNATIONAL RELATIONS

I take great pleasure in convening the hearing this afternoon on U.S.-China economic relations in the context of the ongoing Asia-Pacific Economic Cooperation (APEC) leaders' summit in Bangkok, Thailand.

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Fifth and finally, an interagency task force should review all aspects of our trade and commercial relationship with China to ensure that China is taking adequate steps to meet its WTO commitments and other obligations under U.S. trade laws.

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There are several compelling issues in Sino-American relations which also need to be addressed by this Committee. These will be examined at a future hearing.

I would now turn to my friend, the Ranking Member, Mr. Lantos, for his opening statement.

Mr. LANTOS. Thank you very much, Mr. Chairman.

Yesterday, on the Floor of the House of Representatives, it was my pleasure to express the delight of all of us on this side of the aisle that you have decided to continue your distinguished service in the House of Representatives. Let me, in the Committee, now again publicly express my extraordinary pleasure in looking forward to serving with you for many more years on behalf of our Nation. You have brought great statesmanship with wisdom and diplomacy to this very difficult task, and all of us are deeply in debt.

Chairman HYDE. Mr. Lantos, if I had any idea you were going to say such words as you just said, I would have cut my speech in two. But I thank you from the bottom of my heart. That is very nice. Thank you, sir.

Mr. LANTOS. Thank you, Mr. Chairman. Thank you for calling today's hearing on United States-China economic and trade matters.

Mr. Chairman, I have been traveling to China for decades, and I am pleased to be counted as one who appreciates China's post-Communist economic revolution. In 20 short years, hundreds of millions of Chinese citizens have been lifted out of poverty. China's cities have been transformed from economic backwaters to powerhouses in the global economy. And economic development has spread across some of China's vast agricultural areas.

Despite their horrendous performance on political and human rights matters, two generations of Chinese leaders have adeptly steered the Chinese economy to bring prosperity to many of China's 1.2 billion citizens. I wish our own Nation's economic team would demonstrate similar leadership skills.

As Americans have flocked to Wal-Mart to buy products manufactured in China, the Chinese government has resolutely closed its doors to purchases of American products and services. These formal and informal trade barriers, including the manipulation and undervaluation of China's currency, have contributed to the loss of 3 million manufacturing jobs in America in recent years.

Mr. Chairman, the business community told us that permanent normal trade relations and China's subsequent succession to the World Trade Organization was a magic bullet for market access to China. Perhaps a decade or 2 from now, these leaders will recognize that success finally came. But for now, China's entry into WTO has yet to have any positive impact upon our bilateral trade deficit. In fact, a quick look at the numbers tells us that the problem is getting worse. Four years ago, Mr. Chairman, the bilateral trade deficit that the United States had with China was about $70 billion. Last year, the deficit had grown to $103 billion, and this year I estimate that it will be between $120 and $130 billion.

It is simply impossible for American manufacturing workers to compete against China as long as Chinese businesses operate without regard to international labor and environmental standards. China's leaders adamantly refuse to grant workers the right to organize freely into independent unions. In fact, 2 brave workers who organized street demonstrations in northeastern China last year in which some 30,000 citizens turned out on the streets to protest China's management of state-run enterprises, were unceremoniously tossed into jail. Today, I call on China's leaders to release these two courageous leaders of Chinese labor, and allow them to return to their jobs and to their families.

Chinese enterprises will always be able to underbid their American counterparts as long as China refuses to enforce its environmental standards. When polluted industrial waste can be discharged directly into waterways and dumped by the side of the roads, China's factories will always be able to produce at a fraction of the cost of American companies.

Mr. Chairman, given the devastating impact of the yawning China trade deficit on our workforce, the Administration must develop a much more effective and forceful trade strategy vis-a-vis China. We must use our market leverage and diplomatic skills to convince China not only to meet its WTO obligations but also to comply with internationally recognized labor and environmental standards.

While I recognize that our Administration cannot wave a magic wand at the trade deficit and wish it away, I believe that the efforts made by the Administration to protect American jobs from the Chinese economic juggernaut are dramatically insufficient.

Before concluding my comments today, the presence of a high-level Commerce Department official in the room today compels me to raise a matter of utmost concern. Commerce Secretary Don Evans' mind-boggling reaction on Sunday to the virulently and viciously anti-Semitic remarks of Malaysian Prime Minister Mahathir. As everybody in this room knows, everybody in the United States and the world knows, Prime Minister Mahathir recently proclaimed in a speech that "Jews rule the world," and asserted that "1.3 billion Muslims cannot be defeated by a few million Jews." Such hate-filled statements, particularly from a national leader, should be met consistently and immediately with universal condemnation.

But when Commerce Secretary Don Evans appeared on CNN on Sunday, a tape was played of Mahathir saying, I quote:

> "The Europeans killed 6 million Jews out of 12 million, but today the Jews rule this world by proxy."

Instead of expressing outrage at such hate-filled venom, Secretary Evans responded, and I quote, he didn't "know all of the details behind" Mahathir's remarks. And then elaborated, I quote again:

> "Everybody in the world wants the same thing; we all want to put a roof over our family's heads, we all want to feed our children."

Mr. Chairman, Secretary Evans' response to Mahathir's comments can only be described as hallucinatory. Any member of the

President's cabinet, regardless of his or her portfolio, ought to be able to recognize hate speech when he hears it. I would like to ask Under Secretary Aldonas to hand-carry a letter from me to Secretary Evans expressing my outrage not only at Mahathir's sickening statement, but at the appalling response of the Secretary. I am asking from the Secretary a public apology.

Mr. Chairman, I commend you for calling today's hearing, and I look forward to the testimony of our witnesses.

Chairman HYDE. Does anybody have an opening statement?

Mr. Sherman.

Mr. SHERMAN. Thank you, Mr. Chairman. I would like to echo what Mr. Lantos said, starting off with his great joy that you will be seeking to serve with us in the 109th Congress. The expertise and judgment that you bring to this Committee will make you an outstanding Ranking Member.

I want to echo Mr. Lantos's comments, and the Secretary should regard many of us as endorsing the letter that he is giving to the Under Secretary.

Now, focusing on China. There are four reasons that I have been able to identify why we have the most lopsided, I would say, cancerous trading relationship, a $120 or $130 billion deficit. I have never seen a trading relationship where the imbalance is 10 times the American exports.

In other words, if we doubled our exports, it would still be a lopsided and cancerous relationship. This is outrageous. As Mr. Lantos points out, it comes in part from the fact that labor and environmental laws are ignored and are nonexistent in China. I would go on about that except Mr. Lantos covered it so well.

The dollar is massively overpriced worldwide compared to all currencies, and that is one of the reasons why we have a half trillion dollar deficit with the world. And if the dollar does not slide, it will plummet. Let us hope that the recent little hints from the Administration that the dollar should decline will become slowly—because you shouldn't do this all at once—a dramatic crescendo, probably next year, year after, calling for a realignment of the dollar's value.

But then you look at the yuan currency of China, which we know is underpriced by 40 percent, and it is absolutely outrageous that we continue to allow imports to enter our ports for a single day without a commitment from China to change that by the end of the year.

And then, finally, and usually not remarked upon, is the political pressure sometimes almost hinting on a threat of death to those Chinese business people who might want to import goods from the United States in quantities that their government would not like to see. Imagine, if you will, that you are a business person in China thinking of buying from America. You get a telephone call suggesting that a well-educated person such as yourself would not choose to buy goods from America. After all, you are well educated, and you would hate to think that you needed reeducation. But nothing can explain this lopsided trading relationship other than political pressure not to buy American goods. And, of course, it is not a violation of WTO, because WTO only makes written pressure from the government a violation. The secret phone call can never be the subject of a complaint.

The more public version of this is in co-production. Look at our major exports to the world. Entertainment, we don't export to China, they just steal it. Airplanes, well, Boeing gets a coproduction agreement so that they will eventually be exporting more parts back to us than we sell planes back to them. And every day our ports operate under this Administration, every day you tolerate this. Every day, you tell us it is good. And when toward the end of this decade there is a collapse of the U.S. trading system because of what you have accepted, we will remember we just let it happen $120 billion at a time. And I yield back.

Chairman HYDE. The gentleman from Indiana, Mr. Burton.

Mr. BURTON. Well, I wasn't going to comment on this, but we had a similar problem—the previous speaker, I wish he would listen to this. This is not a problem that is germane just to this Administration. The previous Administration for 8 years tolerated the same thing. So don't cast rocks at this Administration——

Mr. SHERMAN. Oh, I can throw a lot of rocks at the last Administration, too.

Mr. BURTON. I just want to make sure that that is clear.

Mr. SHERMAN. But the problem is now bigger.

Mr. BURTON. You are absolutely correct. It is bigger, and we have got to deal with it. There has to be not only free trade, but there has got to be fair trade. I noticed that the President, in some of his most recent speeches, instead of talking about free trade, I heard him say the word "fair" as well. And I think it is high time that the Administration starts talking about fair trade. And when we are talking about fair trade, we are talking about making sure that the labor in places like China is not artificially held to such a level that we can't compete.

In addition to that, they still have 10 million people in slave labor camps that are getting virtually nothing, and they are making products that we are buying here in America.

The fact of the matter is, it is intolerable that we would have a trade deficit of the magnitude that we have with China. And our government, whether it is this Administration or a Democratic Administration, has to deal with this. And I realize that there is risk in putting the hammer to the Chinese, but something has to be done. It has to be done, and it has to be done relatively quickly; otherwise, we are going to suffer the consequences.

One of the emerging huge powers in this world is China. And if we are not careful, we are going to be ending up subservient to them in 20 or 25 years because we are not dealing with these problems as we should right now.

I think it is extremely important for a number of reasons that we start dealing with them with a much stronger hand than we have in the past. If it involves import tariffs on some of their products to send a message, then we ought to consider that. Teddy Roosevelt, when he was President, believed in some protectionism in order to protect the American economy, and he was a pretty darn good President, and I think we ought to consider that same approach right now because we can't go on with this indefinitely.

Thank you, Mr. Chairman.

Chairman HYDE. Is there anyone on the Democratic side who has an opening statement? If not, Mr. Smith of Michigan.

Mr. SMITH OF MICHIGAN. Mr. Chairman, thank you.

The valuation of a currency of a company of a vetting country, of course, has both positive and negative consequences. I would offer the question, how would America react if China said everything we produce we will give free to the United States. I am sure a lot of good shoppers in America would say well, gosh, that seems like a pretty good deal, in effect, having a yuan that may or may not on the free market go up or down, and some economists suggest that it could very well go down on a free market, which would make the consequences even more negative in terms of the impact on our manufacturing.

So, Mr. Chairman, I guess I would be as much, maybe even more concerned with the restrictions on trade such as phyto-sanitary, such as the tariff rate quota, such as the advantages that China has in some goods by using forced labor. And so I think all of these together I hope that we will take up at this hearing today. And make no mistake, in past history, both recent and far past, the United States has had some effort to do some manipulation on the value of our currency to make a difference in our exports and imports.

So with that, Mr. Chairman, I would ask that my complete statement be entered in the record at this point, and I look forward to the testimony.

Chairman HYDE. Without objection, so ordered.

[The prepared statement of Mr. Smith follows:]

PREPARED STATEMENT OF THE HONORABLE NICK SMITH, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN

Mr. Chairman, as we meet here today, we are all, of course, aware of the public and Congressional concern over Chinese trade practices that we fear may be costing us American manufacturing jobs. We have many concerns regarding Chinese utilization of forced labor, lack of environmental safeguards, and use of tariff-rate quotas and phyto-sanitary obstructions to block the sale of American agricultural goods. Most recently, however, our attention has been focused on the Chinese government's policy of undervaluing currency.

It is through this practice, that we accuse the Chinese of boosting their exports and reducing the importation of American goods. The fixed Chinese exchange rate, however, is only one of many factors affecting US-China competitiveness. More fundamentally, it should be recognized that China is a low wage emerging economy that focuses on export-led growth by specializing as a leading processing center for other countries. The IMF estimates that half of China's exports are from foreign owned firms.

Still, regardless of the reasons, American manufacturing job loss is a major concern. While manufacturing accounts for a larger share of the total jobs lost since the recession than in the past, its not clear whether these losses are cyclical, due to the business cycle and the collapse of the high tech bubble, or due to other factors. Manufacturing's share of total US employment (21% in 2002) has been declining for several decades due to fundamental economic forces: changing technology and a greater specialization into research, design, and utilization of products—not just building them. While currency manipulation may play a part in our current manufacturing woes, it is a minor factor of a more complex dilemma.

Even within this limited scope, the beneficial effects of an undervalued yuan for the U.S. are often not mentioned. American consumer purchasing power has increased as a result of lower-priced imports that has reduced inflation and spurred competition. US producers have become more competitive through the importing of less costly Chinese capital equipment and component parts. US borrowers have benefited from lower interest rates and higher investment spending created by Chinese purchasing of U.S. Treasury securities. As interest rates are lowered, our government's interest payments are lower and spending in interest rate sensitive sectors is similarly increased. Though overlooked, these are the positive side-effects of the Chinese policy.

But how significant are these benefits? On net, the Congressional Research Service says in a report that:

"Nationwide, these effects *{beneficial effects on consumption, interest rates and investment spending}* should offset job loss in the trade sector, at least in the medium term . . . It *{an undervalued yuan}* is expected to have no medium or long run effect on aggregate US employment or unemployment . . . some areas will gain while others will lose. And by shifting the composition of US output to a higher capital base, the size of the economy would be larger in the long run as a result of the capital inflow/trade deficit." [CRS report RS21625, September 29, 2003, italics added.]

Mr. Chairman, thank you for opening up this important hearing regarding the trade relationship between the U.S. and China. As we explore this issue, I would encourage us to take an objective look at all the implications of these trade-distorting measures. It is only with a balanced look that we can positively impact the future for our economy without picking winners and losers among our constituents.

Chairman HYDE. And I would like to welcome the Honorable Grant Aldonas to our Committee this afternoon. Grant Aldonas was confirmed as Under Secretary for International Trade Administration at the U.S. Department of Commerce on May 10, 2001. Prior to joining the Commerce Department, Under Secretary Aldonas served as Chief International Trade Counsel to the Chairman of the Senate Finance Committee, helping to pass significant trade legislation.

While working as a partner with the law firm Miller & Chevalier, Mr. Aldonas served as Counsel to the Bipartisan Commission on Entitlement and Tax Reform, and as an advisor to the Commission on U.S. Pacific Trade and Investment.

We welcome you, Mr. Under Secretary. And please proceed with a 5-minute summary. We shall be flexible. Your full statement will be made a part of the record. Mr. Secretary Aldonas.

STATEMENT OF THE HONORABLE GRANT D. ALDONAS, UNDER SECRETARY, INTERNATIONAL TRADE ADMINISTRATION, U.S. DEPARTMENT OF COMMERCE

Mr. ALDONAS. Thank you, Mr. Chairman, and Mr. Ranking Member. And I just want to say, Congressman Lantos, that I know whenever Secretary Evans says we all want the same thing, he was speaking in general terms, and certainly wasn't endorsing the Prime Minister's, what I would regard as horrific comments.

Mr. LANTOS. With all due respect, he should have denounced them and expressed his outrage, and to express hallucinatory observations is an unacceptable response for a Secretary.

Mr. ALDONAS. I appreciate what you are saying, and I will convey those thoughts directly to the Secretary.

Mr. LANTOS. I thank you.

Mr. ALDONAS. I do want to make the point, that certainly from our perspective, the statements of Prime Minister Mahathir are equivalent to pouring gasoline on a fire right now, given the situation in the world. Not only are they abhorrent, but completely uncalled for under the circumstances, particularly in the setting in which he was speaking.

I would like to turn to the topic at hand, if I could, Mr. Chairman. It is an incredibly timely hearing, both because of the nature of our trading relationship, but equally important because of what is going on in the U.S. manufacturing sector. And I want to touch on both as a part of my discussion today.

The other thing I want to underscore is that we are in the midst of what I would describe as a 3-month dialogue with our Chinese counterparts about precisely these issues. And there is no doubt that the level of interest expressed by the Committee, this Committee in particular, in our relationship with China and our economic relations is incredibly important at this time. And I know when I will be traveling to Beijing this coming week I will make use of the vigor of the Committee's statements in terms of our discussions with the Chinese.

That dialogue that has been going on has been taking place at the highest levels. President Bush will meet with President Hu this week in Thailand on the margins of the APEC summit. Treasury Secretary Snow laid the groundwork for that visit with his visit to Beijing in late August. Ambassador Zellick will follow the President's meeting with a session to Beijing on our trading relationships. Secretary Evans and I will be in Beijing next week to discuss the same set of issues. And this will wrap up with Premier Wen's visit to the United States in late November, early December, as well as an annual meeting, the meeting of the Joint Commission on Commerce and Trade in December.

We expect that—from the Chinese, frankly, we have for a very long time, I think, both Congress and the Administration in the first year of China's implementation of its WTO obligations have been extraordinarily patient, but the time has come to measure up as a practical matter. So the weather is definitely changing in terms of the context of our economic relationship.

The stakes are high. As a number of the statements have pointed out, China has become our fourth largest trading partner, although China's trade is in rough balance with the world as a whole. United States exports to China are growing faster than any other market. China, nonetheless, currently runs a $100 billion heading toward a $120 billion trade surplus with the United States. The reason for that seeming inconsistency, in my view, is the rise in China as the final assembly point for much of what we used to import from Asia as a whole.

There is an obvious upside to China's growth. The economic policies that they have pursued over the last 20 years have pulled 200 million people out of poverty, which means there is about 900 million to go. A lot of their policies are driven toward maintaining employment, encouraging sectors that involve manufacturing because it is employment they want to see. They have their policies. I think our job is to make sure that we are very clear about what the lines are in terms of the trading system.

Now, having said that, their policies do translate into an expanding market for goods and services. The fact that China's trade is in balance overall, although it is running a huge surplus with the United States, reflects the fact that there is a rising level of import demand.

And I do take some exception to Congressman Sherman's statement simply because our exports have grown on the order of 21 percent in the first 8 months of this year, and that falls on roughly similar sorts of growth in the last 2 years since the WTO agreement. What that reflects, in my view, is that the WTO agreement at least on paper is an enormous success, knocks down many of the barriers to entering China's market. Today, the tariff rates that China imposes are lower on average than much of the rest of the developing world and, in fact, lower in some instances than our developed country trading partners. The WTO agreement obliges China to protect the intellectual property of the United States manufacturers and service suppliers.

It also eliminated of the barriers to the free distribution of American goods in the Chinese economy. But what has become clear, both in economic and political terms, as we move deeper into the second year is that we now need to see actual enforcement of the laws and enforcement of the rules in other areas.

The gains from trade—and this is probably the more fundamental point than even the WTO rules—the gains from trade come when we trade between economies and we gain from the benefits that comparative advantage yields. But where one economy is organized on principles that are inconsistent with that of the free market model, it can cause an enormous amount of injury and friction within our trading relationships. And that, in my view, is the current situation in China.

Fundamentally, China has changed from a nonmarket economy to one that operates fully on market principles; and it is far from complete. Whereas United States companies face continuing pressure from our capital markets to turn a profit, that pressure simply does not exist in many instances in China. It is time for that to end. There is no reason, given its relative competitiveness, that its industry needs that kind of support either in China or in other Asian countries where we still have these same problems. It is precisely these sorts of practices that are so injurious and lead to the concerns of our manufacturers about the fact that there is not a level playing field internationally. It also undermines, I think, the support in the country, particularly from our manufacturing sector for a trade liberalizing agenda, as I know you pointed out, Mr. Chairman, and as did the Ranking Member.

That is why one of the most forward leaning recommendations we tend to make regarding our trade is the establishment of an office within the Commerce Department, the sole function of which would be to investigate these sorts of practices. Traditionally, under the trade laws the way Congress has set those up, we will wait for a petition and industry will have to prove that they are injured before they could come in and request relief. And, in my view, it is not a question of requesting the relief. We in the Commerce Department should be acting on a proactive basis, identifying the problems and sorting these things out with our trading partners; and only if we fail at that should we have to resort to something like imposing prohibitive tariffs on commodities coming into the United States. I would rather try to solve the problem positively if we can.

We will vigorously pursue China's compliance with its WTO commitment and will enforce our domestic unfair trade laws rigorously. As both President and Secretary Evans have made clear—and Congressman Burton, I know you noted the rhetoric in the President's speeches. And I just want to confirm that, in fact, that has been a part of his rhetoric since the campaign, as a practical matter, because there is no doubt that in this trading system, we have always put a little more on the table than other people in terms of opening up our market to keep the system moving. There is a point in which the bill comes due, and we are at that point now, frankly.

That was reflected in many of the proposals we took into the Doha Round and into Cancun where we are really asking for the developing world and China in particular to reduce their tariffs to United States levels before we all went to zero. We were willing to go that far, as was our manufacturing sector, but really, it is time that the rest of the world measures up as well and addresses some of the imbalances in the trading system.

Now, I want to spend a little bit of time with what time I have remaining, Mr. Chairman, on the President's manufacturing initiative, because it provides a context for much of our discussions in terms of our trade with China.

In March of this year, Secretary Evans, during Manufacturing Week in Chicago, announced the initiative. He directed me at the time to undertake a 6-month inquiry into the challenges facing our manufacturers, and what we did was conduct 23 roundtables across the country with virtually every manufacturing industry with businesses from very large to very small to identify the challenges. And what I most want to focus on, frankly, and particularly with this Committee, is one salient point that I think came out of it, and it was probably reinforced for me most a couple of weeks ago when I was in Maine.

Senator Snowe was chairing a field hearing of the Senate's Small Business Committee, which she chairs. And in the discussion, she had Pam Olson, the Assistant Secretary of Treasury and me on the first panel; the second panel was a group of seven manufacturers. And while much of the discussion did focus on China and did focus on international trade, when Senator Snowe put the question to every member of the manufacturing panel and asked them what the one single thing was that the United States Government could do, every one of them identified a domestic economic policy choice that is in front of Congress right now.

My point in saying that is I think the time has come where we have to understand that in a global economy, that there is no domestic economic policy choice we make that doesn't have implications for the competitiveness of our manufacturing sector. And probably the single most important message that I took away from the roundtable, the 23 discussions across the country, was increasingly the need in global economy to think about all choices we make, whether they are on trade policy, whether they are on energy policy, whether they are on tort reform, through the lens of competitiveness of our manufacturing sector on a global basis.

Now, in addition to that, the concerns that have been registered here were registered by manufacturers, whether it was about exchange rates, whether it was about trade practices. It was an important part of the dialogue, I think, to understand and underscore for them the degree to which we have tried to tackle these things inside the Administration. I thought it was helpful for the manufacturers to understand that of the many dumping cases that have been taken up by this Administration, fully 50 percent of them or more are against China. It is where there is an awful lot of friction in the trading system right now. And the goal has to be to go after those trade practices as aggressively as we possibly can. And I am willing to stand on our record in that respect.

We will be issuing a report I hope in November, which will include the recommendations. It certainly will include some things that bear on discussions that we have had here in the past with respect to our export promotion programs, Mr. Chairman. We have always appreciated your support and the Committee's support on a bipartisan basis of what we are trying to do. China represents some unique challenges, and I think we are going to work hard together to try and meet those challenges. Increasingly, when we think about promoting exports, we are going to have to think not so much about exporting to geographic destinations but exporting into global supply chains so that if you are a participant as a component manufacturer, you may not export directly, but your livelihood may well depend on your ability to satisfy Caterpillar's needs. We may increasingly have to think about exporting to Toyota as opposed to exporting to Japan, because Toyota will take our component suppliers globally. As a matter fact, that is the nature of competition today.

That is a flavor of some of the things that have come up in our discussions, and I will be following through. Let me stop there, because I definitely want to get to your questions, Mr. Chairman.

Chairman HYDE. Thank you, Mr. Aldonas.

[The prepared statement of Mr. Aldonas follows:]

PREPARED STATEMENT OF THE HONORABLE GRANT D. ALDONAS, UNDER SECRETARY, INTERNATIONAL TRADE ADMINISTRATION, U.S. DEPARTMENT OF COMMERCE

Mr. Chairman, thank you very much for inviting me to participate in this hearing to discuss the "U.S.-China Ties: Reassessing the Economic Relationship." The topic is particularly timely since it comes in the midst of an ongoing dialog with our Chinese counterparts about our economic relationship in general and our trade relationship in particular.

That dialog is taking place at the highest levels. President Bush met with President Hu a few days ago in Thailand at the Asia-Pacific Economic Cooperation summit. Treasury Secretary Snow laid the groundwork for those discussions with his visit to Beijing in late August. Ambassador Zoellick is also in Beijing this week. Secretary Evans and I will travel to Beijing next week. Those discussions will culminate this year with the visit to Washington of Premier Wen and the annual meeting of the Joint Commission on Commerce and Trade, also here in Washington, in December.

I appreciate the opportunity to appear before the Committee for another reason as well. It offers me the chance to review with the Committee some of our findings from the six-months of more than 20 roundtable discussions the Department held with U.S. manufacturers, both large and small, across the country. In particular, it offers the chance to put our trading relationship with China in an appropriate context among the other issues raised by U.S. manufacturers due to their impact on our industrial competitiveness.

The Economic Context

Let me start by setting the economic context for discussing both the health of our manufacturing sector and our trade relationship with China. I want, first, to take the argument that American manufacturers are weak and being "hollowed out" head on. They are not. We have the strongest, most dynamic manufacturing sector in the world. While focusing on the legitimate concerns raised by our manufacturers, we tend to forget that the United States remains far and away the largest producer and exporter of manufactured goods in the world. Standing alone, our manufacturing sector would rank as either the 4th or 5th largest economy in the world. Far from being hollowed out, our manufacturing sector is, in fact, larger than the entire economy of China.

For those of us old enough to remember many of the industrial policy debates of the 1980s, we recall that the issue, in the face of an onslaught of Japanese imports, was the decline in American productivity. The debate recognized that a healthy manufacturing sector is critical to the U.S. economy not only because it currently makes up 14 percent of our gross domestic product and 11 percent of total employment, but also because of the innovations that it creates that allow us to be more productive. Even the severest critics of President Bush's economic policies acknowledge that productivity is a key measure of our manufacturing sector's and our economy's health. Paul Krugman, for example, put it this way—

> Productivity isn't everything, but in the long run it is almost everything. A country's ability to raise its standard of living over time depends almost entirely on its ability to raise output per worker.

How do the U.S. manufacturing sector and our economy measure by Krugman's standard today? In fact, productivity is higher today than it was even during the late 1990s when everyone was glorifying the "new economy." The U.S. manufacturing sector's hard won gains in productivity, and the policies that we have adopted to reinforce them, allowed the United States to reclaim the top spot in the World Economic Forum's 2002–2003 rankings as the most competitive economy in the world.

Having said that, there is no doubt that our manufacturers face a uniquely challenging competitive environment today. The combined effects of rapid changes in communications and transportation technology have made more trade possible just as trade barriers have been falling worldwide and the end of the Cold War ended the decades-old division of the world economy. That has meant continuing pressure on pricing power and profit margins due to the excess capacity on the market for manufacturers worldwide, not just in the United States. A week ago, the Wall Street Journal reported on the decline in factory employment worldwide. For purposes of this hearing, it is probably useful to contrast the roughly 11 percent decline in manufacturing jobs from 1995 to 2002 against the more than 15 percent decline in manufacturing employment in China.

What is different for U.S. manufacturers is the fallout from several macroeconomic events that have flowed through the trade accounts. Starting with the Asian financial crisis in 1997, U.S. exports of manufactured goods have faced a considerable slow down in foreign demand. The fact that major trading partners like Germany and Japan, which still make up over 20 percent of the world economy, fell into recession at roughly the same time as the United States meant that they could not act as a counterweight when the U.S. economy fell into recession in late 2000. Significantly, the recession in manufacturing began 10 months earlier in the 1st Quarter of 2000. What that meant, as then-Secretary of Treasury Lawrence Summers said, was that the "[w]orld economy is flying on one engine," and that engine is the United States. The net effect was upward pressure on our trade deficit.

Fortunately, as the stimulus of the 2001 and 2003 tax cuts have begun to kick in, the U.S. economy has returned to a vigorous rate of growth—3.3 percent in the second quarter of this year and the pace of economic activity, according to most private sector economists' estimates, appears to have accelerated since then. It now appears that manufacturing, after many months of very slow growth, is beginning to participate in that broader economic recovery. Durable goods' orders have been up generally, although down in August. And, the Purchasing Manager's Index, a key indicator of future economic growth, is now consistently above the level that means stronger growth ahead.

Even on the unemployment front, there are signs of job growth consistent with a stronger economy. The most recent figures reflect that unemployment claims are falling and the Labor Department's household survey, which generally picks up on job growth faster than its survey of employers, shows rising employment. Just to put that in perspective, virtually all economists agree that due to rapid policy responses, the recession was shallower than most and unemployment, with the exception of a rise to 6.3 percent in June of this year, generally stayed within 5.5 and 6 percent throughout the recession and the early stages of the recovery. Not long ago, according to an article in the Wall Street Journal, then-President Clinton was encouraging this Committee to take a hard look at our unemployment insurance programs on the grounds that we were at full employment by historical standards—at the time President Clinton made that statement, unemployment stood at 6.8 percent.

Having said that, I want to reiterate, as the President has, that the Administration is committed to working towards an economic climate where everyone that wants a job has one. And there is an important story to tell about the unemployment figures in manufacturing. The job losses began in 2000 when, as I noted, the manufacturing sector entered into a recession about 10 months earlier than the economy as a whole. The economy was just beginning to cope with the effect of a sharp drop in business investment as industry pulled back from a period of heavy investment in technology. Not surprisingly, the industries with the most significant job losses in manufacturing are precisely those industries—telecommunications equipment and computing—that benefited most from the boom in investment related to the "dot.com bubble" of the late 1990s and then fell when that bubble burst and the stock market began to decline sharply.

What has surprised most economists has been the fact that manufacturing continued to shed jobs deep into the recovery of the economy. Employment in manufacturing has been declining for decades as productivity gains have significantly reduced the number of worker-hours needed to produce a given product. In the last 15 years, in particular, those gains have averaged 3 percent or more, demand for manufactured goods has grown less than that amount, and employment in manufacturing has fallen commensurately. Some share of the recent reduction in manufacturing employment during the initial stages of the recovery and expansion is directly attributable to the efforts of manufacturers to cut costs and raise productivity. Under considerable competitive pressure, American manufacturers are finding ways to do more with less. And, the labor market is responding by shifting jobs to other industries where growth in demand outstrips rises in productivity.

With that as context, I want to focus on the link between the competitive pressure that has driven American manufacturing to pursue those productivity gains and what is going on in the international environment, particularly with respect to our trade with China and its emergence from a fully state controlled economy to become a major force in manufacturing globally.

On the international front, one of the most frequently cited statistics is our trade deficit, which has been growing overall and particularly with China. Although the trade deficit is often thought of as an indicator of our competitiveness, it is better understood as a reflection of the relative growth in our economy compared to our trading partners. Perhaps the best example comes from the 1991–92 recession, when the trade deficit contracted sharply. No one would suggest that the decline in the trade deficit was due to a further opening of world markets to U.S. exports—neither the NAFTA nor the Uruguay Round of multilateral negotiations were yet complete at that stage. Nor had Japan, which saw the greatest decline in its trade surplus with the United States, suddenly opened its economy to U.S. goods and services. Instead, the decline in the deficit was directly attributable to the differences in the rates of growth in the U.S. economy and the world economy as a whole, Japan's in particular.

In past recessions, continuing growth abroad mitigated the effect of the U.S. recession on our manufacturers. In the most recent recession, that did not happen. The data behind the trade deficit bear out the effects of differences in economic growth rates between economies. In eleven of the last twelve years, US economic growth has outpaced that in Japan, Germany, and the European Union. What's more, slow growth among our leading trading partners is not new. Japan's economy, which still represents close to 2/3 of the gross domestic product of Asia, has barely grown for a decade. Germany's economy has not grown appreciably in three years. On top of that, the rest of Asia, with the notable exception of China, has presented a very mixed picture in terms of economic growth since the onset of the Asian financial crisis in 1997. While some economies have recovered, others have not. And, these are markets that were once among the fastest growing in the world B markets that had become significant consumers of the sorts of advanced technology capital goods that our manufacturers sell.

What that should tell us, both in terms of the economy as a whole and the manufacturing sector in particular, is that perhaps the most significant single action we could take is to step up encouragement of our trading partners, particularly Japan and Germany which together make up 20 percent of the world economy, to jettison their anti-growth policies and to adopt policies that are designed to boost economic growth. We need to preach what we practice because the alternative to growth is always a zero-sum game of dividing up the existing pie, and that leads directly to the sort of strains we are seeing now in our trade relationships.

But, those statistics also bear on our economic relationship with China in two respects. First, it is clear that China's extraordinary growth—currently estimated to grow 8.6% this year and another 8% in 2004—has helped our manufacturers in that it has provided a source of foreign demand that would not otherwise exist in today's world economy. It is worth underscoring that, for U.S.-based automotive companies, earnings in China may well be the difference between profitability and losses. That has a very human dimension that I do not want us to lose sight of in our discussions on China—growth there right now is one of the reasons our automobile companies can continue to keep their U.S. workers employed and to pay the pension benefits they have guaranteed their retirees.

Our Trade Relationship with China

Which leads me to China. In the more than 20 roundtables the Department held with manufacturers across the country over the past six months, there was no single topic that garnered more attention than China, its emergence from state-imposed economic isolation to become a major center of manufacturing, and our trade with China. The Chinese have made considerable progress over the last two decades in lifting more than 200 million people out of poverty by relying ever more heavily on the market to direct resources within its economy.

The stakes involved are high. China is our fourth largest trading partner. Bilateral merchandise trade reached $147.2 billion in 2002. Last year, China overtook Japan to become our third largest source of imports. In July of this year, China surpassed Mexico to become our second largest source of imports. Our imports from China are more than five times greater than our exports. The bilateral trade deficit hit $103 billion in 2002 and reached $65 billion in the first seven months of this year.

A large share of what we now import from China used to be imported from other Asian countries. China's role in the restructuring of global manufacturing is that of the final assembly point for most Asian electronic equipment destined for the United States China becomes the exporter of record before would have been export to the United States from other Asian countries. What that means in practical terms is that it would be more appropriate to look at our trade account with China as an indicator of our competition in manufacturing across Asia, as opposed to the rise of Chinese manufacturing alone.

There is an obvious upside to China's growth and the benefit the Chinese derive as investment in Asia shifts toward China for final assembly. That shift, together with China's economic policies, has brought about a rising standard of living in China and a considerable rise in disposable income for the average Chinese. And, what that has created is a consumer demand that did not previously exist in China. What that means is an expanding market for goods and services, as opposed to the largely one-way street of the past. The fact that China's trade is nearly in balance overall, even though it runs a huge surplus with the United States, reinforces the point about rising consumer demand and growth in imports.

To put that in perspective, China, along with the United States, currently accounts for most of the current growth in the world economy. It is worth noting that since 2001, China has been our fastest growing export market by far among our top ten trading partners. Our exports to China surged 19 percent in 2001, 15 percent last year, and more than 22 percent from January to July of this year, even while our exports to the world as a whole declined 7 percent in 2001, and 5 percent in 2002, and rose less than 3 percent during the first six months of this year.

All of that makes China an attractive market for much of what we produce in the United States, including for our manufacturers. We are far more likely to sell the sorts of capital equipment in which we have a comparative advantage in China than in most world markets based simply on the growth in the Chinese economy and the nature of that growth. If, for example, we continued to see the construction industry boom in China and a major investment in infrastructure to link the western provinces with the coast, companies like Caterpillar will find a growing market for what they sell. The same is true for Boeing.

Here, it is worth stressing that we need companies like Caterpillar and Boeing to succeed in the Chinese and other overseas markets because their supply chains are filled with what are known in business as tier 3 and tier 4 suppliers. Many of those suppliers are small and medium-sized businesses that do not export directly, but their future success depends on whether Cat and Boeing remain globally competitive.

But, it is not just the Boeings and Caterpillars of the U.S. manufacturing sector that see growth in the Chinese market as an opportunity. Direct exports by small and medium-sized businesses in the United States have grown as well. For example, Bitrode Corporation is a Fenton, Missouri, company that manufactures equipment used by the battery manufacturing industry. The company produces testers as well as chargers, and all their equipment is for use by battery manufacturers or researchers. Many of Bitrode's products are destined overseas, including two specific products for China. Last year the company sold equipment to China to the tune of $1.5 million. The company says their exports to China are growing about 15 percent annually, while their sales in the United States are holding even at best.

Similarly, Numatics, a Highland, Michigan, company that works in a highly specialized field, developing and manufacturing components for automated machinery used in many branches of industry, including automotive, petro-chemical, aerospace, and medical equipment, participated in a Commerce Department trade mission in early May, 2002, to China and signed deals with four new distributors, each covering different geographic regions of China. Last year, Numatics staff worked closely with the new Chinese distributors to complete training and set up inventory. In 2003, Numatics reports that sales are picking up. The company is planning to participate in a Chinese trade show in November.

One of the basic reasons for negotiating for 15 years with the Chinese over their accession to the World Trade Organization was to ensure that we would knock down the many barriers to entering China's market. On paper, the accession agreement represents a considerable success. Today, the tariff rates that China imposes are lower on average than much of the rest of the developing, and in some instances, the developed world. In addition, the WTO agreement obliges China to protect the intellectual property of U.S. manufacturers and service suppliers. The agreement also phased out many of the barriers to the free distribution of American goods throughout the Chinese economy. American goods are freer to move through a variety of channels instead of being beholden to trading through a Chinese state enterprise as in the past. The situation facing our manufacturers from a competitive perspective was far worse prior to China's entry into the WTO. Our manufacturers lacked access to the Chinese market, but their manufacturers had relatively free access to ours.

In the first year following China's accession to the WTO, I think both Congress and the President showed an extraordinary amount of patience as China reviewed literally thousands of laws and regulations in an effort to make the necessary changes to bring them into compliance with WTO rules. Now, as we move deeper into the second year of China's participation in the WTO, we need to see actual enforcement of those laws and basic compliance with WTO rules in other areas. I know that the President, Secretary Evans, Ambassador Zoellick, and most recently Secretary Snow have all made that point vigorously with their counterparts in China. And, I can attest that, at a working level, the rest of us have taken up the cause just as vigorously.

But, there is still a very, very long way to go. And, that distance goes to the heart of the complaint many manufacturers have about China. It is the pace of the ongoing reform of the Chinese economy toward a market model, of which the implementation of the Chinese WTO obligations is a part, that causes friction within our trade relationship. The WTO rules, and, indeed, the whole concept of trade is based on free competition in the marketplace. The gains from trade arise when countries open their economies to gain the benefits that comparative advantage yields. But, where one economy is organized under principles that are inconsistent with that free market model, it can cause an enormous amount of injury and friction within our trading relationships. That is, in my view, the current situation with China.

The recently concluded plenum of the Central Committee of the Chinese People's Congress reinforced the commitment of the Chinese government to undertake the reforms needed to push their economy toward a market-based model. That renewed commitment is welcome. That said using WTO compliance as a surrogate for China's overall movement toward a free market model reflects the distance we still have to go. We have considerable challenges in terms of WTO compliance, particularly in areas like the protection of intellectual property that represents the key U.S. competitive edge in many manufacturing industries.

In fact, no country raised more attention as a source of concern than China during the roundtable discussions. Our manufacturers complained about rampant piracy of intellectual property; forced transfer of technology from firms launching joint ventures in China; a broad range of trade barriers; and capital markets that are largely insulated from free-market pressures. We also heard rising concerns about the timeliness and direction of China's implementation of its WTO commitments in areas such as transparency, trading rights and distribution services, agriculture, financial services, and standards.

In the area of standards, the Commerce Department and U.S. Government complaints on a new Chinese standard for cadmium levels in fertilizer has led to an indefinite delay in China's finalization of the standard. Strong export sales of U.S. fertilizer to China continue and industry representatives are pleased with the results of our engagement with the Chinese standards authorities in this matter. We will continue to work to ensure that any mandatory standards China issues, in this sector or others, fully comply with its WTO obligations in the area of Technical Barriers to Trade.

Construction services are another area in which we have made some progress. Working with the Department of State and others, Commerce successfully convinced China's Ministry of Construction ("MOC") to extend the deadline for non-Chinese construction companies to incorporate as either foreign invested construction enterprises or construction design firms. This will allow foreign firms to continue to operate on a project-by-project basis. MOC officials have also agreed to meet with industry to discuss the new rules. Commerce and State currently are working to organize this meeting.

Fundamentally, China's change from a non-market economy to one that operates fully on market principles is incomplete. Although the Chinese often make the case that they are a market economy because they want the benefits that designation would yield under our antidumping laws, the simple fact is that many of the main drivers of the Chinese economy remain in state hands. Whereas U.S. companies face continuing pressure from our capital markets to turn a profit, that pressure simply does not exist in many cases in China.

In one sense, this problem is not new. American firms have seen the same pattern in other Asian markets for years. Even the 1997 financial crisis has not weaned industries or governments from those unhealthy practices—witness Korea's continuing support for the *Hynix* semiconductor operations, a company that was otherwise headed for liquidation. On the other hand, we need to make clear that it's time for this to end. There is no reason today for this kind of support either by China or by other Asian countries of their manufacturing industries. It is precisely these sorts of practices that are so injurious, not only to our own industry, but to the process of trade liberalization that all can benefit from as long as we are all playing under the same rules.

I recognize that many commentators see a demand for a Alevel playing field@ as a demand for protection, but that is not always, or even usually the case. Most manufacturers I have spoken with over the last six months did not want protection; they wanted the unfair trade practices that rigged the game against them eliminated. A good example is the forest products industry, which has an enormous fight with Canada over subsidies. Yet, in the context of our roundtable on forest products manufacturing what these firms sought was not protection—they asked that the President negotiate the elimination of the barriers they faced abroad and the subsidies they faced in terms of competition from imports. The same held true for most manufacturers with whom we discussed China. There was a strong recognition that we were better off in a world in which the rules were observed and the competition was fair, than a world segmented by trade barriers which would mean less trade and slower economic growth for all.

At the same time, I also must stress that there are significant parts of our manufacturing sector that are under extraordinary pressure to adjust to new levels of competition from imports, particularly from China. Industries like textiles and apparel in the South and tool and die in the Northeast and Midwest offer examples of the sorts of pressures our manufacturers face. Both the challenges and the pain felt in many communities are very real. In the case of textiles and apparel, the challenges are particularly intense because the industry is emerging from a 40-year period when it was protected by quotas on imports of competing material and clothing. As a consequence, the industry remains highly fragmented and is being forced to go through, all at one time, the adjustment and consolidation that most U.S. industries went through in the 1970s and 1980s.

In the last round of world trade negotiations, President Clinton agreed to phase out the quota system that had protected the textile industry. Most of the truly sensitive items from the perspective of U.S. industry were given the longest phase-outs. But, the quotas will come to an end on January 1, 2005, and that will mean still stronger competition from imports. What is not generally understood is that most of the sharp increase in Chinese imports has come at the expense of our other trading partners. As new products have been freed of quota arrangements, retailers no longer face the need to source products from multiple countries. Instead, much of what was previously shipped to the United States from other Asian countries now comes to us from China. But, that has not meant less pressure on U.S. manufacturers in terms of price competition.

While the argument most frequently raised about China by commentators seems to be the difference in wage rates, most of my conversations with manufacturers, particularly in textiles, suggested other reasons for increased Chinese competition. What is not often understood is that, today, the textile industry is actually very high tech. There is very little labor involved in many products that come out of the industry and wages are a relatively small portion of the total cost of production except in the case of products that require considerable hand stitching.

The truth of that statement was brought home to me in a conversation with a North Carolina manufacturer of textile products used in the luggage industry. Most bags today are made with some form of rip-stop material, none of which is hand sewn. Nor is the frame of most roll-on bags manufactured by hand. Yet, the North Carolina manufacturer showed me 5 suitcases, one nesting inside the other, that sold for a total price—delivered from China—of under $30. In other words, the total cost of the five bags was below the North Carolina manufacturer's cost of materials alone.

The point to that story is simply that it is not wages alone that allowed the Chinese manufacturer to sell the 5 pieces of luggage for a delivered price of less that $30. The cost of most of the materials is determined in world markets, so if the Chinese economy were open to international trade and competition, then the Chinese manufacturer's materials costs would be comparable to that of the U.S. costs. This means that to get the delivered price down to below $30 there must be a very large amount of government subsidy, express or implied, to the manufacturer—a subsidy that can take the form of an outright cash grant to the exporter, but more often will take the indirect form of tariff protection against competition, the forgiveness or rebate of taxes, or the continuing extension of credit to noncredit worthy enterprises.

In my view, although the textile industry is commonly criticized for seeking protection based on the past 40 years of quotas, the complaint that has led the industry to seek safeguards against Chinese imports stems from a different motive. There is no real argument that the Chinese market operates fully on a market basis, and the reasons for the industry's request for help stem from that simple difference between the pressures they face in our market on a day-to-day basis and the pressures that their Chinese competition does not.

What that also points out is the fact that, in addition to pressing the Chinese at every opportunity on their compliance with their WTO commitments, we also have to be extraordinarily vigilant regarding the injurious effects of other forms of government support for Chinese industry that are not covered by current WTO rules. Those sorts of practices require a different type of tool—one that requires digging out the facts regarding the underlying competitive differences that our industry faces in terms of import competition from China.

As I noted above, the textile industry is not alone in facing Chinese subsidies and protection. Other industries like tool and die and U.S. foundries face similar competitive conditions. That is why one of the most forward-leaning recommendations we intend to make regarding our trade is the establishment of an office in the Commerce Department, the sole function of which will be to investigate these sorts of practices. When we find these anti-competitive practices, we will vigorously seek their elimination by the Chinese and by other trading partners.

The one thing I can assure you is that the Department of Commerce is dedicated to making sure China does play by the rules. We will vigorously pursue China's compliance with its WTO commitments and we will enforce our domestic unfair trade laws rigorously and fairly, as both President Bush and Secretary Evans have made clear. And, that will be the single most important topic of conversation with our counterparts this coming week.

The Department of Commerce's Role in Trade With China

The Department of Commerce, in close coordination with USTR and other agencies, has adopted an aggressive and multi-pronged approach to ensure that China honors its WTO commitments and that U.S. companies benefit from these opportunities. We will target unfair trade practices wherever they occur. We are exploring the use of new tools to expand our trade promotion activities in China. We are expanding efforts to engage Chinese officials to make sure they Aget the rules right@ as they continue their enormous task of restructuring their economic system.

The Commerce Department has actively provided WTO-related technical assistance to China since September 2000, well before China's accession to the WTO. Initial programs focused on increasing the awareness of general WTO principles among Chinese government officials. As China developed an increasingly sophisticated understanding of the WTO system, our programs have been tailored to more specific areas, such as standards development and intellectual property right (IPR) protection. For example, in 2003 Commerce sponsored or coordinated programs on fertilizer standards, antitrust, government procurement, medical device regulatory training, and information and communication technologies standards and conformity assessment.

Despite China's commitments to crack down on rampant piracy, counterfeit CDs, DVDs, and pharmaceuticals continue to flood the market. In addition, piracy and counterfeiting in China has a significant impact on U.S. intellectual property rights holders in China itself. In fact, the International Intellectual Property Alliance estimates that business software, music, movie and entertainment software piracy rates in China exceed 90%, with damages of $1.85 billion in 2002. We have raised specific IPR concerns during our meetings with senior Chinese government officials and have repeatedly demanded that the Chinese government uphold its bilateral and multilateral IPR commitments.

Through the annual Special 301 process, we scrutinize China's IPR conditions in close coordination with our colleagues in other agencies. To make sure that China has the tools to implement its commitments, we have organized a series of seminars with Chinese officials. Programs in development for later this year include a WTO pharmaceutical regulatory seminar and anti-counterfeit training, and IPR criminal & border enforcement seminars. We have worked on these programs on an intra and inter agency basis, using the resources of US Patent and Trademark Office, Department of Justice and other agencies. We think China can and should do better in these areas. We continue to press for progress.

However, keeping our focus on China's WTO implementation and the country's other trade practices is only part of the solution. We must continue to enhance the ability of U.S. businesses to compete in China. We are increasing our efforts to ensure that U.S.-developed technical standards are accepted in China just as they are throughout the world. We are launching ADoing Business in China@ seminars in cities across the country to address concerns about the Chinese market from small and medium-sized businesses. We are exploring ways to develop more trade leads in China and to provide even more targeted information on opportunities in China for companies in the U.S.

Combined with these domestic efforts, we regularly engage Chinese government officials to ensure trade agreement compliance and market access for our products and services. Secretary Evans will visit China in October to advance U.S. interests and advocate for a level playing field in our economic relations with China. We will have another opportunity to raise outstanding issues during the 15th U.S.-China Joint Commission on Commerce and Trade (JCCT) to be held in Washington in early December.

The President's Manufacturing Initiative

With that, I would like to turn to the topic of the President's Manufacturing Initiative and the context it provides for our discussion of trade with China. In March of this year, during Manufacturing Week, Secretary Evans had the opportunity to speak before the National Association of Manufacturers in Chicago. At that time, he announced the President's Manufacturing Initiative. As a part of that initiative, Secretary Evans directed me to lead a comprehensive review of the issues influencing long-term competitiveness of U.S. manufacturing. The central goal of the review is to develop a strategy to ensure that government is fostering an environment that promotes a dynamic manufacturing industry. The review will conclude with the release of a report later this fall.

The Commerce Department's senior management, including Secretary Evans and Deputy Secretary Bodman, all pitched in. We held roundtable discussions with manufacturers in the aerospace, auto, semiconductor, and pharmaceutical sectors, among others, in more than 20 cities across the United States—from Manchester, New Hampshire to Columbus, Ohio, to Detroit to Los Angeles—to develop the report and recommendations.

What we heard from manufacturers in terms of the challenges they face was significant. While the international competition is what has garnered most of the attention in the press, by far the greater weight of the manufacturers' comments focused on domestic issues—what I call "keeping our side of the street clean." What I mean by that is simply paying attention to the needs of our manufacturers as we develop legislation or implement regulations. It is the steady accumulation of multiple burdens, rather than a single cause, that has had the most severe impact on the competitive environment in which our manufacturers operate.

The list of issues our manufacturers identified should not surprise anyone who has taken a serious interest in manufacturing. While our manufacturers have tightened their belts and raised their productivity in an effort to remain competitive and, in fact, to succeed in the day-to-day competition in the marketplace, they have seen that advantage and the hard-won productivity gains eroded by everything from higher energy costs to higher medical and pension costs to higher insurance costs due to a run-away tort system.

Just a few examples might suggest why manufacturers have seen their costs rise. We heard from manufacturers in New Jersey that 30 cents of every dollar of revenue went to pay health benefits for employees. Manufacturers gladly pay for their employee's health benefits because they see their own interest served by a healthy and motivated workforce, but if we are serious about manufacturing, we have to be serious about grappling with the underlying drivers that have created 145 percent increases in health care insurance costs that obviously are not sustainable indefinitely.

In Michigan, I met with auto parts suppliers that faced continuing pressure from the auto companies to lower their prices by 20 percent or face the prospect that the auto companies would turn to overseas sources of supply. The concern those parts suppliers reflected involve the terms on which they compete with those overseas suppliers, particularly in China. But the auto parts suppliers knew that the ultimate source of the problem lay in an auto industry that is grappling with the same sorts of legacy costs that burdened the steel industry. If we are serious about manufacturing, then these industries will have to get those financial obligations under control.

In Columbus, Ohio, Des Moines, Iowa, and in my hometown of Minneapolis, Minnesota, I met with manufacturers in the plastics and adhesives businesses that are heavy users of natural gas. The companies in the plastics businesses in particular risk seeing whole new markets fall to their foreign competitors who see lower natural gas prices. If we are serious about manufacturing, we have to adopt a national energy plan that will help us access new sources of supply and improved transmission to reduce the cost of energy to our manufacturers as well as to consumers.

Another example we heard from virtually every manufacturing trade association we met with was the need to eliminate the complexity and the disincentives our tax system creates for investing in manufacturing in the United States. A number of issues fall in that category. Take the bias in the current tax code against equity financing, which raises the cost of capital, thereby reducing the investment. This bias also translates into a preference for debt, which yields highly leveraged companies and a highly leveraged country, all the while encouraging the worst sorts of gaming as clever tax lawyers try to find ways to take what is an equity interest and call it debt in order to qualify for an interest deduction. Taken together, even without cutting rates, reforms of the tax code could make a profound difference to the relative attraction of investing in manufacturing in the United States.

But, perhaps the most egregious example comes out of the tort system in this country. One issue, in particular, stood out among the manufacturers' concerns about the tort system. That was the ongoing asbestos litigation. There, the continuing litigation has yet to help many individuals who were harmed by prolonged exposure to asbestos, while, at the same time, the litigation hangs over virtually all U.S. manufacturing, raising their insurance costs and dampening their returns. Clearly, if we are serious about manufacturing, we have to get serious about reforming the tort system.

Manufacturers also pointed to declining vocational school programs, declining enrollments in engineering and the funding of scientific research, all of which are essential to the productivity gains that keep our manufacturing sector competitive and keep a skilled workforce employed.

Finally, as I noted above, in addition to keeping our own side of the street clean, U.S. manufacturers demanded a level playing field. For most, that translated into a demand that we negotiate down tariff rates that are higher than ours and break open new markets. Or it translated into a demand for the enforcement of rules barring the theft of intellectual property. It translated into a demand for the enforcement of our unfair trade laws or laws against customs fraud.

What I did not see was an interest in outright protection. Rather, most manufacturers saw trade as a simple question of equity. If we keep our markets open to our trading partners goods, they should do the same for us. But, where our trading partners did not live up to the terms of our agreements or otherwise heed the rules, our manufacturers expected that those trading partners should pay a price.

That is where what we do domestically bears on our trade with China. In my view, if we have done what we can to grapple with the disincentives we create for investing in manufacturing here in the United States, our manufacturers will be in a far better competitive position to gain access to the supply chains that will take them global and into the Chinese market in particular. In addition, we would come to our discussions with the Chinese knowing that any disparity in competitiveness between U.S. and Chinese manufacturers is not attributable to our own actions, but to the function of the market or the intervention of the Chinese government on behalf of their firms. Most manufacturers I have met with are prepared to live with the first result; they are not prepared, nor is this Administration, to live with the second.

While we are still in the process of finalizing the report and recommendations across many fronts, Secretary Evans has outlined several new initiatives in response to the concerns we heard from manufacturers, particularly the need for a stronger focus within the U.S. government on manufacturing and the most immediate cases of unfair trade affecting our manufacturers. The first initiative, announced by the President on Labor Day, is a new Assistant Secretary of Commerce to serve as the point person in the Administration and within the U.S. government for manufacturers and as an effective advocate for the manufacturing sector's competitiveness. There are many programs within the federal government that bear on manufacturing, but heretofore there was no one person or one office responsible for bringing their efforts into a coherent strategy. The second would call for the creation of Assistant Secretary for Trade Promotion to boost our exports, particularly to those markets that our negotiators have recently opened to our trade like China. And, the third is the establishment of an Unfair Trade Practices Team to track, detect, and confront unfair competition before it injures an industry here at home.

We expect the manufacturing report and the remainder of the recommendations to be out soon. In addition to moving on the implementation of those recommendations, we intend to do two things to follow up. The first is to go back to the manufacturers we visited earlier this year to get their reaction on what we have suggested and to help us refine our approach as we move forward. The second is to discuss the next set of issues we intend to tackle as part of our on-going commitment to support our manufacturing sector.

That concludes my testimony. I would be pleased to answer any questions that you may have.

Chairman HYDE. We will now entertain questions. Mr. Lantos.

Mr. LANTOS. Thank you very much, Mr. Chairman.

Mr. Secretary, you will be traveling to China next week, as I understand it. Can you pledge to this Committee that you will raise with your Chinese interlocutors the issue of their total lack of compliance with internationally recognized standards of labor? Will you pledge to raise the issue of the two labor leaders who have been unjustly imprisoned, and as we speak, are still in prison? Will you raise the issue which we have been doing unsuccessfully for over a decade of intellectual property rights? Pirated CD ROMs are being pedaled at the very gates of the United States Embassy of Beijing. And the Chinese are laughing at us, because apart from the ceremonial raising of these issues, nothing happens.

Now, you don't have to be a genius in understanding relationships to clearly see that with a $120 billion trade deficit, we have enormous leverage over China. I agree with my friend, Mr. Burton, that neither the Clinton Administration nor this Administration has used our enormous leverage. At what point will the Department of Commerce and the Administration go beyond simple oratory and no action? Because so far we have seen no action.

Mr. ALDONAS. First, with respect to the labor laws and the labor leaders, both Secretary Evans and I make it a routine part of our discussions with our counterparts to raise the human rights issues as well as the economic issues.

Mr. LANTOS. But if you will allow me to interrupt. You know, Cicero finished every speech by saying, pro forma, that he recommends the destruction of Carthage. And that was a throwaway sentence. And it seems to me that you and Secretary Evans and your predecessors have these pro forma pronunciamentos to placate the Congress. And that is all these perfunctory pronouncements mean. You are not using the leverage which is at your disposal; you are making standard statements so that you can tell us that you raised the issue. But nothing happens.

Mr. ALDONAS. Well, it won't surprise you if I quarrel with your description of the discussions we have had with our Chinese counterparts, Congressman Lantos, because when I raise these issues, the two things I point out is, not only is it inconsistent with human dignity and human rights in terms of their practices, but I also point out to them that one of the key features, frankly, of moving in a direction that is going to best serve their interests economically as well as their participation in the trading system, is to make sure that the freedom they want to give firms and enterprises also extends to individuals.

And as long as an individual in Chinese society has to hold a card which tells them where they have to work, that is not a society that is free. And that point is both political and economic. And, frankly, I think we all have to be honest, that increasingly and to the extent that we can increasingly individuate the economic interests of any actor, whether it is someone, a worker or whether it is an enterprise, we are sowing the seeds of political pluralism. And that is as much in our interest from an economic point of view as it is from a political point of view as it is from a human rights perspective.

So I don't want to say that it is a throwaway when we raise these issues. I am very conscious not only of the concerns, but I am very conscious of the sorts of things that the President has said about the conditions of human rights around the world, particularly with respect to China. And it does affect our trade. There is no doubt about that.

In terms of intellectual property laws, there is probably no issue that is more important in some respects. And I say that because people have a tendency to forget about the importance of our manufacturing sector, not just because it is 14 percent of the GDP or 11 percent of the employment. But it really is a crucible within which most of the innovation in our society is created. Those productivity gains that we have seen are now higher in the United States' economy than it was even during the 1990s when we were talking about a new economy. Those productivity gains flow largely from the manufacturing sector. And if you think about how we trade globally, the one thing you have to do is protect the ideas that are the source of that innovation.

What we have in China right now, you can take software as an example, is that about 90 percent by some industry estimates of the software is currently pirated. A fair amount of that is pirated software is use in the halls of the Chinese government. That has to the end. And I agree with you, absolutely, Congressman Lantos, that a price has to be paid in the absence of compliance with the rules that they have signed up to, particularly on intellectual property, because it is so critical to the future of our manufacturing sector.

As we have all talked I think throughout the 1990s about the need to move up the value chain and what that will require from U.S. manufacturing, the keystone has always been our ability to maintain the technological edge. And at the end of the day, that means that we have to protect the intellectual property. So that definitely will be the top item in terms of the specifics of trade.

The leverage of the market, I have no quarrel with the idea of using the leverage of our market. But I would object to the notion that we have not been vigorous. You can't look at 50 percent of the anti-dumping cases taken up by this Administration and the consistent pressure we put on the Chinese to reform the underlying practices and say that that is not action. The range of duties that apply to these are extremely large.

We pointed out that they will maintain a nonmarket economy status until we have seen the changes that you and I would both agree are part of the status of a true market economy. And until such time, they will face the penalties under our unfair trade laws. We are always happy to have a conversation with the Chinese about what it take to be a market economy if they want to engage in that discussion. But until such time as they have taken those steps, they will continue to be nonmarket economy status and face those penalty under the law. And we will be aggressive in enforcing them.

Chairman HYDE. Mr. Green.

Mr. GREEN. Thank you, Mr. Chairman.

Mr. Under Secretary, one issue you didn't deal with directly in your oral statement is Chinese currency exchange rates. Does the Administration believe that Chinese currency policies have, in fact, caused or constricted to the trade imbalance between the two nations?

Mr. ALDONAS. I should leave the specifics of the value of the dollar to the Treasury Department. But I have a tendency to look past the exchange rate and try and understand the underlying dynamic in the Chinese economy. And one of the reasons the exchange rate is a surrogate is the fact that you have an economy where the capital markets aren't functioning. They don't function like you would be used to. It is not as if the banker comes to the door and says, you are not turning a profit; I am not going to lend you any more money. That doesn't happen. And as long as there is less of that pressure in their system—it is fundamentally different than ours. And that does contribute directly to the trade surplus that they currently enjoy and their competitors.

Mr. GREEN. I guess the answer is yes?

Mr. ALDONAS. Ultimately, the exchange rate protects what they view as a very fragile financial system. And so whether it is the peg or whether it is grappling with the underlying issues, you have to tackle the problem. I will say that this President and this Treasury Department has been much more forthcoming than any other in recognizing the nexus between exchange rates and trade. And I recall not that long ago where the discussions took place, as if there was no relationship between exchange rates and trade. Certainly what Secretary Snow did and what the President has been doing this week in Thailand is a direct reflection of the understanding of the dynamic issue.

Mr. GREEN. And I would agree that the statements that we have seen in recent weeks have been a step in the right direction. I think they have been a recognition of the problem. What steps can the Administration take to push the issue and to try to actually produce some results of the issue of—and I am going to focus on currency rates because I think it is something tangible that many of us here think are important. What steps could the Administration take? What steps does it plan to do? What is it the Administration is willing to do to force this issue to try to get some progress made here?

Mr. ALDONAS. Well, probably first and most importantly is, as I was alluding to, Congressman Green, is to try to tackle the underlying issue. And one of the things that the President succeeded in doing was getting the Chinese agreement to focus on that problem. Because while they have made the commitment that they are willing to move in the direction of flexible exchange rates, what they have also said is they have problems they have to solve in their underlying capital market. What the President was saying was, let us get to those problems. He wasn't saying that you shouldn't be moving in terms of the exchange rate itself.

Now, beyond that, you know, I think you always have to be very clear with any of our trading partners, I would say with the Chinese in particular, about what your expectations are and what the consequences are of those expectations. And right now, within the traditional trade tools we have, there certainly has been a liberal application of the anti-dumping laws to address them on an industry specific basis. There certainly are opportunities to continue more aggressively to investigate those sorts of practices on the theory, should industry present it, that what that alleged undervaluation represents, in fact, is just to draw some full circumstance on it, Congressman Green, in fact, the largest subsidy that the Chinese system confers is the lack of the capital market pressure.

Mr. GREEN. You refer to it as alleged undervaluation. I have seen the White House fortunately be a little bit more specific. They don't refer to it as alleged undervaluation; they refer to it as a factual undervaluation. But let us be more specific. You talk about the need to present the issues and talk about consequences. What are those consequences potentially? What is it that is taking place in these conversations that would cause representatives of the Chinese government to do anything other than nod their heads and say, well, we promise to talk to you about this?

Mr. ALDONAS. Well, in the discussions, certainly with my counterparts, the point that I am making, have been making to them, and will be making again this coming week is that what we are facing right now in this context is either we have to have a change in the Chinese behavior, or what you will see is the Administration itself leading the investigations. This isn't going to be something where we are simply going to wait for an industry to be injured and then file a petition, because, as we have been around the country talking with manufacturers, whether it is textiles and apparel, which lots of times people think they are just looking for outright protection, but right now are facing difficult circumstances precisely because of things like a 17 percent value added tax rebate, the work that our foundries produce, machine tools, furniture. You can certainly go down that list. Where we feel price competition, that is where the stuff that the Chinese do has the greatest impact, and those are going to be the target.

Chairman HYDE. The gentleman's time has expired.

The gentleman from Oregon, Mr. Blumenauer.

Mr. BLUMENAUER. Thank you, Mr. Chairman.

Mr. Secretary, I appreciate your comments. I have been sort of turning them over from the perspective of somebody who has supported the initiatives of the last two Administrations to try and normalize the trade relationship, with the understanding that if we had a framework, if we had the protections, if we opened it up, that it would—it was a good gamble that we would have a softening effect on some of the Chinese practices, a philosophy that I would hope this Administration would consider extending to China. If we can do this with Godless Communist China, then we can do this with Cuba as well.

A little symmetry might help. But I bought into this, but I have been deeply concerned that we continue to have the reports, and you have heard from some of my colleagues here, and there is excellent testimony that I have had a chance to scan that talks about the barriers that are being thrown up contrary to the intent of what we have tried to do with WTO. Not just the abuse of labor rights, but human rights, continuing slave labor. And nothing that I saw in any of the testimony that I scanned, but you cannot spend any time in China without being stunned at the lack of investment in environmental standards, just trying to breathe the air and the disadvantage that some of our competitors here in this country have.

And last, but by no means least, I am hearing from American manufacturers that they are being directly pressured to locate manufacturing offshore, not because that is where it is in the best interest of their company or the company for whom they are customers of American entities, but that this is part of an effort to simply placate the Chinese by moving more production offshore to China.

I am wondering if there is any contemplation of using the tools that are available to us under WTO to start bringing about a rebalancing. I would appreciate your positive words, but to this point, I don't think we have filed any actions, and I wonder where we are in that process and what is going to have to happen until some action occurs.

Mr. ALDONAS. They are all good questions. Do you want me to take up Cuba, or was that a throwaway?

Mr. BLUMENAUER. That is not a throwaway. It is something that I hope the Chairman will be able at some point to come back and deal with some sense of parity.

Mr. ALDONAS. If I could then, Congressman. To me, I think there is one elemental difference, which is, we have not seen—although the President has outlined the willingness on the part of the United States to adopt a different approach if we saw something forthcoming from Fidel at this point, which we haven't seen with Cuba actually as any degree of movement toward a market economy as you have seen with the Chinese. What you won't see in Cuba my strong guess is, based on the recent statements and the oppression of human rights activists in Cuba, is the sort of thing that the Chinese are doing, which is about to enshrine private rights of property in constitution. That isn't going on.

The second thing that I think is important to understand is that even where other countries trade freely with Cuba, the profits end up going to the Cuban government. They don't end up extending to the individuals in Cuban society. And the net result has been that has been a bad deal not only for the Cuban people, it has also been a bad deal for the companies involved.

Mr. BLUMENAUER. Reclaiming my time. I would be happy to continue that. I think the magnitude of the human rights abuses that continue in China and the relative tiny environment with which we are talking about in Cuba, I would think that there are some of my Republican colleagues here who would join me in thinking that there is a more productive dialogue. But if you could address when you are going to be moving under WTO, it would be useful, before my time disappears.

Mr. ALDONAS. Well, a couple things. One is, one shouldn't adopt the approach that if we file a case, that is the only thing that means we are moving under WTO. There has been consistent pressure for compliance with respect to the WTO rules, and we have had successes in individual instances, particularly on agricultural commodities, with moving the Chinese in the right direction. Where we have had the biggest problems, I would suspect those are the targets for future cases. And the reason is, things like intellectual property. You know, if it is within the government's power to ensure that at least within the government through its purchases they are acquiring Microsoft software through the legal means, then they should be adopting that practice. And those are the sorts of things that I think are the likely targets.

Chairman HYDE. The gentleman's time has expired.

Mr. Tancredo of Colorado.

Mr. TANCREDO. Thank you, Mr. Chairman.

During the debate on PNTR the last time, there were three or four arguments that were made that were designed to get people to support PNTR. One was that if we did it, we would begin to reduce the imbalance of trade with China. Of course, we know that that has not happened.

Two, it was that if we did it, we would reduce the instances of human rights abuses that were prevalent in China. Of course, we know from testimony and from comments from Members of the Committee here that that has not occurred.

We were told that it would inspire the Chinese to, in fact, clean up their act literally by doing some of the environmental work that is necessary to make them a little cleaner in their manufacturing capabilities. Of course, we know that is not happening.

We also were told, well, eventually Jeffersonian democracy would break out all over China and we would see the end of the Chinese dictatorship, and I know that hasn't occurred and I don't see anything that would lead in that direction.

But the one question that I don't know the answer to, I suppose, we were also told that if we did this we would see a reduction in the rates of investments on the part of the Chinese government in military as opposed to the civilian side of their economy. What has happened there?

Mr. ALDONAS. I don't know about the investment by the military in terms of a military buildup. I am sorry. I will get back to you on that particular question.

Mr. TANCREDO. Do you know if the Chinese military is still a significant stakeholder in most of the economic enterprises, especially the most important economic enterprises?

Mr. ALDONAS. To put it bluntly, at least since the 1980s under their own policy they were supposed to be out of the business. The phenomenon in China of what was known as wearing two hats was supposed to have been ended. As a practical matter, does it still go on? Certainly. I know from my own experience when I was in private practice you would see that investment in commercial transactions periodically. So I would not argue that there isn't still some involvement. But by their own policy they are supposed to be out of the business.

Mr. TANCREDO. I have searched in vain for any indication that that has happened. I believe that we would be able to identify in fact several cases where the Army in particular is the main stockholder in a number of the most significant and high-tech corporations in China.

Well, that makes us 0 for 5 in terms of the reasons we were given to support the PNTR. I am glad I did not support it, I should say, and I thank you very much for clearing that last one up for me or at least attempting to.

Chairman HYDE. Mr. Sherman.

Mr. SHERMAN. I think the gentleman from Colorado has expressed it well. We are in this odd circumstance where whatever China needs temporarily, well, that is okay. So if someone loses their job and that leads to alcoholism, that leads to domestic abuse or suicide, well, that is okay for now because China has problems. We know that currency is 40 percent undervalued and they will do nothing about it. And there will be a suicide in America as a result because, well, we don't want to deal with it today.

Mr. Lantos quoted Cicero. I think the more apt analogy is Nero who fiddled while Rome burned, and we are fiddling around with a dumping case here or there. A 40 percent violation every day on every item and we don't do anything except, well, we have talked to them about it. I have got to commend the Chinese negotiators for one thing.

They are able to wait until the Americans leave the room before they start laughing, and that takes a level of self-control that I can only admire. I come from a city of actors, most of whom would find that difficult.

I am particularly concerned about the businesses in China that demand co-production agreements or in any other way basically say you can't export to China unless you do a number of things that is illegal for them to ask us to do. I am also concerned about the Chinese businessmen and women who are told they better not import from the United States. Sir, what level of refugee status for a business person and their entire family could be granted on an emergency basis if they had evidence of governmental pressure not to purchase American goods?

Mr. ALDONAS. You have to ask the State Department.

Mr. SHERMAN. Would the Commerce Department regard that as something to be taken up at the very highest levels? Would the Secretary himself welcome these people with open arms or is that something that your Department doesn't care about?

Talking about people who have evidence that can explain why we have the largest, most cancerous trade deficit.

Mr. ALDONAS. At the same time, Congressman Sherman, I think you have to put that right side by side the fact that exports to China have been growing at 20 percent the first 8 months of this year. So the idea that somehow everybody is having a gun held to their head——

Mr. SHERMAN. Well, not everybody. Obviously China wants to have some imports from the United States.

Mr. ALDONAS. Having said that, if you look at the automobile industry in this country, the hottest growing market is in China. And in the absence——

Mr. SHERMAN. Do you really believe that we are going to see 100,000 vehicles assembled in this country and shipped to China?

Mr. ALDONAS. Congressman, right now, General Motors, the difference between being profitable and maintaining employment in the United States is the earnings they are generating in Asia. And when you think about the workers in Detroit, you need to be thinking about the enterprise that General Motors represents.

Mr. SHERMAN. So basically whatever is good for General Motors is good for America?

Mr. ALDONAS. I didn't say that. But if you want to draw that conclusion, you might draw the conclusion what is good for General Motors is good for the UAW.

Mr. SHERMAN. When the UAW comes before this Committee and says let us import all of our auto parts from China and let us ignore a 40 percent acknowledged problem on the currency value and let us go to sleep for another day or week on that——

Mr. ALDONAS. Congressman, do you ask them at that point how they are going to pay for the contract that General Motors just signed with the UAW, where the profits are going to come from?

Mr. SHERMAN. It is incredible that you would come here and say what we need to do to help American workers is to export their jobs.

Mr. ALDONAS. What is incredible is not understanding the fact that in a global economy with a globalized auto industry, that being the most competitive market in the world today where the demand is rising fast enough, is not in the interest of auto workers in this country.

Mr. SHERMAN. So we have to export our jobs so that General Motors can make enormous profits because some crumbs may go to some of the workers here. What—no one in Beijing believes that the way to help Chinese workers is to run a $120 billion trade deficit with the United States. Their leaders understand that workers need jobs, and our leaders understand only that General Motors can make huge profits in exporting those jobs.

Chairman HYDE. The gentleman's time has expired. However, I think the Under Secretary may want to respond to the last several questions from the gentleman.

Mr. ALDONAS. I think it is always important to realize when you think about the manufacturing sector in this country is that while we have real concerns about different parts of it, it is still standing alone, the fifth largest economy in the world, fourth largest economy in the world, larger than the size of the Chinese economy. It is one of productivity rates are higher than they were in the 1990s. And at the end of the day what makes them competitive is being globally competitive.

I don't want to take away or penalize a company for being globally competitive because at the end of the day the jobs that exist in this country depend on them succeeding on a global level. That is the only point I was saying, whether it is the Chinese market or anywhere else in the world. And if you think that China is the only place we are running a trade deficit, you ought to take a look at Europe, where we have seen it balloon more than China. What you have right now——

Mr. SHERMAN. You are saying $120 billion of deficit for $20 billion of exports?

Mr. ALDONAS. The rate of growth. What you need to focus on——

Chairman HYDE. The gentleman's time has expired, if you don't mind.

Mr. Burton of Indiana.

Mr. BURTON. Well, hopefully the grilling will be a little less severe from this side of the aisle, but nevertheless I think we do have some very difficult questions that need to be asked. We have lost about 3 million jobs. One of the things that saved the world in World War II was the industrial base of the United States. And there is a lot of concern about the erosion of our industrial base in the past 20, 30 years and all these jobs, industrial jobs, going elsewhere.

The President has imposed some import tariffs on steel for the very reason that there was dumping taking place. So I would like to know what the Commerce Department can do to make sure that our industrial base erosion stops. The Bible tells us there are going to be wars forever. And for us to carry out our number one responsibility, and that is to protect the American people, we have to have a very strong industrial base.

The small tool industry for all intents and purposes is gone. And so I would like to know, and this is a very general question, what the Administration or what the Commerce Department views as the long-term solution to making sure that we don't have a continuation of the erosion of our industrial base and how we are going to deal with it.

Mr. ALDONAS. Thank you, Congressman. Let me answer it in two parts. The first side is keeping our own side of the street clean. If you are serious about manufacturing and you listen to manufacturers about what they need, what they will tell you is they have to have a tax environment with what they have got that is less complexity, less cost compliance, and lower tax rates to be able to compete.

What they tell you is we have to have a comprehensive energy strategy that is designed to increase the sources of supply and decrease our dependence on foreign oil. What they will tell you is you have to make sure you have the kind of pipelines that are in place that will get natural gas prices down, because it is both the feedstock and it is something they use for power. And industries like plastics, where we have a comparative advantage but won't if energy rates keep going up, what they will tell you is you are going to have to clean up a run away tort system and you are going to have to do something about asbestos, which is just a cloud hanging over the manufacturing sector in this country. That is that sort of the street.

On the international side, if I could, Congressman, you have to press consistently, particularly among your trading partners, for a system of exchange rates that is based on the market. It has to be driven by the market. Even in the absence of all the economics behind it, the goal has to be to remove those things that are a friction in the trading system.

The second thing is you do have to press, and this has to happen at the negotiating table. And all the manufacturers we met said we want an aggressive trade liberalizing agenda. They sit behind that protective wall and make it a competitive advantage competing back in the U.S. market. So it is both a barrier to our exports as well as a subsidy to domestic producers who then try and compete in the U.S. market. So their goal was to get things down. And finally you got to enforce the trade laws.

Mr. BURTON. I am for free trade and fair trade. The one thing that worries me is the loss of industry and jobs going overseas. Has there been any thought by the Administration, the Commerce Department and other departments collectively to submit to the Congress a tax structure or tax proposals that would encourage industry to stay here instead of going overseas. It seems to me there has to be some kind of incentive in view of the fact that wage rates are so much lower elsewhere and the environmental concerns are so much lower elsewhere and environmental costs, there has to be some inducement for American industry to stay here. Have we given any thought to change in the tax structure that would encourage industry to stay here?

Mr. ALDONAS. It takes two forms. One of course is the bill going through Congress right now that is—there are two pieces of legislation, one on the Senate side and one on the House side that Chairman Thomas is developing that offers slightly different approaches, but both are designed to grapple with that issue and it approaches it by cleaning up some of the complexity in the existing system so it reduces the cost of compliance and gets rid of what the manufacturers call the anti-manufacturing tax or application of the alternative minimum task to allot the small corporations that are basically small- and medium-sized businesses, family-owned, things like that.

The flip side of it is it also takes a nick out of the rates that apply to manufacturing income, as I understand it. So I think there is good positive movement. It also helps us solve the trade problem with respect to the WTO ruling on the Foreign Sales Corporation. But that is a very healthy package for manufacturing in terms of grappling with some of those.

My own view of the tax system, having spent a fair amount of time with it in private practice, is you have to really eliminate an awful lot of rules that exist now that penalize manufacturing. Currently, depreciation rates are completely inconsistent with where manufacturing is in the kind of turnover and capital equipment. So there is more to be done there I think in terms of reform.

Chairman HYDE. Mr. Faleomavaega.

Mr. FALEOMAVAEGA. Thank you, Mr. Chairman, and I certainly want to welcome Mr. Aldonas before the Committee.

I thought maybe I would add a little humor to our dialogue here with Secretary Aldonas. I remember former Governor Connelly of Texas was nominated by President Nixon to be Secretary of the Treasury, and there were some questions raised as to his qualifications since he was not an economist. Governor Connelly said he could add 2 plus 2 and that was all that he wanted to stress to the people who were questioning his qualifications.

I want to say, Mr. Secretary, I would be the last person to claim that I would be qualified, because I am not an economist. But I do have a different historical perspective from some of my colleagues here on the Committee. The fact that our country being about 227 years old, and the colonial legacy that some of these Asian countries have had to endure, the French in Indochina and Vietnam and the British in China, some very difficult historical events have transpired. The fact is the People's Republic of China was founded in 1949. They already had 400 million people in place since 1949.

I wanted to ask you, if you were a chief policy maker of a country now of 1.3 billion people, what kind of an economic system would you recommend to make sure that all these people are going to be provided for? I suspect if our country had 1.3 billion people, we would have some serious problems as policymakers as to how to go about finding some sense of equity and fairness in the process. We want to repeat this process. This country is only 54 years old and we are expecting them to reach the highest levels of economic fairness with the other countries like ourselves?

I am not tooting China's horn here, Mr. Secretary. I am trying to show with some sense of historical perspective here that we seem to be treating the Chinese people and leaders as greedy and adversarial. I respectfully have to say we need to rethink this. Your comments that our exports have grown to 21 percent in the last 8 months seems to indicate that we are doing something on an equal and fair basis with the Chinese, despite the fact that there may be some issues. But you show me one country or one region that we are not fighting against regarding their own economic policy. Let us take our European friends for example. We are still fighting over foreign subsidies.

I just want to share this perspective with you, and I want to ask you what kind of an economic system would you recommend to a country that is only 54 years old and trying to provide for the needs of 1.3 billion people?

Mr. ALDONAS. I would recommend a market economy, and there is a reason for it. It is the one way you can ensure that the resources within that society are being allocated to their highest and most effective use. A lot of the problems that China is having right now in its own economy are directly a part of the fact that the state-owned bank subsidizes the state-owned enterprises to provide employment.

At the same time, the best vehicle for creating employment is to make sure that they are moving in the direction of a market economy. And you really got your finger on something in the sense that what causes the friction in the trading relationship between us and China, particularly for our manufacturers, is that process of change isn't moving fast enough. If these guys were a market economy, it would be a different story. When I go talk with manufacturers everybody is content, just as you were saying, Congressman Burton, if the playing field is level they are willing to compete basically. And the bottom line is how do you get to that point because we are not there yet with China. And it is the very nature and structure of their system that is the principal difference.

So even as a second order of preference, I would be moving in the direction of a market economy because they recognize the

United States is the market they have to participate in. If they are going to succeed economically, they have to prove they are a player in this market because it is the most competitive market in the world. And the only way to do that and not face the pressure they are going to face on trade is to make sure you have that process continuing to move toward a market economy.

Mr. FALEOMAVAEGA. At least from the time of Mao Tse-Tung, which nobody disagrees was an extreme situation. They all realize this is not the way to go. It may be that they are trying to get into a market economy like other countries. Give them some credit for their efforts. Certainly I would like to think that they understand the situation and hopefully that they will make every effort to work as mutual partners and not as adversaries.

Mr. ALDONAS. And I do have to say that our discussions with the Chinese leadership, our counterparts, are very pragmatic. They have specific economic goals. It is up to us to draw the line for the United States. We have to defend our interests. They have a pretty clear idea where they are going and where they think they need to move in terms of the pace of change, and it is our job to tell them that pace of change has to accelerate otherwise you are going to see the friction.

Mr. FALEOMAVAEGA. My time is up, but I want to note, Mr. Chairman, the loss of jobs has been mentioned a couple of times. This did not just happen yesterday. This has been going on for the past 10 years. Fifty thousand jobs for textile workers are gone and it wasn't necessarily to China. There were other regions of the world that got these jobs. I wanted to make that point.

Chairman HYDE. Thank you, Mr. Faleomavaega. Mr. Smith.

Mr. SMITH OF MICHIGAN. The reports indicate that most of the imports from China are produced in factories and companies owned by the United States and other non-Chinese companies; is that correct?

Mr. ALDONAS. It depends very much on the industry. If you look at textiles and apparel right now, which is under assault, actually most of the factories would be Chinese owned. On the other hand, in the electronics area most of the investment is from other Asian countries.

Mr. SMITH OF MICHIGAN. I am from Michigan. A lot of our automotive industry is now being produced in China. What is the reason? Why are our manufacturers, why are our companies moving to China? What is the greater influence to take advantage of the China market by producing over there or to take advantage of the low cost labor by being able to better compete and send their products back to this country?

Mr. ALDONAS. It is both, and both relate to being globally competitive, in the sense that if it is General Motors, Ford, Chrysler, what they are trying to operate is a globally competitive supply chain and what that makes them move on a variety of components is to the lowest price. Unfortunately what our guys are facing in the tier 3, tier 4 suppliers in the automotive market is a real crunch on their pricing power, because everyone in the auto industry, since they have to pay for their health benefits and pension retirees and the contracts they have signed, is trying to drive the cost down and they drive that cost all the way down their supply chain.

And in fact some of the best businessmen I met when I was going across the country are from Michigan and they are in tier 3 and tier 4 and they have to be the best business people to grapple with this cost structure that the OEMs in the auto industry drive down.

So it basically boils down to price. Some of what they are doing certainly is to access the Chinese market. General Motors, for example, manufacturing in China, doesn't export the vehicles back here. Those are for sale in China.

Mr. SMITH OF MICHIGAN. The finished product. But the components—still there are a lot of components coming in.

Mr. ALDONAS. Yes.

Mr. SMITH OF MICHIGAN. And I am trying to figure out a couple things. One is the advantages and disadvantages. Certainly, the low cost imports and the imbalance of trade that I am told that—roughly 11 percent of the imbalance of trade comes from China as opposed to trade throughout the rest of the world?

Mr. ALDONAS. It is a little higher, it is about a fifth.

Mr. SMITH OF MICHIGAN. So the——

Mr. ALDONAS. China's share of the trade deficit about a fifth.

Mr. SMITH OF MICHIGAN. In terms of that influence on our economy, in terms of the downward pressure on interest rates, in terms of what we need to finance this huge deficit spending that government is undertaking, so that 100 billion of positive balance that the Chinese has, where is it going? Is it going into treasuries or equities?

Mr. ALDONAS. Actually there has been a shift recently and this is true not just of Chinese investors, but investors generally moving into treasuries relative to stocks. And it has been a movement in part because of the performance of the stock market. It was a shifting out toward bonds. But some of it recently is no doubt because we are in the market more in the way of public funding. They are finding security in those treasuries. So there is a circle where that stuff is coming back to the United States in the form of investment, but the mixture has shifted. One of the things that I think when we look out and we worry about is the degree to which the investment that is coming back in is going into direct productive investment that will generate a profit that helps you pay the folks back as opposed to going to current consumption.

Mr. SMITH OF MICHIGAN. Do you have any kind of substitute crystal ball that can project at what point in the future there is going to be a balancing out of the advantage—short-term advantages that China has? I am not so much concerned about the short-term consequences. In fact *The Wall Street Journal* yesterday, wherever they come up with their figures, said that China has lost more manufacturing jobs than the United States has. What I am concerned with is our long-term ability to increase our competitive position, our productivity, because if we don't do that and it starts looking like other places are a better place to invest, we have become so dependent and so desperate on the investments to finance our overspending in this country, our overspending in government to finance our research and development as far as investment in our equities. Do we know what percentage of our equities and what percentage of our treasuries are owned by foreign investors?

Mr. ALDONAS. You know, I don't know off the top of my head, but I can get you the answer to it. But the answer to your underlying question is something quite different than the topic of the underlying hearing. Probably the two best measures of our competitiveness are, one, our productivity. It is way up. It is sky high. And indeed, some of the productivity gains are putting pressure on the ability to generate jobs in the manufacturing sector; in other words, the more productive you become, you make goods with less things, you make goods with less people.

Mr. SMITH OF MICHIGAN. In fact, the percentage of our GDP that comes from manufacturing has slightly increased.

Mr. ALDONAS. While the employment has been going down. What you are really seeing is the other factor. The other factor is the share of world trade made up by our exports, and that actually increased from 1980 until about 2001. And then what you saw is a sharp drop in the share of world trade made up by our exports. And what that tells you is you are looking at very small growth with our trading partners.

So while much of the discussion has been about China, one of the things you have to focus on there is there is no growth in Germany and there is no growth in Japan, and that is still 20 percent of the world economy. Basically you have a world economy that is flying on one-and-a-half engines, the United States and China. China has grown about 10 percent and we are growing roughly at 4 right now. And what you are looking at in Japan is still ⅔ of the GDP in Asia. You have to buy an awful lot of things from the United States but the demand is way down because there is no growth. And that is where you see the sharp fall in our exports.

To address the trade balance, as a practical matter, you have to see growth abroad. The only other way you will get the trade balance down is if our economy slows, and nobody is interested in doing that.

Chairman HYDE. Gentleman's time has expired. The gentleman from Texas, Mr. Paul.

Mr. PAUL. Thank you, Mr. Chairman. I have a couple of comments and then two questions. It seems like the argument is that we have lost manufacturing jobs and everybody is concerned about it and rightfully so and that our dollar is too strong. If we only could raise the yuan and if they don't do that we add tariffs. That seems to be one of the arguments going on in Congress right now, and I think that is overly simplistic and that it is more complicated than that. It has to do with the world dealing with fluctuating fiat currencies. Everybody has the paper currency and everybody is printing it at a different rate and everybody's perceptions are different. It is an unmanageable affair in that, if the world had a single currency that could be agreed upon that had real value we wouldn't even be talking about this.

That is not the case. A good example of what could happen if we had that would be something that does actually occur in our country. We have poor States and rich States and we don't even measure the difference in the trade between the States. It balances it out and it becomes a nonissue because everyone is dealing with the same currency. But politics gets involved. Military gets involved. Perception gets involved, all sorts of things that create these problems. And I think this whole idea, this notion—this idea that if we could just lower the—or raise the value of the yuan, everything is going to be okay.

I am interested in the bigger picture of the current account deficit, which is made up of more factors than trade. It is made up of the goods and services as well as earnings. But if you are a free market person and you don't want to deal with that, you are getting involved. Then we get into these WTO fights and these trade fights and they don't ever get anywhere. If you want to deal with earnings, then you have to get into capital controls. And that of course is an end stage of this whole process.

But there is a third element that adds—contributes to our current account deficit, and that is our unilateral transfer payments. Now there is where I think we have the responsibility and we never talk about it. And yet China has tremendous benefits from unilateral transfer. If you look at the EX–IM Bank, it is into the billions of dollars. So we provide their credit for them at a discount rate, which takes it away from somebody here. At the same time, they then have dollars left over that they can monkey around with and prop up their currency. It seems to me—and I have some bills that would deal with this, that removes these subsidies to our competitors. That to me seems to be going in the right direction of a more free market rather than going in the wrong direction of threatening our partners for them to do something that they may be able to or they may not be able to. And if they don't, we are going to threaten with tariffs. That is certainly going in the wrong direction.

So I would like you to comment on that as well as the whole idea of competitive devaluations because we are talking about competitive devaluations. Now I never could understand this because they seem on the short run to have these tremendous advantages. That is like saying I worked all my life, I put my money in the bank and I am going to live off my CDs and then somebody comes along and says, I want to devalue your money. I want you to get a lot less for your money. It is criminal. It is immoral and wrong. I don't think there should ever be an advantage, you know, to devalue the money that somebody has saved and it is a further incentive not to save.

Give me an idea of what you think about the economic history of competitive devaluations. Have they worked? Are they really worth getting involved in that or is there a good argument of just forgetting about competitive devaluations?

Mr. ALDONAS. Competitive devaluations don't work for two reasons. You are right on target there, Congressman Paul, in the sense that either one, they may give you a short-term advantage, but it is a hugh cost to your own economy. It is really what assumption you are working under in terms of the economy. You are trying to raise living standards or you are simply trying to drive production out the door and keep people employed at any cost. So those who adopt the latter more mercantilistic approach will generally say, yes, I am going to engage in a competitive devaluation.

The second thing is that in the longer term, what they generate is so much friction in the trading system that you will see retaliation. And generally what we saw—although lots of people point to

Smoot-Hawley as the source of the Great Depression, it wasn't. That was a reaction to the Fed, but it certainly exacerbated the Depression as did the competitive devaluations of that era. And what it became was just a game of tit for tat where everybody lost.

At the same time, the President's request that at least among our major trading partners that the market govern is not consistent with the right approach economically. It is not suggesting anybody should engage, including us, in any form of competitive devaluation. What it is saying is the market ought to decide it at the end of the day because that is going to be the best resource allocator.

One thing you always put your finger on, which I think is exactly right, there is always a difference you can see at the approach of the macro level and the micro level approach that our manufacturers face where they just have to grapple with the things that are shaping their own personal competitive environment. And where trade policy is right at the interstices between these two things because I think what you got the target on is the right macro picture and then how that plays out for the individual manufacturers is where we see the friction. And my point has always been, if what you are preaching is getting the economic fundamentals right here in the United States as well as with China, and that means moving toward a market economy, there should be no doubt about that. That is the greatest way to relieve the trade friction in the system, because when you put things in any part of your economy that constrains that sort of thing it generates a sense of unfairness.

Mr. PAUL. Could you comment on the unilateral transfers?

Mr. ALDONAS. There, I think of course you understand that the perception is going to be you are seeing this competition in that micro setting and so what you want to do is be able to compete. So you are right in a sense it is a unilateral transfer to China. They are benefiting from unilateral transfers not only from the United States, but from a variety of other players in the market. But from the guy who has to export, he is looking at how do I compete with the guy who is getting financing from Germans. And the pressure in terms of the Administration policy has been to try and clean up that side of it. Let us get out of business at that point. Until we do though, I think in defense of our exporters, we got to make sure that we are at least trying to put them on the same competitive terms.

Chairman HYDE. The gentleman's time has expired. I want to thank you, Mr. Secretary, for an exciting afternoon. You certainly earned your salary today, and we do appreciate your instructive testimony. Thank you so much.

We have a second panel and I would like to welcome Mr. Frank Vargo. Mr. Vargo is Vice President of International Economic Affairs at the National Association of Manufacturers, commonly known as NAM. NAM is the nation's largest industrial trade association, representing 14,000 member companies, with a mission to enhance the competiveness of American manufacturers. Mr. Vargo is the Association's chief spokesman on trade issues and is leading the manufacturing community effort to reduce foreign barriers to American industrial products. Prior to joining NAM he had a distinguished career at the U.S. Department of Commerce, serving as

Deputy Assistant Secretary for Asia, Deputy Assistant Secretary for WTO Affairs and trade agreements compliance, and Deputy Assistant Secretary for Europe.

Our next witness is Dr. Nicholas Lardy, a Senior Fellow at the Institute for International Economics. Prior to joining IIE, Dr. Lardy was a Senior Fellow in the Foreign Policy Studies Program at the Brookings Institution for 8 years. From 1991 to 1995, he was the Director of the Henry M. Jackson School of International Studies at the University of Washington. Dr. Lardy has taught at the University of Washington and Yale. He serves on the Board of Directors and Executive Committee of the National Committee on United States-China Relations and is a member of the Council on Foreign Relations. He is the author of numerous books and articles on the Chinese economy.

I would like to welcome Ms. Thea Lee, Chief International Economist for the American Federation of Labor and Congress of Industrial Organizations, commonly known as AFL–CIO. This is a voluntary federation of 64 national and international labor unions. And Ms. Lee oversees research on international trade and investment policy in the AFL–CIO's Public Policy Department. Previously she worked as an international trade economist at the Economic Policy Institute in Washington, DC and as an editor at *Dollars & Sense Magazine* in Boston. Ms. Lee is co-author of *A Field Guide to the Global Economy*. She has testified before several Congressional Committees on trade issues as well as a frequent guest on television and radio programs.

Our next and final witness is Ms. Jonna Bianco, President and Chairwoman of the American Bondholders Foundation. Ms. Bianco represents over 150 American citizens from more than 25 States who are holders of over 18,000 Chinese government bonds dating to 1913. Welcome, Ms. Bianco.

We are honored to have you four appear before us today. And Mr. Vargo, we will start with you and entreat you to try to confine your remarks, everyone, to 5 minutes or so, so we can finish at a decent hour.

STATEMENT OF FRANKLIN J. VARGO, VICE PRESIDENT, INTERNATIONAL ECONOMIC AFFAIRS, NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. VARGO. Thank you, Mr. Chairman. It is a pleasure to be testifying on behalf of the NAM. I appeared before this Committee many times over the years when I was at the Commerce Department. I have a prepared statement and just have very brief remarks at this time.

The NAM is looking for a very positive and balanced relationship with China. China poses very formidable challenges to us, but it also poses enormous opportunities. Our trade with China is the most imbalanced in the world. One figure, so far this year China is accounting for 40 percent of the entire growth of all United States imports of manufacturers from the whole world. Imports from China are six times as large as exports and that is a very difficult number to deal with.

My prepared statement shows a matrix on the last page, so you can see with various export and import growth rates just how difficult it is to level off our trade balance much less than having the deficit decrease. Unfortunately, it is clear that even at 33 percent annual rate of growth of our exports it is not going to be enough to begin to stabilize our deficit and keep it from growing rapidly. We are going to have to have a moderation in our import growth. And the whole question is how do we do that without resorting to protections because we can't do that. We have been there in the 1930s. It doesn't work. It will just result in cascading protectionism.

The first thing we need to look at is the Chinese currency. It is controlled just as the Chinese economy is not a market economy, and were it to become a market currency or to emulate a reasonable level, this would be a very good start in helping us get our export growth up and moderate the import growth by the market, not by United States Government intervention.

Let me just briefly touch on outsourcing, because a couple of comments have been made that indicate that all this growth is coming from American companies in China. It is not. Under Secretary Aldonas may not be as familiar with the economic figures as I am. I once ran the Research Office at the Commerce Department, and the latest figures from Commerce state, and these are the figures, that only 3 percent of our imports from China come from United States production in China. The vast bulk of United States production in China is for the local market. And even if you take Japanese companies and other companies, all of the multinational companies that import into the United States are 20 percent of the total. So 80 percent is coming from Chinese companies. So it is certainly true that a lot of United States companies are saying they may have no choice but to move to China.

This is still a manageable situation, particularly if we begin addressing the things that are raising the cost of manufacturing and making the U.S. a less hospitable place for American manufacturers to be.

My second point is we must press harder for full implementation of China's WTO requirements and commitments. It is my view if we had gotten China into the WTO 15 or 20 years ago, we wouldn't have the size of the deficit we have today. We just let China stay as a closed market for too long, and now we have this situation where our imports are six times as large as our exports and we say it is a tough problem, which it is.

But in areas such as semiconductors, Mr. Chairman, where the Chinese provide in essence a 14 percent subsidy for producing your chips in China rather than importing them, that is contrary to the WTO litigation and it has to stop. Ambassador Zoellick is in China now discussing this and other issues, but we all need to press to see that China does implement its obligation.

Finally, Mr. Chairman, not all on China's side, we have to put our own house in order both by looking at all the factors, the litigation costs, the health care costs, the energy costs and other things that are making it difficult for American companies to produce here. But we also have to recognize we have to do more to sell more to China.

The NAM would like to work with this Committee, with the Appropriations Committees and with the Commerce Department to have a massive, massive increase in United States export promotion to China. We would like to look at ideas such as permanent American trade centers. We would like to increase the resources for something known as the Market Development Cooperative Program where vertical trade associations, not horizontal ones like the NAM, can engage in trade promotion using the Export Trading Company Act creatively with China so we can get thousands of American companies selling to China. One of the things we have to do is sell a lot more to China, and a lot of that is incumbent on us. So there is a lot that needs to be done all around, but the currency is certainly important.

[The prepared statement of Mr. Vargo follows:]

PREPARED STATEMENT OF FRANKLIN J. VARGO, VICE PRESIDENT, INTERNATIONAL ECONOMIC AFFAIRS, NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. Chairman and Members of the Committee:

I am pleased to testify today on behalf of the National Association of Manufacturers (the NAM) regarding the U.S.—China economic relationship. In my testimony today I would like to discuss the U.S.-China trade imbalance and its impacts on the U.S. and Chinese economies, the effects of China's fixed exchange rate, U.S. investment in China, China's record in implementing its World Trade Organization (WTO) commitments, and policies the United States needs to implement to do its part in bettering the bilateral economic relationship.

The NAM represents 14,000 U.S. manufacturing companies, including 10,000 small and medium-sized firms. Mr. Chairman, I can tell you that no other trade issue comes close to commanding the attention that China is getting from both large and small NAM member companies. China is simultaneously the greatest concern of our import-competing members and the fastest-growing global market for many larger companies that operate internationally.

I want to stress at the outset that the NAM seeks a positive and balanced trade relationship with China that reflects market forces as closely as possible. The Chinese economy poses huge opportunities for U.S. exporters and investors, and these will grow rapidly. We need to nurture these opportunities as we simultaneously deal with the fact that so many import-competing U.S. firms are challenged by China as never before.

It is also important to recognize that while the rising trade imbalance with China is a growing factor affecting U.S. manufacturing production and employment, it is far from the only factor. Domestic costs, falling U.S. exports, a generalized dollar overvaluation that is only now ending, regulatory pressures, and other issues are also at work. China must not be a "scapegoat" and an excuse for not tackling the other problems. Nonetheless, the economic relationship with China is so important that it must be addressed.

MANUFACTURING: VITAL TO AMERICA

Since manufacturing only represents about 16 percent of the nation's output, who cares? Isn't the United States a post-manufacturing services economy? Who needs manufacturing? The answer in brief is that the United States economy would collapse without manufacturing, as would our national security and our role in the world. Manufacturing is really the foundation of our economy, both in terms of innovation and production and in terms of supporting the rest of the economy. For example, only about 3 percent of the U.S. workforce is on the farm, but they manage to feed the nation and export to the rest of the world. How did this agricultural productivity come to be? It is because of the tractors and combines and satellite systems and fertilizers and advanced seeds, etc. that came from the genius and productivity of the manufacturing sector.

Manufacturing is truly the innovation industry, without which the rest of the economy could not prosper. Manufacturing performs over 60 percent of the nation's research and development. It also underlies the technological ability of the United States to maintain its national security and its global leadership. Manufacturing makes a disproportionately large contribution to productivity, more than twice the rate of the overall economy, and pays wages that are about 20 percent higher than in other sectors. But its most fundamental importance lies in the fact that the manufacturing sector truly underlies the entire U.S. standard of living—because it is the principal way by which the United States pays its way in the world.

Manufacturing accounts for over 80 percent of all U.S. exports of goods. America's farmers will export somewhat over $50 billion this year, but America's manufacturers export almost that much *every month!* Even when services are included, manufacturing accounts for two-thirds of all U.S. exports of goods and services.

If the U.S. manufacturing sector were to become seriously impaired, what combination of farm products together with architectural, travel, insurance, engineering and other services could make up for the missing two-thirds of our exports represented by manufactures? The answer is "none." That, most basically, is why the United States cannot become a "nation of shopkeepers."

Manufacturing went into recession in 2000 and only now—three years later—is showing signs of a turnaround. Shipments of manufactured goods have fallen an astonishing $270 billion since 2000, and 2.8 million American factory jobs have been lost—roughly one in every six jobs. Manufacturing represents 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.

With the tax cuts that have been enacted, low interest rates, and appreciation of major foreign currencies from their previously highly-undervalued positions, the stage is now set for a turnaround in manufacturing. However, despite recent promising signs that the manufacturing sector is recovering from its three-year long recession, U.S. manufacturers continue to struggle in the face of weak demand and the most intense global competition in history.

The NAM Board of Directors has identified four priority policy areas that demand prompt attention from government policy makers:

- Reducing the cost of producing in the U.S. by containing health care costs, enacting legal reforms, including asbestos litigation reform, ensuring adequate and affordable energy supplies, and reforming the regulatory process. This is the single most important problem, and the difficulties of its solution must not be allowed to preclude action.
- Leveling the international playing field by ensuring that our major trading partners, including China and other Asian nations, reduce trade barriers, comply with international trade rules and allow markets to determine exchange rates.
- Promoting innovation, investment and productivity through tax reforms that encourage investment and R&D, domestic and international tax rules that keep U.S. manufacturers competitive and promote inward investment, and strengthened R&D programs.
- Ensuring an adequate supply of skilled workers through greater emphasis on technical education, including engineering and science; expanded business-government partnerships; and a redirecting of federal programs to assist displaced workers.

The NAM is very pleased with the rising level of awareness on the part of the Administration and the Congress. Last month Commerce Secretary Evans gave a major speech in Detroit announcing the launch of a new Administration initiative on manufacturing that includes many of the NAM's own recommendations. In addition, Members of Congress have shown more interest in manufacturing issues and proposed several positive resolutions that address concerns the NAM has raised, notably on China's undervalued currency.

TRADE

In looking at why the manufacturing recession is so sharp and why the sector is behaving differently from the rest of the economy and why recovery is so slow, trade immediately stands out as a huge factor. Of the $270 billion drop in U.S. manufactured goods shipments since 2000 (through July 2003, at an annualized rate), $80 billion stems from a drop in U.S. manufactured goods exports—accounting for roughly one-third of the fall in production. A one percent increase in import penetration of manufactured goods over that time accounted for a further $40 billion of the production decline—about 15 percent. All of the increase in import penetration came from China. Import penetration from the rest of the world has been flat since 2000—meaning U.S. imports from them grew no faster than U.S. consumption.

Since 1997 the U.S. merchandise trade balance has gone from a deficit of $180 billion to an annual rate of $545 billion so far this year—an increase of over $350 billion. The fundamental cause has been the extreme run-up in the value of the U.S. dollar since 1997. At its peak the dollar rose about 25 percent over its early 1997 level according to the Federal Reserve Board's (FRB) trade-weighted broad currency index. Using the Institute for International Economics' rule of thumb that each one percent change in the value of the dollar leads to a $10 billion shift in the trade balance, the appreciation of the dollar could account for about $250 billion of the $350 billion increase in the deficit—or about 70 percent.

This is why the NAM worked hard to seek a dollar policy based on market-determined exchange rates reflecting economic fundamentals. The Administration began enunciating such a policy last year. More recently, Treasury Secretary Snow has been very definite in his statements that markets must set currency values free of intervention. He has succeeded in achieving G–7 agreement, as reflected in their forceful support for market-determined currencies in the communiqué from their September 2003 meeting.

With the Administration's insistence that currency values should be determined by market forces, major currencies have been adjusting for over a year now. The FRB index of industrial nation currencies today is virtually back to normal levels, standing only 5 percent above its early 1997 rate. This welcome development will do much to move trade toward greater equilibrium. However, the FRB's broad index of currencies, which includes most Asian currencies, is still nearly 15 percent above the 1997 level, basically because Asian countries have not allowed their currencies to adjust.

Together, four Asian economies—China, Japan, South Korea, and Taiwan—hold $1.2 trillion of official reserves, up $600 billion in the last four years and up $250 billion in just the last 12 months as they have purchased dollars to prevent an excess supply of dollars from lowering the value of their currencies. It should be pointed out that these four countries account for 60 percent of the entire global U.S. trade deficit in manufactured goods.

U.S.–CHINA TRADE

The U.S. trade deficit with China is now the largest in the world, standing at $103 billion last year, as shown in Exhibit 1. China now accounts for close to one-third of America's total deficit in manufactured goods trade. Through July 2003, U.S. manufactured goods imports from China are up 24 percent over the same period of last year, while U.S. manufactured goods imports from the rest of the world are up only 4.8 percent. So far this year, China is accounting for 40 percent the entire increase in U.S. manufactured goods imports. That is why we hear so much about China from so many of our members.

Trade with China is extremely imbalanced, with imports being six times as large as exports. This makes correction of the bilateral deficit extremely difficult. Exhibit 2, attached to my statement, shows alternative U.S. trade balances with China in five years under various import and export growth rates. A continuation of the existing trends would result in a tripling of the trade deficit, to more than $330 billion. There is no question that such a level would result in enormous calls for widespread protection. This must be headed off while there is time.

The important thing is that the trade situation with China is still manageable, if addressed now. While information from our member companies makes it plain that industries such as plastics, machine tools, hardware, furniture, tool and die and others are feeling strong pressures from China now, the situation will become considerably more serious unless corrective steps are taken. One good development is already apparent. U.S. exports to China have broken their long-term trend and are now growing close to 25 percent a year. I believe this reflects the fact that China's market is beginning to open as a result of its entry into the World Trade Organization.

Unfortunately, as the matrix in Exhibit 2 makes clear, no feasible sustained rate of export growth to China can slow the growth of the deficit, precisely because imports are six times as large as exports. Even a 33 percent annual rate of export growth would see the deficit grow two and a half times in five years, to $250 billion.

Thus if the deficit is to grow more moderately or fall, the rate of import growth must decline from the rates we have seen. The question, though, is how import growth rates can be moderated without resorting to protectionism. Protectionism must be avoided. We cannot reverse the open trading system that has been such a source of growth for the United States and the rest of the world and risk a downward cycle of trade deterioration. The answer, therefore is that we must rely on market mechanisms—very importantly, including market-driven currencies.

CHINA'S CURRENCY

There is no question that the Chinese currency is seriously undervalued and is having a major effect on U.S. bilateral trade and on the trade of other nations as well.

China has maintained its currency at its 1994 level against the dollar for the last nine years—despite a huge increase in production capability, productivity, quality, production range, foreign direct investment inflows, and other factors that would normally be expected to cause a currency to appreciate. The currency is controlled by the government, and is not allowed to fluctuate freely. Were it able to float, the degree of upward pressure that the yuan would feel is amply indicated in the amount of reserves that the Chinese government has to accumulate to prevent upward movement of its currency.

China is accumulating dollar reserves faster than any other country. China's reserves at the end of August 2003 stood at $365 billion dollars—120 percent of China's annual exports and nearly one-third of China's $1.23 trillion GDP. China has added $110 billion to its dollar reserves in just the last 12 months.

There are many estimates of where the currency would move if it were able to float—i.e., what its market value would be. The NAM commends the work of Dr. Ernest Preeg, of the Manufacturers Alliance, as well as that of the Institute for International Economics' Dr. Morris Goldstein, as well as other economists' estimates. Most estimates indicate an undervaluation between 15 and 40 percent. Given the price pressures expressed by many NAM member companies, I tend to believe the market price would be toward the upper end of that range.

The Chinese currency is the key, not just because of the huge bilateral imbalance, but also because other Asian countries are all looking over their shoulders at Chinese competition and are reluctant to allow their currencies to move up against China's. Once China's currency appreciates, though, they will be less reluctant to allow theirs to move upward as well.

Would a considerably stronger Chinese yuan have beneficial effects? Absolutely. Many of our member companies tell us that a 20 percent or more price shift would change the competitive situation dramatically.

Moreover, China's huge purchases of dollars are pumping so much local currency into the Chinese economy that it is getting overheated and risks a serious asset bubble and inflation that will worsen the living standards of many Chinese. The International Monetary Fund's (IMF) recent international economic report makes it plain that currency reserve buildups by Asian nations are destabilizing to the world economy and need to be addressed. Thus a currency revaluation that would slow China's reserve accumulation would be a "win-win" situation.

Commentators who state that Chinese wages are so low that no amount of currency appreciation would make a difference overlook the fact that labor costs are only one factor in the production process. In fact, production worker wages and benefits are only 11 percent of the cost of U.S. manufactured goods, on average. An exchange rate reflecting market forces would shift the competitive equation significantly. Certainly many Chinese industries would remain extremely competitive, but others would find their artificial advantage diluted. U.S. exports would also grow more rapidly, helping to bring about a more sustainable trade position.

At that same time, the currency situation and trade with China must be seen in their proper perspectives. While the undervalued Chinese yuan is a major aspect in our growing bilateral trade imbalance, it is not the only factor. Growing concerns over China's shortcomings in implementing World Trade Organization (WTO) commitments and other factors are important factors in the imbalance as well, and I will turn to WTO implementation later in my statement.

Additionally, it is important to recognize that not all of China's rapid export growth to the U.S. market competes with U.S. production. For example, Japan's share of U.S. imports has fallen as China's has risen—implying the possibility of considerable substitution of Chinese for Japanese goods. China is now the largest supplier of computers and related components into the U.S. market. Yet in 2000, China was only our 5th-largest supplier. Though total U.S. imports of computers and components fell from 2000 to 2002, imports from China soared nearly 50 percent, while imports of these products from Japan fell 50 percent and from Korea fell over 40 percent.

The Administration has recognized the importance of having a Chinese currency that reflects market forces, and the NAM applauds the initiatives the President has taken and the work that Treasury Secretary Snow has been doing to obtain progress in this direction. It is important that these efforts bear fruit.

CHINA AS A MARKET

Let me stress that we are seeking a market-oriented approach to U.S.—China trade. The U.S.—China trade relationship needs to be among the largest and strongest in the world, and needs to proceed in a way that clearly benefits both countries. It is also very important to avoid viewing China in a one-sided manner. In addition to being a rapidly rising supplier of imports into the U.S. market, China is also a quickly growing market for foreign goods and services, and this must not be overlooked.

Last year China was our fastest-growing export market. While our overall exports fell 5 percent, our exports to China were up 15 percent. Last year China was the second-largest market for U.S. commercial jet aircraft. China has the same potential for many products.

There is enormous potential for expansion. Only 8 percent of China's imports come from the United States. The European Union sells considerably more to China than we do. We need to examine why the U.S. has such a small share of China's import market, and what—in addition to a currency shift—U.S. exporters need to do to change this situation and help boost two-way trade.

Exporting is not the only way American companies sell abroad. In fact, investing overseas to produce in markets abroad is the predominant way that American companies compete around the globe. These investments strengthen the competitive ability of American firms globally and allow them to increase their market position in countries all around the world.

American companies invest in China, as they do in other countries, but the size of the investments are surprisingly small. Ninety percent of U.S. foreign direct investment goes to the high-income countries, predominantly Europe, to enable U.S. producers to be close to the market. The vast majority of the production of U.S. affiliates is sold locally, in the country of production. Aside from Canada, whose economy is tightly inter-related with ours, only 10 percent of U.S. offshore manufacturing production is exported back to the United States. The rest is consumed locally or exported to third countries.

The same is true with U.S. investments in China. First, they are still very small. Less than 5% of U.S. global foreign direct investment in manufacturing is going to China. Commerce Department data show that the bulk of the output of U.S. firms in China is sold in the local Chinese market. Commerce's data imply that only three percent of U.S. imports from China came from U.S. manufacturing affiliates there. Census Bureau data show that imports into the United States by all multinationals (U.S., European, Japanese, etc.) from their Chinese affiliates account for only 20 percent of total imports from China.

Thus, the data do not support the view that a huge rush of outsourcing has resulted in our trade imbalance with China. Nevertheless, it is certainly true that more U.S. companies are beginning to talk about the necessity of moving to China to stay globally competitive. A growing erosion of our manufacturing base is a real possibility. The best way to ensure that investment flows follow economic fundamentals while maintaining growing manufacturing production in the United States is to have market-determined currencies and a better investment environment in the United States. We need to avoid artificial factors that distort trade and investment, but we must also take the steps necessary to reduce the cost of production in the United States and to improve the attractiveness of the United States as a place for both U.S. and foreign companies to invest.

CHINA'S WTO COMPLIANCE

China's accession to the World Trade Organization in December 2001 was an important positive development for manufacturers because China has now committed to abide by the same international trade rules that apply to the United States and most other countries. Prior to China's accession to the WTO, we had very few enforceable rights in trade with China. Now, with its accession to the WTO, China is reducing tariffs and quotas, and is required to make far-reaching changes that will enable U.S. firms to have a much more open market in China. It is absolutely essential that those changes and commitments be fully implemented by China.

The Office of the U.S. Trade Representative recently asked for views on China's WTO compliance. In order to provide an accurate NAM view to USTR, we surveyed our members. What we found is that as China concludes its second year as a WTO member, its compliance record is decidedly mixed.

While U.S. exports to China continue to increase (by 22 percent in Jan.–June 2003) and a growing number of U.S. companies are trading and investing there, the NAM has also received far more complaints about unfair Chinese practices than in the previous year. These practices are playing a significant role in sustaining the large U.S.-China trade imbalance.

Currency Manipulation—In the view of many manufacturers, China's undervalued currency is the single most important factor driving the growing trade imbalance between the United States and China. As I have discussed this extensively already, I will only add that China's tightly controlled currency creates a trade disadvantage, and we view this as going against the intent of the WTO, which seeks to remove trade barriers and allow markets to determine trade flows. Article XV, for example, states that "Contracting Parties shall not, by exchange action, frustrate the intent of the provisions of this Agreement . . ."

Subsidized Exports—We continue to receive reports from different industries that Chinese products are being sold in the United States at prices so low that they could not even cover the cost of raw materials and shipping much less full production and marketing costs. These reports suggest the possibility of widespread use of subsidies, either direct or indirect, to help Chinese exporters gain a competitive advantage in the U.S. market. One important source of indirect subsidy is continued bank lending to money-losing and insolvent Chinese manufacturers, often state-owned or state-controlled enterprises. Since the Chinese banks providing these loans are either state-owned or state-controlled, the Chinese government bears responsibility for their lending practices.

Counterfeiting and Ineffective Enforcement of IPR Protection—While Chinese laws on intellectual property rights (IPR) have improved considerably, the lack of effective enforcement of the IPR protection remains a serious problem. Violations of trademarks through product counterfeiting is rampant and on a massive scale. The violations involve a wide range of products, including consumer hygiene and health care products, athletic footwear, pharmaceuticals, food and beverages, motorized vehicles and even entire automobiles. And the also involve unauthorized use of U.S. testing and product quality marks. China needs effective laws and enforcement to criminalize counterfeiting. It also needs to enforce commitments to stop the export of counterfeit goods.

Manipulation of VAT and Other Taxes—We have reports that China is manipulating the application of taxes, notably the Value-Added Tax (VAT), to both restrict imports and indirectly subsidize exports. For example, the scrap recycling industry and semiconductor industry have brought specific examples to our attention. In the case of semiconductors, the rebate to domestic, but not foreign, producers could provide as much as a 14% production advantage for firms to locate in China—and appears to be contrary to the WTO's basic requirement that foreign firms receive national treatment for their exports to China.

Inappropriate standards and product testing requirements—NAM members have raised concerns about application of technical standards and the "CCC" China quality mark system. We note several problems including the high cost of having Chinese inspectors audit factories in the United States and other foreign countries on compliance with the standards; continued delays in allowing U.S. testing and certifying bodies to certify compliance for the CCC mark; and lengthy delays and relatively high cost of obtaining testing and certification for the CCC mark in China. Product-specific problems were reported that affect electrical products and tires.

In short, then, we see a variety of unfair practices that are impeding U.S. exports to China or providing Chinese products with competitive advantages in the U.S. and global marketplace. On the other hand, China has implemented most of its required changes, or at least has put laws into place. Some significant problems remain, though, despite the attempts of the Beijing government to bring about the necessary changes.

The NAM recognizes that China is still in transition to a market economy and in the process of phasing in certain WTO market-opening commitments. However, because China is such an important global importer and exporter, it is vital that the United States work to ensure that China complies with all WTO obligations and particularly those that have a significant impact on U.S. economic interests.

MASSIVE EXPORT PROMOTION PROGRAM

There is one more dimension to our trade I would like to discuss before concluding my statement, Mr. Chairman—and that is our exports to China. The NAM believes we must undertake a massive joint public-private export trade effort to increase U.S. exports to China. In 2003, China is set to become the world's 3rd largest importer but the United States only has an 8 percent share of all Chinese imports.

We believe that very rapid rates of U.S. export growth to China are possible—rates of 25–33 percent annually. There is no reason the United States could not double or triple its share of China's imports and benefit fully from China's rapid growth. This would make a significant contribution towards more balanced and sustainable trade with China and would also make a substantial contribution to U.S. economic growth.

We believe the time has come for a total revamping of the U.S. government's export promotion efforts in China. The stage is set. With China's market opening moves stemming from its WTO obligations, restoration of reasonable exchanges rates vis a vis our major competitors, and what we hope will be a Chinese currency that reflects a reasonable market valuation, U.S. export are set to boom.

But they will not do so on their own. The Chinese market is too distant and unfamiliar to most U.S. companies, and they need a partnership with the U.S. government—and particularly the Commerce Department. The NAM envisions a bold program, which could include:

- Permanent American Trade Centers that will attract Chinese buyers to see U.S. products and technologies,
- A large increase in Commerce Department personnel in China, with a full market research program and tailored export promotion assistance to individual firms,
- A huge increase in export financing to put us on a par with competitors,
- A several-fold increase in the Market Development Cooperator Program enabling vertical industry associations (not horizontal ones like the NAM) to promote their industries' exports, and
- Imaginative use of the Export Trading Company Act to create China-specific trading companies enabling thousands of U.S. companies to penetrate the Chinese market.

The NAM looks forward to working with the Congress and the Administration to discuss these and other ideas that could bring into reality our vision of a truly massive program to expand U.S. exports to China.

CONCLUSION

I want to conclude by reiterating that China is only one of the problems facing American manufacturing. We will not succeed in preventing the migration of our manufacturing base to China and other foreign countries if we do not address the high cost of manufacturing in the United States and get the U.S. economy moving again. A fairly valued Chinese currency is important, but we must not forget that the bulk of our problems are home-grown.

U.S. industry is burdened by legal and regulatory systems that retard growth and destroy jobs. Unrestrained asbestos liability alone, for example, could cost U.S. industry $250 billion, resulting in the bankruptcy of even large corporations. Rapidly rising health care costs are a constant worry, particularly for small manufacturers. Uncertainty over sources of energy supply has led to price volatility. Lack of support for research and development threatens to undermine U.S. technology leadership. And shortages of skilled workers have many manufacturers wondering how they can expand in the future.

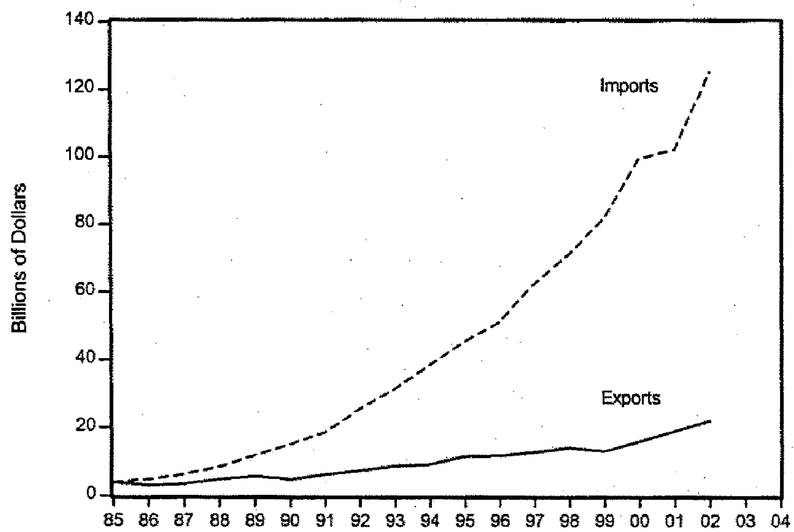
Additionally, bilateral, regional and WTO trade agreements must be negotiated as quickly as possible to get foreign trade barriers eliminated, or at least down to our own low level. U.S. tariffs on manufactured goods average less than 2 percent, while in many parts of the world U.S.-made goods face tariffs 10–15 times higher—or even more.

Unless these challenges are also addressed, we can expect a growing erosion in the U.S. industrial base. Competition with China will only accelerate the trend. However, if we begin to act now, with both a refocused and positive trade policy toward China and a concerted strategy on economic growth and manufacturing renewal, we can restore the dynamism and competitiveness of U.S. industry and ensure the global leadership that is so central to our economic and national security.

Thank you, Mr. Chairman.

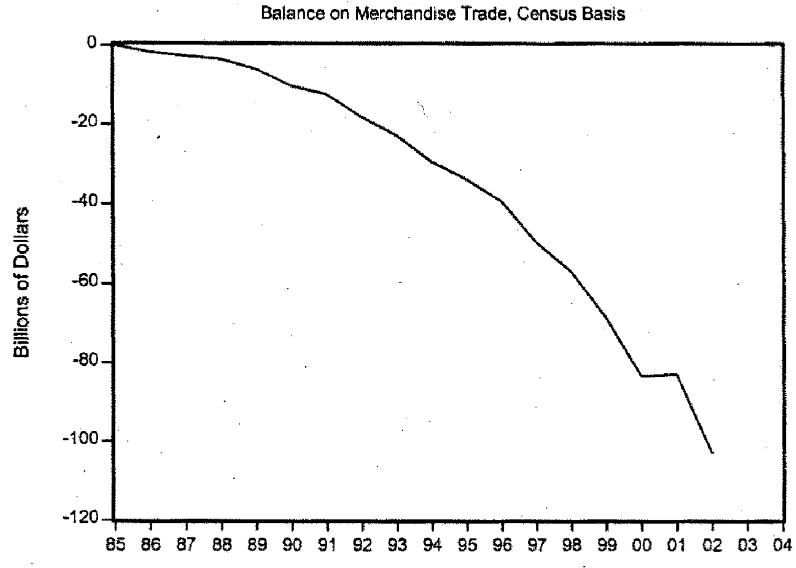
Exhibit 1

U.S. TRADE WITH CHINA



U.S. TRADE BALANCE WITH CHINA

Balance on Merchandise Trade, Census Basis



Source: Census Bureau, U.S. Dept. of Commerce

NATIONAL ASSOCIATION OF MANUFACTURERS

EXHIBIT 2

ALTERNATIVE U.S. TRADE DEFICITS WITH CHINA

20-Year Trend: Exports to China up 12% per year; Imports up 20% per year

IF THESE TRENDS CONTINUE FOR 5 MORE YEARS THE CHINA TRADE DEFICIT WILL TRIPLE, TO $330 BILLION

Projected 2008 Trade Deficits with China
Under Alternative Export and Import Growth Rates
(Billions of Dollars)

Import% \ Export%	12%	25%	33%
20%	($330)	($290)	($252)
15%	($246)	($205)	($167)
10%	($178)	($138)	($100)
7%	($144)	($104)	($66)

Chairman HYDE. Thank you, Mr. Vargo.
Mr. Lardy.

STATEMENT OF NICHOLAS R. LARDY, PH.D., SENIOR FELLOW, INSTITUTE FOR INTERNATIONAL ECONOMICS

Mr. LARDY. I am delighted to have a chance to be here and talk to you about this very important trade relationship between China and the United States. I think you have heard the numbers already. China is our third largest trading partner today. The United States is China's second largest trading partner, and the trade between the two countries is growing extremely rapidly.

I would like to begin talking primarily about the causes of the bilateral trade imbalance. We have heard a lot about it already this afternoon. It has been a continuous source of concern, and I want to underline what I think was one of the key points that Secretary Aldonas didn't have time to elaborate, and that is that the bilateral trade imbalance has emerged primarily because China has become the leading location for the assembly of a broad range of goods that used to be assembled elsewhere in Asia. The parts and components for these goods come predominantly from elsewhere in Asia. The final goods are sold predominantly in North America and Europe, and the result is that China has a large and growing deficit in its trade with most of its Asian trading partners and a large and growing surplus in its trade with the United States and with Europe.

I think this is a structural deficit. It reflects very little about exchange rates or Chinese protectionism. I have said for at least a decade that because of this underlying structural problem the surplus that China has with the United States is likely to continue to expand as we go forward regardless of what happens to the Chinese exchange rate.

Now let me turn secondly to the question of whether or not this is an open or a closed economy. I think we heard a number of expressions today that China is basically a pretty closed economy and it is very hard to sell there. I would point out that over the last 12 years; that is, from 1990 to 2002, Chinese imports grew at an annual rate of 15 percent. They went from $53 billion to $295 billion. In the first 9 months of this year, China's imports rose by an additional 40 percent. Their imports this year will grow by more than 100 billion U.S. dollars. Chinese total imports this year will exceed those of Japan for the first time. This will make China the third largest importing economy in the world.

If you look at the ratio of imports to GDP, which is a common indicator, it has roughly doubled over the last 13 years, up about 15 percent from 1990. It will be more than 30 percent this year. In Japan that ratio is 8 percent. In the U.S., that ratio this year will be about 14 percent. As measured by the ratio of imports to what the economy is producing for a large continental size of the economy, China has a remarkably high import ratio.

I point out finally that their import tariffs are very low. Their import tariffs on manufacturers are only 10 percent. They will go to 9 percent when China's WTO commitments are fully phased in in 2005. If you take four other large economies, when they fully implement their Uruguay Round commitments in 2005, I am talking about Argentina, Brazil, India and Indonesia, their tariffs on manufactured goods will be 31 percent, 27 percent, 32 percent and 37 percent, respectively. In other words, China already has the lowest tariffs of any emerging market economy. They are substantially lower than most other comparable economies.

I will close finally with a few remarks on the exchange rate. I certainly agree with what has been said by several people already. The Chinese currency is undervalued. I think the Chinese leaders' own actions already implicitly have acknowledged that. They are taking a series of ad hoc measures to try to reduce pressure on the currency. They do not want to, however, introduce a float. And indeed, I would say that a floating exchange rate with liberalized capital controls is desirable in the long one, but it certainly is not a viable strategy now even though it is highly desirable in the long run. I think the appropriate strategy now would be a revaluation in the range of 15 to 25 percent. I think that would help them end the buildup of foreign exchange reserves which is complicating the ability of the authorities to conduct monetary policy. I would hasten to add even if China were to revalue by this amount, the effect of the bilateral deficit would be modest, perhaps less than $10 billion. It could be somewhat larger if it led Taiwan and South Korea and perhaps other Asian countries to revalue their currencies as well. But a Chinese revaluation even in the 15 to 25 percent range would not make a huge difference to the bilateral trade imbalance.

As I said earlier, I think there is a long-term structural problem that has very little to do with either the exchange rate or Chinese protectionism.

Thank you very much.

[The prepared statement of Mr. Lardy follows:]

PREPARED STATEMENT OF NICHOLAS R. LARDY, PH.D., SENIOR FELLOW, INSTITUTE FOR INTERNATIONAL ECONOMICS

Thank you very much Chairman Hyde for inviting me to appear before this House Committee on International Relations hearing on United States China economic ties.

Bilateral trade between China and the United States has grown rapidly in recent years. China is now our third largest trading partner. Firms located in China are now the second largest supplier of imports to the United States, having gone ahead of Japan in 2002 and Mexico this year. China is the sixth largest market for firms located in the United States. The United States is China's second largest trading partner. The United States has long been the single largest export market for firms located in China, taking over 30 percent of total exports produced in China. It has been a more modest supplier of imports, for reasons explained below.

Causes of the Bilateral Trade Imbalance

While bilateral economic ties between China and the United States are robust, they have been characterized for more than two decades by a growing bilateral trade imbalance. Initially the balance in China's favor was small. But in recent years it has grown substantially and now constitutes the largest single bilateral deficit of the United States. The principal cause of the growing imbalance is not the nature of China's exchange rate system or Chinese protectionist measures that keep out foreign goods. It is rather that China has become a leading location for the assembly of a broad range of manufactured goods, most of which previously were assembled elsewhere in Asia. The major parts and components that comprise these goods are purchased mainly from other Asian countries and the final goods are sold predominantly in North America and Europe. The vast majority of these goods are assembled by foreign firms that have relocated their assembly activities to China. It is no accident that as the U.S. bilateral deficit with China soared from US$10 billion in 1985 to over US$100 billion last year that the share of China's exports produced by foreign firms rose from 1 percent to 52 percent over exactly the same period.

As a result of China's emergence as a major base for foreign firms to assemble manufactured goods, China runs a trade surplus with the United States and Europe and a significant deficit with Asian countries. Its overall trade surplus, however, is quite modest. As measured by its current account, its surplus has averaged only 2 percent of gross domestic product since it pegged its currency to the U.S. dollar in 1994. This year, for reasons explained below, its current account surplus will be below 2 percent.

China's global pattern of trade—surpluses with the United States and Europe but deficits with most of its Asian neighbors—stems from several sources. First, and most importantly, it reflects Chinese policies welcoming foreign direct investment, particularly in manufacturing. Foreign firms by the end of the first half of 2003 had invested about US$480 billion in China, far and away the largest amount of foreign direct investment in any emerging market. A little over half of all this investment has been in the manufacturing sector. Not only does China place few restrictions on foreign ownership of manufacturing firms, through its tariff and other policies it allows foreign firms that produce for the export market to operate at international prices. Machinery and equipment that goes into foreign joint ventures and wholly foreign-owned firms is entirely exempt from import duties. And the foreign-sourced parts and components that are assembled into finished goods are also exempt from all import duties when they are reexported in the form of finished goods. Moreover, manufacturers are eligible for a rebate of almost all domestic valued-added taxes they have paid for any content in their exported goods that is sourced from within China. Combined with relatively low cost, high productivity labor, these policies have made China one of the most competitive global locations for the assembly of manufactured goods for export.

China's globally competitive position is clearly reflected in the pattern of U.S. imports. China, not South Korea and Taiwan as in the past, became in the early 1990s the single largest source of imported footwear in the United States market. China, not South Korea, Taiwan, and Hong Kong as was the case in earlier years, for more than a decade has been the single largest source of imported toys and sporting goods in the United States market. And China last year replaced Japan and Mexico as the largest single source of U.S. imports of consumer electronic products and information technology hardware such as computers.

The pattern of trade mentioned above, in which China runs trade surpluses with the United States and to a lesser extent the European Union while running trade deficits with its Asian neighbors, stems also from two additional factors. First, firms based in other Asian countries have undertaken the vast majority of foreign direct investment in China. Contrary to the common impression here, United States and European firms are relatively minor investors in China. Asian firms, notably those from Hong Kong, Taiwan, Korea, and Japan account for about 70 percent of China's inward foreign direct investment. Firms based in these countries tend to source their high valued added parts and components for their China operations from their home countries. As a result China, for example, last year ran a massive trade deficit of more than $25 billion in its trade with Taiwan. Two-thirds of China's imports from Taiwan last year consisted not of finished goods but of parts and components that subsequently were assembled in factories owned by Taiwan firms. The resulting final goods were exported into the global market, predominantly to the United States and Europe.

A second factor is that unlike other Asian firms that tend to use China as an export platform, most U.S. and European firms operating in China have invested there primarily to sell into the domestic market rather than to export. The best example would be Volkswagen, which has had a dominant share of the Chinese car market for over a decade. The output of Volkswagen's joint ventures in Shanghai and Changchun is sold entirely on the domestic market. Firms producing for the domestic market tend also to source their inputs largely on the domestic market rather than from their home countries.

In short, American and European investment in China is relatively modest and geared primarily to the domestic market. The investment of Asian firms in China is not only much larger but it tends to be directed to sales in North America and Europe. And these Asian firms source a large share of parts and components they use from their home countries. The combination of these factors creates the pattern of trade sketched earlier.

Finally, I would underline that China's large and growing bilateral surplus in its trade with the United States does not constitute evidence that China's trade practices are systematically protectionist. Yes, China does protect some specific sectors and products, at times in violation of its commitments to the World Trade Organization. But China is certainly one of the most open; perhaps the most open of all emerging market economies.

China's high degree of openness is reflected in several measures. First, its global imports have been growing at a prodigious rate in recent years. China's imports grew from US$53.4 billion in 1990 to US$295 billion last year, a growth rate of more than 15 percent annually. This year China's imports in the first nine months increased by 40 percent, more than double the rate of increase in the first nine months of 2002, and are on track to expand by well over US$100 billion for the year as a whole. China's global imports this year, which are likely to exceed $400 billion, will for the first time exceed those of Japan, making China the third largest importing nation in the world after only the United States and Germany. China's economic growth this year is exhibiting a distinct up tick. It is a measure of the relative openness of its economy that as economic growth has accelerated this year that Chinese import growth has accelerated at an even more rapid rate.

A second measure of China's economic openness is the ratio of its imports to gross domestic product, sometimes called the import ratio. China's import ratio increased from under 15 percent in 1990 to almost 25 percent last year. This year the ratio likely will reach 30 percent. Thirty percent is almost four times Japan's import ratio of 8 percent and twice the likely 14 percent import ratio for the US this year.

A third measure of China's openness is the degree of protection provided by its import tariffs. Even prior to the time China became a member of the World Trade Organization it had reduced its average import tariff rate by about three-quarters, from a peak of 55 percent in 1982 to 15 percent at the beginning of 2001. Today China's average import tariff is 11.5 percent and the average tariff on manufactured goods is only 10.3 percent. This, of course, is significantly higher than the tariff levels of the United States and other advanced industrial economies. But China's average tariff rate on imported manufactured goods is far lower than the rates prevailing in other large emerging markets. For example, when their Uruguay Round commitments are fully implemented in 2005 the average tariff on manufactured goods in Argentina will be 31 percent, in Brazil 27 percent, in India 32 percent, and in Indonesia 37 percent. China's current import tariff rate of 10.3 percent on manufactured goods is scheduled to drop to 9 percent by 2005, only one-quarter to one-third the rates that will prevail in these four countries.

In short by all three standards—the large size and rapid expansion of the volume of imports, the high and rising ratio of imports to gross domestic product, and the sharply declining and relatively low degree of tariff protection—China is a relatively open economy. That conclusion does not absolve China of its need to fully implement its WTO commitments. The Office of the United States Trade Representative and other U.S. government agencies should continue to press China to fulfill all of its trade commitments. While China's full compliance with its commitments could be quite important for some individual U.S. exporters, it is important to bear in mind that it is unlikely that full compliance would have a major impact on the bilateral deficit the United States has in its trade with China. That deficit is a function of the structural factors discussed above, not protectionism in China.

China's Exchange Rate

Is China's currency undervalued? If so what is the appropriate Chinese response? What difference would this response make to bilateral trade between the United States and China?

There is little doubt that the Chinese currency is undervalued. Since it pegged its currency to the dollar in 1994 China has had a current account surplus averaging two percent of its gross domestic product. And in the four years since the Asian financial crisis China has also had a capital account surplus of a little over 1 percent of gross domestic product. To keep the currency pegged at 8.28 yuan to the dollar China's authorities have had to purchase significant amounts of foreign exchange in recent years and reserves have risen accordingly.

The Chinese authorities, through their own recent actions, have implicitly admitted that the yuan is undervalued. To date they have chosen to try to reduce the pressure on the currency through a series of ad hoc measures, rather than making any change to their exchange rate regime. Just last week the government announced that it would reduce by an average of three percentage points the rate at which it rebates the value-added tax on products that are exported. That will tend to make Chinese exports more expensive in international markets. But, unlike an exchange rate change, this will have no effect on the relative price of imports. The authorities also have signaled an easing in the approval process for outward-bound foreign direct investment; liberalized outbound Chinese tourism; and allowed one domestic financial institution to issue dollar-denominated debt. They are contemplating allowing domestic insurance companies to purchase foreign-currency denominated financial assets; approving a qualified domestic institutional investor program that would allow Chinese, within carefully defined limits, to invest in securities traded on foreign markets; and so forth. All of these measures would tend to increase the demand for or reduce the supply of foreign exchange, which would contribute to a lessening of the build-up in official foreign exchange reserves.

The United States policy of encouraging China to adopt a more flexible exchange rate system is certainly appropriate as a long-term objective. The Chinese authorities over the years have repeatedly expressed the goal of moving toward a convertible currency and a more flexible exchange rate regime. There is no debate on the long-term desirability of such a policy.

In the short and medium run, however, a convertible currency and a floating exchange rate is not a viable option for China. Chinese households have more than ten trillion yuan deposited in savings accounts in the banking system. Very few Chinese savers have had any opportunity to diversify the currency composition of their financial savings. Eliminating capital controls could well lead to a substantial move into foreign-currency denominated financial assets, most likely held outside of Chinese banks. Given the well-known weaknesses of China's major banks, such a move could easily precipitate a domestic banking crisis. As a result, the authorities do not anticipate relaxing capital controls on household savings until they have addressed the solvency problems of the major state-owned banks.

My colleague at the Institute for International Economics, Morris Goldstein, and I recently have written two articles outlining the case for a revaluation of the Chinese currency. Our tentative judgment is that the currency is undervalued by an amount in the range of 15 to 25 percent. We believe that the currency should be revalued and at the same time the authorities should widen the band within which they permit market forces to determine the value of the currency and that at the new parity the Chinese currency should be pegged to a basket of currencies rather than pegged simply to the U.S. dollar. I have submitted these two articles, which appeared originally in the *Financial Times* and *The Asian Wall Street Journal*, for the record so will not repeat the case for revaluation here.

What difference would a revaluation of the yuan by 20 percent, the mid-point of our range, make to the bilateral trade relationship? A 20 percent revaluation of the yuan would reduce China's current account position by about US$40 billion, that is imports would increase and exports would contract by an amount summing to US$40billion. Since the U.S. accounts for somewhat less than one-quarter of China's trade, the expected reduction in the U.S. bilateral trade deficit with China would be under US$10 billion. Given the lags with which in the price effects of an exchange rate change work through the markets, the US$10 billion likely would be reflected in a slowdown in the rate at which the bilateral imbalance grows, rather than a reduction in the absolute size of the deficit.

The effect of a Chinese revaluation on the overall U.S. current account, however, is likely to be much larger than the influence on the bilateral trade balance alone. The reason is that China may be the key to a general realignment of Asian currencies. Given China's increasing competitiveness as a global exporter, Taiwan and South Korea, for example, have been reluctant to let their currencies appreciate. Instead they have been intervening in the market, adding substantially to their foreign exchange reserves to prevent their currencies from appreciating. China's revaluation could well be a catalyst for revaluation of the Taiwan dollar and the Korean won, as well as helping to sustain the recent appreciation of the yen vis-a-vis the U.S. dollar. The cumulative effect on the overall U.S. current account deficit of such a general realignment of Asian currencies in response to a 20 percent revaluation of the yuan would be several times the $10 billion estimated reduction in the U.S. bilateral trade deficit with China.

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COMMENTARY

TWO-STAGE CURRENCY REFORM FOR CHINA

By MORRIS GOLDSTEIN and NICHOLAS LARDY

It was the unstoppable force meeting the immoveable object. During his recent visit to Beijing, U.S. Treasury Secretary John Snow stated that his objective was to get China to commit to moving to a "free-floating" currency, while senior Chinese officials stressed the contribution that a "stable" yuan had made to economic stability and development in China, Asia and the world. How then to square the circle that seems to call for three objectives: a near-term revaluation of the yuan, greater stability of the yuan in the medium term and greater flexibility and market determination of the yuan a little later down the road?

Most proposals for Chinese currency reform fall prey to one of two problems. If revaluation of the yuan has to wait until China is willing to undertake full capital-account liberalization, then the rest of the world has to live for too long with a misaligned yuan. Alternatively, if China is asked to free float the yuan and adopt capital-account convertibility before it puts its domestic financial sector on a firmer footing, it would be casting aside one of the main lessons of the Asian financial crisis.

Our answer to this dilemma is that China should view reform of its currency regime as a two-step process. The first step should be a medium-size (15% to 25%) revaluation of the yuan, a widening of the currency band (to between 5% and 7%, from less than 1%), and a switch from a unitary peg with the dollar to a three-currency basket peg, with weightings of roughly a third each for the dollar, euro and yen. Step two should be adoption of a managed float, after China strengthens its domestic financial system enough to permit a significant liberalization of capital outflows.

The Chinese leadership implicitly recognizes the yuan is undervalued. But they apparently believe the disequilibrium in the foreign-exchange market can be ameliorated by selective liberalization of current- and capital-account transactions while leaving unchanged the current fixed parity with the dollar.

The authorities recently increased the amount of yuan that Chinese tourists can convert to foreign currency and began to allow Chinese firms with certain types of foreign-exchange earnings to retain them rather than surrender them to the central bank. They have given the green light for a state-owned bank to issue its first dollar-denominated bond on the domestic market and have already signaled that requests for outward foreign direct investment are now more likely to be approved.

They are also discussing a reduction in the value-added tax export rebate rate to 11%, down from its current level of 15%. And they may allow mainland residents and certain financial institutions to purchase limited amounts of foreign securities. The authorities hope that these steps will either increase demand for, or reduce supply of foreign exchange, thus relieving the upward pressure on the currency.

While the go-slow approach presumably appeals to the leadership because of its limited short-run effect on China's exports, incoming FDI, and trade-related jobs, it is likely to do little to remove the misalignment of the yuan that has pushed China's overall balance of payments into a larger surplus, fed a huge reserve accumulation over the past 18 months, and increasingly concerned many of China's trading partners, including the United States, Euroland, Japan and South Korea. Very small adjustments could simply stoke further capital inflows by persuading market participants that speculation on the yuan is a one-way bet. Although the low interest rates paid on domestic central bank bonds has meant that sterilization of international reserves has so far been less onerous in China than in many other emerging economies, experience shows that sterilization becomes more costly and less effective the larger it is and the longer it goes on.

With its mountain of bad loans, China cannot afford to let capital inflows exacerbate the already excessive expansion in bank lending, money-supply growth and investment. The recently announced increase in reserve requirements for banks indicates that overextension of the financial system is now clearly visible on the central bank's radar screen.

In contrast, consider the advantages of our proposal for a medium-size revaluation. This would immediately deal with the existing undervaluation of the yuan and remove the incentive for further speculative capital inflows and reserve accumulation. No longer would the foreign component of the money supply be working at cross-purposes with the needs of domestic stabilization. It would show trading partners that China is not attempting to manipulate its exchange rate, thereby lessening the threat of protectionist measures against China's exports. It would make the yuan part of the solution to the global pattern of payment imbalances—not part of the problem.

In doing so, it would add to the plaudits that China received during the Asian financial crisis for conducting a responsible exchange rate policy and for taking the wider interest of the region into account. It would also increase the odds that Japan and emerging economies elsewhere in Asia would be willing to allow their exchange rates to appreciate, reducing the burden on the euro contributing to the needed downward adjustment of the dollar and limiting the deterioration in China's competitiveness. By adopting a wider band, China would gain valuable experience in allowing the exchange rate to be more responsive to market forces.

Just as important, by moving to a three-currency basket peg, China would increase the stability of its overall trade-weighted exchange rate. In a context where the dollar needs to depreciate further to help reduce the unsustainable U.S. current-account deficit, a basket peg would permit the dollar to depreciate against the yuan without a series of yuan parity changes. That could not happen if China retains its present unitary peg to the dollar.

The key to reconciling China's desire for exchange-rate stability with the need for the yuan to play its proper role in global balance of payments adjustment is to recognize that a fixed rate for the yuan need not be at the present parity. Stability of China's exchange rate should be interpreted against a wider set of reserve currencies than the dollar alone. The transition from "fix" to "flex" need not occur in one fell swoop, since liberalization of the capital account will proceed in stages.

Looking farther down the road, China will find it in its interest to move to a regime of managed floating because capital mobility in and out of China will increase and because it will want to exercise greater monetary-policy independence for stabilization purposes. It would be unwise to float now because the domestic financial system is still far too fragile to rule out large-scale capital flight in response to bad news. In addition, the government still dominates foreign-exchange transactions to a degree that precludes the market functioning properly. But these obstacles to floating the exchange rate should lessen as China reduces its large stock of nonperforming loans in the banking system, government involvement in the credit-allocation process declines in favor of market forces, and the progressive dismantling of restrictions on international capital flows widens and deepens the scope and liquidity of foreign-exchange trading.

As a host of emerging-market crises of the past decade have demonstrated so dramatically, high capital mobility vastly increases the vulnerability of a publicly announced target for the exchange rate. With China's public debt burden rising under the weight of bank recapitalization and assumption of pension liabilities, fiscal pump priming will be more constrained and monetary policy is likely to take on an increased share of stabilization duties. Thus China will want to increase the flexibility of its exchange rate regime.

But this need not mean slavish adherence to a pure float. If and when market forces push the yuan beyond the levels consistent with its economic fundamentals, China, like other countries, should retain the option to manage the float by intervening in the exchange market—so long as that intervention is not prolonged and not just in one direction. In short, a managed float should be the preferred regime choice for the second stage of reform.

The currency regime that has served China well in the past is not the currency regime that will serve China best today or in the future. Likewise, if the U.S. wants to persuade China to reduce the serious undervaluation of the yuan and to play a larger role in the global adjustment process within the next year or so, it too will have to alter its opening negotiating position by dropping the suggestion that China move in one great leap forward to a free float and completely open its capital markets. With some compromise by all parties and with the right sequencing of China's currency reform, a workable solution is in sight.

Messrs. Goldstein and Lardy are senior fellows at the Institute for International Economics.

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A MODEST PROPOSAL FOR CHINA'S RENMINBI

By MORRIS GOLDSTEIN and NICHOLAS LARDY

The current debate on the renminbi exchange rate is appropriate given China's role as a leading economic and trading power. But the debate has become so politicised that crucial facts are being ignored and dubious arguments are replacing sound analysis. A medium-size revaluation of the currency may not be as "sexy" as a large revaluation or no revaluation but it rests on a firmer foundation and is more consistent with China's long-term interest.

Those arguing for a large revaluation of the renminbi—35 per cent or more—sometimes confuse bilateral trade balances with overall current account balances. While China is running a large (Dollars 100bn in 2002) bilateral trade surplus with the US, its trade balance with the rest of the world is in deficit, at Dollars 75bn (Pounds 47bn). Bilateral trade balances are especially misleading in this case because China processes goods previously exported to industrial countries by other emerging Asian economies.

During the first half of this year, China's current account surplus declined to about 1 per cent of gross domestic product. Adjusting for the recent overheating of its economy and other factors, China's underlying current account surplus is probably no greater than 2 or 3 per cent of GDP.

China's capital account surplus is often overestimated by focusing too much on foreign direct investment. The overall capital account surplus during the 1999–2002 period averaged a modest 1 per cent of GDP—far below the 4 per cent surplus for FDI.

When China does liberalise capital account outflows, there will be downward pressure on the renminbi. With a stock of household savings equal to about 100 per cent of GDP, it would not take much international diversification to turn net capital flows from surplus to deficit.

China's build-up of Dollars 135bn in international reserves over the past 18 months does not imply that it is passing up profitable investment opportunities. The investment share of GDP and the rate of expansion of bank lending are both too high. The real risk of an undervalued exchange rate is that it will handicap China's efforts to achieve long-term financial stability.

Those who maintain that a revaluation of the renminbi is unnecessary have done no better in their analysis. As long as China maintains controls on capital outflows, runs surpluses on both the underlying current account and capital account and accumulates reserves, there is a compelling argument that the renminbi is undervalued. Export processing means that it takes a larger revaluation to change China's trade balance.

China's average import tariff rate has fallen following entry to the World Trade Organisation and future trade reform is likely to expand imports further. But clothing, one of China's main exports, is likely to receive a big boost from the scheduled expiry of the multi-fibre agreement at the end of 2004, potentially doubling China's share of the market. Thus, China will not necessarily switch to running current account deficits in the future.

China's exchange rate cannot be analysed in isolation from the pattern of global payment imbalances. At 5 per cent to 6 per cent of GDP, the US current account deficit is not sustainable and its correction would be aided by a further depreciation of the dollar.

But an appropriate dollar depreciation will be frustrated if the Asian economies do not do their part on currency appreciation. China has a weight of nearly 10 per cent in the dollar's trade-weighted index and an appreciation of the renminbi is a sine qua non for Asian currencies to appreciate more generally.

Consumer prices have risen over the past two quarters and, with monetary growth expanding and good prospects for economic growth, exports and FDI, renmimbi appreciation need not drive China into Japan-style deflation, as some have argued.

If China does not adjust its exchange rate, it risks further over-expansion in its financial sector, a reversal of the progress made against its bad loan problem, an upsurge of protectionism in the US and Europe against China's exports and increased regional tensions within Asia. A medium-size revaluation of the renminbi—between 15 and 25 per cent—would be the best response to the current disequilibria. It would be an investment in China's financial stability and could set the stage for a wider international agreement on a more sustainable pattern of exchange rates and payments positions. By acting soon, China can lead the way.

The writers are senior fellows at the Institute for International Economics

Chairman HYDE. Thank you.
Ms. Lee.

STATEMENT OF THEA LEE, CHIEF INTERNATIONAL ECONOMIST, PUBLIC POLICY DEPARTMENT, AFL–CIO

Ms. LEE. Thank you very much, Mr. Chairman. I appreciate the opportunity to come and testify today on behalf of the 13 million working men and women of the AFL–CIO. The issue of United States and China economic ties is of tremendous importance to our members, something we hear about pretty much every day from our local union leaders and activists.

In our view, the United States Government has failed to act effectively to stem the job losses resulting from the burgeoning United States trade deficit with China. The Bush Administration has had opportunities and yet has failed to take concrete steps to ensure that the Chinese government live up to its international obligations on trade, currency manipulation and human rights. It has denied American businesses and workers import relief they are entitled to under the law and has taken positions at the World Trade Organization that will only worsen our trade relationship with China.

John Sweeney, President of the AFL–CIO, said in a press statement released yesterday:

> "Despite this crisis at home and abroad, the Administration has been alarmingly slow to respond and their efforts to date appear to be little more than fig leaves."

I am submitting my testimony for the record, but I'd like to outline a few of the areas in which there have been opportunities for the Bush Administration to take action either on the trade front or the workers' rights and the human rights front, but in fact we have seen a complete failure to act.

In terms of WTO rules we have seen that China has consistently violated its WTO obligations in terms of market opening, and the United States Government has failed to take effective action. The Bush Administration has not used the Transitional Review Mechanism, which was established in China's accession agreement to monitor China's compliance with its WTO commitment, and part of the failure, according to the GAO, was that United States officials were not prepared for the TRM.

In terms of currency manipulation, Mr. Vargo has already talked at some length about the problems of currency manipulation. In our view the Chinese government's manipulation of the currency through the accumulation of reserves creates an enormous competitive disadvantage for U.S. products. It may be that there are advantages to some American businesses that are either producing in China for the United States market or importing from China, but for American workers and for companies producing here in the United States this creates an impossible competitive problem and it is in clear violation of WTO rules.

WTO rules clearly prohibit currency manipulation to gain trade advantages that are inconsistent with GATT provisions. I think you can see why this would be so, why it doesn't make sense for the WTO to put so much energy into reducing tariffs and to limiting subsidies and then to allow countries to manipulate their currency, which undermines all the other commitments that are made in the context of the WTO.

We believe that it is crucially important for the Administration, and for the Congress to take whatever steps are necessary to force the Chinese government to cease the manipulation which has been so disadvantageous especially for American workers. We don't have the opportunity to outsource ourselves to work in other countries. American workers need to find their jobs here, and if our currency is out of equilibrium with a major trading partner like China, that is something which creates a huge problem for us.

I think the most serious problem, and I want to put most of my emphasis on this today, is the problem of the violations of workers and human rights in China. We see the Chinese government's systematic repression of fundamental workers' rights as a key contributor to the unfair advantage Chinese exports enjoy in the United States market. Chinese workers' most basic rights are routinely repressed and they don't even enjoy the political freedom to criticize, let alone change, their government.

Mr. Aldonas, when questioned earlier, said he would recommend a market economy for China. I would say it would be important to start with a democracy. I know we are talking about political systems versus economic systems. But to the extent that Chinese workers in fact have no voice in their own government and don't even enjoy the basic protections of the law in that country, they are not going to be able to benefit from the wealth that they are producing. We are not going to see the kind of growth and middle class growth in China that would in fact create a good market for American products and allow us to have the kind of trade relationship which would be mutually beneficial.

We see a systematic suppression of wages and rights in China. I quote the Congressional-Executive Commission on *China's 2003 Report*. Chinese workers cannot form or join independent unions. They can't even advocate for an independent union. Out of 1.3 billion people, it is a pretty devastating imbalance, and the Bush Administration has failed to even raise the case of China before the U.N. Human Rights Commission, even though this is something that has been done by the United States regularly in the past. And we think that this is a serious omission, that the very least that the United States can do is consistently raise these issues.

And let me just say in addition that the United States has not implemented a China specific safeguard. It has not invoked the textile import surge protections that would allow extension of the quotas. It has not brought the dumping cases even when the ITC has found that there are dumping margins.

Let me conclude by saying that American policymakers have an important choice to make in our trade relations with China. They can side with the importers and the outsourcers and stand by passively as the Chinese government takes advantage of its WTO membership and its access to the United States market, abusing its own workers and artificially undervaluing its currency in order to undercut American workers and domestic manufacturers or they can take a stand for American jobs and act now to ensure that China plays fair in the global economy.

I thank you for your attention.

[The prepared statement of Ms. Lee follows:]

PREPARED STATEMENT OF THEA LEE, CHIEF INTERNATIONAL ECONOMIST, PUBLIC POLICY DEPARTMENT, AFL–CIO

Mr. Chairman, Members of the Committee, I thank you for the opportunity to testify today on the U.S.-China economic relationship on behalf of the thirteen million working men and women of the AFL–CIO. As you know, addressing the problems in the U.S. economic relationship with China is of enormous importance to our members.

The U.S. bilateral trade deficit with China hit $103 billion last year, up almost 25 percent since China was granted Permanent Normal Trade Relations status in 2000. The U.S. deficit with China is up another 22 percent in the first eight months of this year compared to the same period last year. Our imports from China continue to outstrip our exports by more than five to one, making this by far our most imbalanced trade relationship with any major trading partner. Meanwhile, the United States has lost more than 2.5 million manufacturing jobs since March 2001.

While many factors contributed to this devastating job loss, it is clear that the Chinese government's manipulation of its currency, violation of international trade rules, and egregious repression of its citizens' fundamental democratic and human rights are key contributors to an unfair competitive advantage. The Chinese government is flouting its international obligations, and the U.S. government must act urgently to hold it accountable.

Unfortunately, to date, the U.S. government has failed to act effectively to stem the job losses resulting from the burgeoning U.S. trade deficit with China. The Bush Administration has refused to take concrete steps to ensure that the Chinese government live up to its international obligations on trade, currency manipulation and human rights, has denied American businesses and workers import relief they are entitled to under the law, and has taken positions at the World Trade Organization (WTO) that will only worsen our trade relationship with China. As John Sweeney, president of the AFL–CIO, said in a press statement released yesterday, "Despite this crisis at home and abroad, the Administration has been alarmingly slow to respond, and their efforts to date appear to be little more than fig leafs."

Violations of WTO Rules Continue

China became a member of the World Trade Organization (WTO) in 2001, and since then China has repeatedly and consistently failed to comply with WTO rules. The Bush Administration, rather than take advantage of the WTO's formal dispute settlement mechanism to address these violations, has preferred to rely on prolonged discussions and informal consultations in its failed attempts to guarantee China's compliance. Access to China's markets has actually gotten worse for some products like meat and poultry, and China has used a host of new rules and tariff-rate quotas to block access for a variety of products including soybeans, wheat, and cotton.

China has taken few meaningful steps to protect intellectual property; piracy rates are still as high as 90 percent or more, and problems with piracy of textile designs and trademark infringement continue to grow. China has reneged on its commitment to allow certain high technology products into China tariff-free, continues to use unpredictable customs valuations procedures that do not assess tariffs based on the stated value of a product, and imposes value-added taxes on certain imports. But the U.S. has yet to launch one formal WTO complaint against China for all of these violations. China, on the other hand, has joined in the WTO challenge to the U.S. steel safeguard and has increased its use of anti-dumping actions against the United States.

The Bush Administration has also failed to make the transitional review mechanism (TRM)—established in China's accession agreement—an effective means of monitoring China's compliance with its WTO commitments. The WTO committees that were supposed to review China's compliance last year were not even able to outline the areas where China was violating WTO rules, and did nothing more than submit the minutes of previous meetings as their final TRM report. China insisted that the TRM take place in a single meeting, and refused even to give written responses to some questions. According to the GAO, part of the reason for the failure of the TRM was a lack of preparation among U.S. officials.

Failure to Act on Currency Manipulation

China has kept its currency—the yuan—pegged to the dollar at the same rate since 1994, and it is estimated to be undervalued by as much as 40 percent. This gives China an enormous competitive advantage in the U.S. market and creates an inherently unstable and unsustainable situation.

WTO rules clearly prohibit currency manipulation to gain trade advantages inconsistent with GATT provisions. Article XV of GATT 1994, for example, provides that "Contracting parties shall not, *by exchange action*, frustrate the intent of provisions of this agreement" (emphasis added). Currency manipulation nullifies tariff concessions made through WTO processes and amounts to a de facto illegal subsidy of Chinese exports. Deliberate undervaluation of the yuan vis-a-vis the U.S. dollar also violates the principle of most-favored-nation treatment, as it targets one country's currency, adversely impacting that country's trade. Certainly, the enormous bilateral U.S. trade deficit with China relative to other countries is evidence of the un-even impact of China's currency policies on its trading partners. China's choice to artificially bolster its own manufacturing sector at the expense of the United States (and other countries indirectly) is therefore a violation of its obligations under the WTO.

As American University economist Robert Blecker wrote in a recent Economic Policy Institute briefing paper, " [T]he sheer magnitude of the reserves accumulated by these East Asian countries, and the rapidity with which these reserves have increased in recent years, is *prima facie* evidence of efforts to keep their currencies undervalued and prevent their currencies from appreciating to exchange rates that would be conducive to more balanced trade relations with the United States. This is outright currency manipulation of a mercantilist nature, intended to maintain those countries' trade surpluses with the United States, which by 2002 accounted for about 40% of the overall U.S. trade deficit" ("The Benefits of a Lower Dollar: How the high dollar has hurt U.S. manufacturing producers and why the dollar still needs to fall further," EPI Briefing Paper, May 2003).

Professor Blecker estimates that the overvalued dollar (relative to all currencies) has resulted in about 740,000 lost jobs since 1995, as well as a loss of nearly $100 billion in annual profits and $40 billion in annual investment over the same period. Blecker does not break out the impact of the dollar-yuan relationship specifically.

The Chinese government must allow the yuan to reflect underlying economic and market forces. It must end the current peg and cease its accumulation of U.S. dollar reserves. While the Chinese government's reluctance to take this action is perhaps understandable, the Bush Administration's failure to act more forcefully in this regard is not.

We call on the Administration to use all tools at its disposal, including initiating a WTO case, to send a clear message to the Chinese government that the current situation is unacceptable and will not be tolerated. We applaud efforts in Congress to force concrete action on this issue, as it is now clear that simple diplomacy and jawboning have utterly failed.

Inaction in the Face of Violations of Workers' and Human Rights

In addition to the unfair competitive advantage gained through currency manipulation, the Chinese government's systematic repression of fundamental workers' rights is a key contributor to the unfair advantage Chinese exports enjoy in the U.S. market. Chinese workers' most basic rights are routinely repressed, and they do not enjoy the political freedom to criticize, let alone change, their government.

The Congressional-Executive Commission on China released its 2003 annual report a few weeks ago. The Commission concluded that: "Chinese citizens are detained and imprisoned for peacefully exercising their rights to freedom of expression, association, and belief. . . . Chinese workers cannot form or join independent trade unions, and workers who seek redress for wrongs committed by their employers often face harassment and criminal charges. Moreover, child labor continues to be a problem in some sectors of the economy, and forced labor by prisoners is common." In addition, the Commission found that people seeking to practice their faith were subject to harassment and repression, while freedom of speech and freedom of the press were denied.

Enforcement of wages, hours, and health and safety rules is lax or non-existent in many areas of the country. These abuses allow producers in China to operate in an environment free of independent unions, to pay illegally low wages, and to profit from the widespread violation of workers' basic human rights. Together, these policies amount to a deliberate and artificial suppression of wages by the Chinese government. This exploitation impacts American workers, as well as those in other developing countries, and artificially lowers the price of Chinese exports in the U.S. market.

During 2001 and 2002, the number of labor disputes and protests in China rose significantly. In response, the Chinese government jailed a number of workers for demonstrating for their rights and cracked down on any organization that might support the beginnings of an independent trade union. The official labor union—the All China Federation of Trade Unions (ACFTU), which is subordinate to the Communist Party—continued to discourage strikes and work stoppages, and to negotiate sweetheart deals with employers.

In the face of these grave problems, the Bush Administration chose not even to raise the case of China before the UN Human Rights Commission in April of 2003, despite the United States' regular practice of doing so previously. In addition, President Bush did not demand any specific improvements in human rights when he met with China's President Hu in the summer of 2003. Instead, the Bush Administration has only engaged in "cooperative dialogue," a strategy that has not worked. Since deciding to pursue a dialogue instead of UN action or public pressure, Administration officials have noted "backsliding" and a "deterioration in human rights" in the country during 2003, including arrests of democracy activists, harsh sentences for labor organizers, and the suppression of independent media, church groups, and Tibetans.

A recent *Wall Street Journal* article reported that the Chinese government has cracked down on free speech and political dissent, closing four Web sites and clamping down on foreign funding and organizations (Kathy Chen, "China Curbs Growing Debate over Politics," *Wall Street Journal*, September 24, 2003). The government issued a document warning against "hostile forces," urging increased vigilance against Chinese organizations' use of foreign funding or cooperation with foreign experts and organizations. In August, the Chinese government attempted to halt debate on three topics, now labeled "not allowed": political reform, constitutional amendments, and the reassessment of historical incidents (presumably referring to the 1989 crackdown on protesters in Tiananmen Square).

The Administration's failure to take concrete actions on human rights and workers' rights in China allows rampant violations to continue. Workers in China, the United States, and around the world pay the price for this inaction, while companies producing in China enjoy the profits.

In addition to inaction on China's currency manipulation and workers' rights violations, the Bush Administration has failed to enforce U.S. trade laws effectively with respect to China, denying American businesses and workers the trade relief they are entitled to under the law.

Refusal to Implement China-Specific Safeguard

In August of 2002, Motion Systems Corporation, a New Jersey manufacturer of pedestal actuators, filed the first petition for relief under a China-specific safeguard provision included in China's WTO accession agreement with the United States. The U.S. International Trade Commission (ITC) found that China's increased exports of pedestal actuators to the U.S. were indeed causing market disruption to domestic producers, and recommended that quotas be imposed on Chinese imports for three years under the special safeguard mechanism. Yet President Bush unilaterally refused to follow the ITC's recommendations, instead siding with importers and the Chinese government in concluding that import relief "is not in the national economic interest of the United States."

Domestic wire hanger manufacturers filed the second petition under the special safeguard mechanism in November of 2002. Hanger imports from China exploded by 800 percent from 1997 to 2002, contributing to cost cutting and layoffs in the U.S. The ITC found unanimously in favor of the petitioners, and recommended the imposition of duties on wire hanger imports from China for two to three years. Despite this recommendation, President Bush again denied relief, citing many of the arguments made by importers and the Chinese government in the case.

President Bush's repeated refusal to act on the ITC's recommendations left domestic manufacturers questioning the Administration's willingness to ever use the special safeguard mechanism. In both cases, the ITC evaluated all of the facts from both sides in finding that safeguard action was called for, and in both cases President Bush made a political decision to dismiss the findings and deny import relief. After the wire hanger decision, one commentator remarked that the special safeguard was a "dead letter."

Awaiting Action on Textile Import Surges From China

Another special safeguard mechanism created in China's WTO accession agreement with the U.S. deals exclusively with textiles. In July of this year, a group of textile industry associations filed petitions under the provision, seeking the re-imposition of import quotas on brassieres, gloves, gowns, and knit fabric from China. In each category, imports from China have jumped sharply after the elimination of quotas—for example, dressing gown imports rose 698 percent in the 15 months since quota elimination, and glove imports jumped 291 percent during the same period. Yet the Commerce Department has already rejected the industry petition on gloves, and importers are urging that relief be denied in the other product categories as well.

Inadequate Protection from Dumping

One provision of our domestic trade law that U.S. companies have been able to use to secure some limited relief from unfair trade practices by China is in the area of anti-dumping. But much more could be done. Though the United States absorbs almost half of all of China's exports to the world, we account for only 15 percent of the anti-dumping measures imposed against China, according to the WTO. In addition, in many cases the duties imposed under U.S. anti-dumping measures regarding China have been inadequate to provide real relief to U.S. companies.

Anvil International succeeded in getting the Bush Administration to impose a 13 percent tariff on Chinese steel pipe nipples that were being dumped on the U.S. market. But this duty level is far below the 100 to 200 percent dumping margins levied by the Canadian government on the same product. While Anvil's operations have started to recover in Canada, Chinese nipple exports to the U.S. have continued to increase, causing Anvil to close one of its foundries and lay off 350 American workers.

Ward Manufacturing filed an anti-dumping case on malleable pipe fittings from China in 2002, securing small dumping margins in the single digits. Mexico and the European Union, on the other hand, provided dumping margins on the same products from China of 42 percent and 48 percent, respectively, to provide relief to their own domestic producers. After the case was filed, U.S. imports of malleable pipe fittings continued to increase, and Ward has had to lay off workers as a result. A Ward executive testifying before Congress on the inadequacy of administrative action in this case stated, "Our company can either keep 800 Americans working and possible rehire 300 back to work at wages of $14 an hour plus health benefits or the same workers can go on state unemployment benefits, and pursue alternative jobs that pay minimum wage with no health benefits. All we ask for is the real enforcement of the trade laws passed by Congress."

The FMC Corporation's anti-dumping petition resulted in the imposition of a 42.8 percent duty on imports of Chinese persulfate in1997. The Administration began to use a methodology more favorable to Chinese producers in its 2001 review of the case, and in 2002 the duty was completely eliminated. The president of FMC charged that the Department of Commerce "inexplicably ignored clear evidence of fraudulent practices and failed to properly verify Chinese conduct," and that the Administration has reduced the intensity of its oversight of Chinese export practices since China's accession to the WTO.

In each of these cases, the Bush Administration had the opportunity to effectively enforce U.S. trade laws, but chose not to do so, choosing to side with the importers and the Chinese government, at the expense of American workers and producers.

Conclusion

Rifts within the business community have contributed to the U.S. government's passivity and failure to act to date. Companies that produce in China for the U.S. market, retailers, and importers clearly benefit from an undervalued Chinese currency, as well as from the abuse of workers' rights. On the other hand, companies actually producing in the United States—whether for the domestic market or for export—face debilitating and unsustainable disadvantages from currency manipulation, illegal subsidies and dumping, and violation of workers' rights in China.

American policymakers have a choice to make in trade relations with China. They can side with the importers and outsourcers, and stand by passively as China takes advantage of its WTO membership and access to the U.S. market, abusing its own workers and artificially undervaluing its currency in order to undercut American workers and domestic manufacturers. Or they can take a stand for American jobs and act now to ensure that China plays fair in the global economy.

Thank you for your attention and for the invitation to appear here today. I look forward to your questions.

Chairman HYDE. Thank you, Ms. Lee.

Ms. Bianco.

STATEMENT OF JONNA BIANCO, PRESIDENT AND CHAIRWOMAN, AMERICAN BONDHOLDERS FOUNDATION

Ms. BIANCO. Thank you, Mr. Chairman. The American Bondholders Foundation is the incorporated organization representing the consolidated claims of the United States citizens located across America who are holders of full faith and credit sovereign bonds issued by the government of China in which that government has defaulted and continues to evade payment.

The ABF has identified over 5,000 bondholders across this country. The bondholders are comprised of lower to middle class taxpaying citizens. Many of the bonds have been passed down through two or more generations in the same family. None of the ABF members are considered wealthy nor are there any representations of banks, corporations or businesses.

While we realize this debt goes back three generations, that is how long our interest had been neglected. Our claims have been ignored for so long because we are not a syndicate of powerful financial institutions. Rather, we are thousands of American individuals and families that are living on Main Street and not Wall Street.

These bonds were issued between 1912 and 1942. They were issued by a global syndicate comprised of international banks and were sold to investors in the United States, Japan and Europe. The language of the individual bond certificates as well as the language of the loan agreement authorizing the bond issue mandated that these obligations were to be considered as binding upon the government of China and its successors.

These bonds were always endorsed and sold by two major banks, Hong Kong and Shanghai Banking Corporation, HSBC, and Deutsche Bank. These banks were paid 6 percent up front for these bond issues, and yet standards say they have no fiduciary responsibility to these bondholders.

When the PRC and the United States normalized relations in 1979, the Chinese government made a small payment to the United States as compensation for American owners of tangible property located in China that the PRC expropriated in 1949. However, this agreement did not provide for any compensation to American holders of defaulted Chinese government bonds. The PRC Chinese government did recognize the principle of its liability for prepayment and payment of 1949 bonds or pre-1949 bonds to Great Britain in 1987; however, they refuse to pay American citizens. They paid in 1987 to Great Britain because the people protested and wanted no more bonds dropped on their capital markets at that time.

Russia assumed the debt obligations of the Soviet Union after its dissolution in 1991, and even agreed in the 1990s to honor the pre-1917 Czarist era Russian defaulted bonds owed to French bondholders. Germany assumed all the debt obligations of Communist East Germany and other post-Communist Eastern European governments have continued to honor their Communist government era sovereign bonds. So there is quite a bit of precedent in this issue.

The PRC has continued to have unlimited access to all of our capital markets. Find me a U.S. business or entity that is allowed to continue issuing stocks or bonds when they have not resolved the ones that are in default. Why is it that a foreign government is not subject to the same rules and regulations that we as Americans are? Why are the People's Republic of China afforded special rights and privileges far beyond American businesses or individuals?

The international law requires a successor government of a prior internationally recognized and legitimate government of the same nation to honor the financial obligations of the predecessor government. Accordingly, the current government of China is obligated to pay the defaulted full faith and credit bonds owed to Americans that were issued by a predecessor Chinese government.

The Chinese government that issued the now defaulted full faith and credit bonds was a longtime United States ally that had full international legitimacy as a founding member of the United Nations and as the sovereign government of China at the time of issuance of the bunds. Now the PRC publicly mandates that international law be upheld in Iraq or that PRC is owed significant amounts of money. How hypocritical can these leaders be in the PRC when on one hand they demand that Iraq honor its debts from a prior government and on the other hand they choose to ignore international law when it comes to honoring China's financial obligations to American citizens.

In July of this year, ABF representatives went to Iraq. We met with Coalition Provisional Authority representatives, in particular Mr. George Wolfe, a Deputy Counsel with the U.S. Treasury. We presented a proposition to Iraq and its people whereby they have a significant amount of debt that is owed to the PRC. The American Bondholders Foundation which provided an opportunity for them to take our debt, use it under the term of an international offset to be used as payment to China for the debt that they owe. In return—which is an 80 percent savings to Iraq. And in return, our Coalition Provisional Authority receives hundreds of millions of dollars from these American bondholders to help in that situation, as well as funds to help provide for schools, education programs, security for council and cabinet members, and food baskets to help in Iraq.

We have presented this proposal to the Committee on the record as well as my speech. We have met with Iraqi cabinet members and council members. They are very supportive of this. They believe it is good for Iraq, they believe it is good for the American people. It provides a significant amount of funding to programs across this country that have fallen upon deaf ears and massive shortfalls in budgeting. I thank you, Mr. Chairman.

[The prepared statement of Ms. Bianco follows:]

PREPARED STATEMENT OF JONNA BIANCO, PRESIDENT AND CHAIRWOMAN, AMERICAN BONDHOLDERS FOUNDATION

Mr. Chairman, Members of the Committee, Ladies and Gentlemen, on behalf of the American Bondholders Foundation members and their families, we thank you for the opportunity to present this important issue.

What is the ABF:

The American Bondholders Foundation, (ABF) is the incorporated organization representing the consolidated claims of United States citizens located across America who are holders of full faith and credit sovereign bonds issued by the government of China and on which that government has defaulted and continues to evade payment. The ABF has identified over 5000 bondholders across America. These are bonds that were issued between 1912 and 1942.

Who are the Bondholders:

The bondholders are comprised of lower-to middle class tax paying citizens. Many of the bonds have been passed down through two or more generations of the same family. None of the ABF members are considered wealthy nor are there any representations of banks, corporations or businesses. While we realize that this debt goes back 3 generations, that is how long our interests have been neglected. Our claims have been ignored for so long because we are not a syndicate of powerful financial institutions. Rather, we are thousands of American individuals and families living on Main Street, not Wall Street.

What are the Bonds:

The bonds were issued between 1912 and 1942. They were issued by a global syndicate comprised of international banks and was sold to investors in the United States, Japan and Europe. The language of the individual bond certificates, as well as the language of the loan agreement authorizing the bond issue, mandated that the obligations were to be considered as binding upon the Government of China and its successors. These bonds were also endorsed and sold by two major banks, Hong Kong and Shanghai Banking Corporation (HSBC), and Deutsche Bank. Both these banks have extensive operations in the United States. Both these banks were paid approximately 5% upfront to issue these bonds. They made their money, yet now clearly state that they have no fiduciary responsibility to the people that they sold these bonds to.

With the outbreak of the Sino-Japanese war and then WW II, the Chinese Government ceased payments on the bonds in 1939 and never resumed payment. The Communist Chinese Government (the People's Republic of China) assumed control of mainland China in 1949, and repudiated all outstanding debt incurred by the prior Chinese government. While the PRC Chinese Government has received the benefits of the revenues and assets that secured the bonds, it has consistently evaded the corresponding liabilities to American bondholders.

Is there precedent for payment of these bonds?

When the People's Republic of China and the United States "normalized" relations in 1979 the Chinese Government made a small payment (totaling $81 million) to the United States as "compensation" for American owners of tangible property located in China that the PRC expropriated in 1949. This agreement did not provide for any compensation to American holders of defaulted Chinese Government bonds.

The PRC Chinese Government did recognize the principle of its liability for payment of pre 1949 Chinese Government bonds when it paid Great Britain in 1987 to settle the claims of British bondholders. British bondholders had protested when the PRC tried to sell new Chinese Government bonds in London's capital markets without first resolving the claims of British bondholders for pre 1949 Chinese Government bonds that the PRC Government was refusing to honor. Americans own some of the same series of defaulted pre 1949 Chinese bonds that China acknowledged responsibility for in 1987 to British bondholders.

Russia assumed the debt obligations of the Soviet Union after its dissolution in 1991 and even agreed in the 1990's to honor the pre-1917 Czarist era Russian defaulted bonds owed to French bondholders. Germany assumed all the debt obligations of communist East Germany and other post communist Eastern European governments have continued to honor their communist government era sovereign bonds and debts.

The PRC has continued to have UNLIMITED access to all of our capital markets. Find me a US business or entity that is allowed to continue issuing stocks or bonds when they have not resolved the ones that are in default? Why is a foreign government not subject to the same rules and regulations that we as Americans are? Why are they afforded special rights and privileges far beyond American businesses or individuals?

Failure to resolve these defaulted bonds has allowed the PRC free and unfettered access to sell bonds in America in possible contravention of the Johnson debt default act which prohibits US firms from selling securities of sovereign issuers who have defaulted on their full faith and credit obligations owed to America. To date no one in the federal government has thought it necessary to enforce United States laws when the violator is the PRC. Why are the People's Republic of China afforded special rights and privileges far beyond American businesses or individuals?

International law requires a successor government of a prior internationally recognized and legitimate government of the same nation to honor the financial obligations of the predecessor government. Accordingly, the current government of China is obligated to pay the defaulted full faith and credit bonds owed to Americans that were issued by a predecessor Chinese government.

Unlike the pariah Saddam Hussein regime in Iraq, which was subject to condemning United Nations sanctions and resolutions prior to the April 2003 liberation of Iraq, the Chinese Government that issued the now-defaulted full faith and credit Chinese bonds between 1912 and 1949 was a long-time United States ally that had full international legitimacy as a founding member of the United Nations and as the sovereign government of China at the time of issuance of the bonds. Now the PRC publicly mandates that International Law be upheld in Iraq, where the PRC is owed significant money. How hypocritical can the leaders of the PRC be when on one hand they demand that Iraq honor its debt from a prior government and on the other hand they choose to ignore International Law when it comes to honoring China's financial obligations to American citizens?

The People's Republic of China has become an economic powerhouse with full financial ability to pay its foreign debts. They choose to evade payment on the lawful claims of American citizens who hold these bonds. The Chinese Government and its controlled agencies and businesses own large sums of bonds issued by the U. S. Treasury. The People's Republic of China presently receives approximately $4 billion each year from American taxpayers in the form of interest income on U.S. Treasury bonds held by the Chinese government. The PRC also enjoys a $100 billion annual trade surplus with the United States, giving them an estimated $400 billion current account. Yet the government of China continues its discriminatory evasion of payment to American bondholders. It is the position of the Chinese government that China should not have to honor their nation's full faith and credit sovereign obligations if they choose not to. Such an insular worldview, flaunting the flagrant disregard of established principles of international trade and commerce, will not serve the interests of the PRC in the community of nations and is inconsistent with the status of the PRC as a most favored trading partner and member of the World Trade Organization. Such a posture can only act to harm the long term interests of both the United States and China.

On June 13, 2001, at the direction of the White House Counsel, the United States Department of State and the Securities and Exchange Commission, the ABF contacted the Foreign Bondholders Protective Council (the "FBPC") to initiate collection proceedings on these defaulted obligations. The FBPC was created by Presidential Executive Order to assist U.S. citizens in collecting on foreign defaulted debts. The FBPC has successfully completed collection of 47 previous defaulted bond settlements. All of the previous bond settlements have been with the direct involvement and assistance of all three Executive Branches of the US Government. The ABF has appealed to the U.S. Department of State for assistance in resolving this disgraceful situation. Our appeals have fallen on deaf ears anytime it involves China.

Direct appeals to China have been met with the response of: "We do not honor the debts issued prior to the Communist Government coming to power". What they should say is that we do not honor debts to American citizens, even though we have recognized and honored these debts to others.

US citizens need your support. They work hard, they pay their taxes and are then slapped in the face over and over by the continuation of interest payments which are basically their tax dollars going to China for the Treasuries that they hold of ours which we do pay; to losing their jobs due to continual layoffs; to everything that they go to the store to buy is stamped Made in China. This is a shameful injustice to all Americans. The time is now to stop empowering China to continue to evade the rightful claims of American citizens and to uphold International Law. China acts as though the world owes them whatever they demand. Their actions and callous disregard for international law is mirrored in every other arena of international trade and commerce. The community of nations has rules. Hold China accountable.

Solution:

In July of this year, ABF representatives traveled to Baghdad and met with Mr. George Wolfe, Deputy General Counsel for the US Treasury and Director of Economic Development for Iraq through the CPA. The ABF proposed the following:

We took the total amount of bonds that we are holding for our members, then divided them up into 5 billion dollar blocks at current value including principal and interest. We offered to transfer ownership of these blocks over to Iraq to be used as payment towards their debts to the PRC for an 80% discount. In other words, Iraq would pay to the ABF 20 cents on the dollar, yet use 100 cents on the dollar as payment towards their debts to the PRC. For each Block that was purchased and transferred to Iraq, the ABF would provide 100 million dollars to the CPA and an additional 50 million dollars towards construction of schools, school supplies, classroom furniture, food baskets in cooperation with USAID, and security for Council and Cabinet Members. Knowing that Iraq would not have the necessary capital to expend on this proposal, we structured it whereby a small percentage of oil would be used for payment, structured over time. This information has been shared with officials of the Department of Defense who have informed us that they have no opposition with this proposal. In addition, this has been met very favorably by some members of the Iraqi Council and Cabinet. They believe this would be good for Iraq and for America.

In effect, we are accelerating future oil production to the immediate benefit of the people of Iraq and additionally, keep in mind, bondholders pay taxes so a good portion of whatever they receive, comes right back to Uncle Sam which in turn helps fund the $87 billion dollar request, plus provides funding through the foundation by which millions of Americans will benefit.

In addition to Iraq, under very similar structures as aforementioned with Iraq, the ABF is in current negotiations and has pending contracts with several other countries that have outstanding significant debts with the PRC.

Chairman HYDE. Thank you very much.

Mr. Faleomavaega.

Mr. FALEOMAVAEGA. Thank you, Mr. Chairman.

I would like to thank the members of the panel for their testimony, and the interesting observations made by Dr. Lardy and Mr. Vargo is worth mentioning here. I get the strong impression from Mr. Vargo's statement that part of the problem is that we are putting the blame on China, and the exchange rate is not necessarily the issue.

I wanted to ask, Mr. Vargo, you said that the high cost of manufacturing in the United States alone is one of the critical factors causing some of the problems in our own base and not the exchange rates and whatever other things. You also mentioned that there is too much red tape. This is domestic now, in terms of how our own economic structure is being placed, with rising health costs, uncertainty in the supply of energy, limitations of resource and development, even shortage of skilled workers. All these added together seems to indicate that it is more than just China as the culprit in all this.

Mr. VARGO. Absolutely, Congressman, and we have never maintained anything other than that. China is, however, a significant problem, and it is going to grow if we can't get our arms around it now. And when you get a chance, I hope you will take a look at the last page of my testimony and you will see. The problem is still manageable. There is no question that China is not the largest problem we face. There is no question that the bulk of our problem in manufacturing is home grown.

For too many years and decades the Congress and successive Administrations have not given manufacturing the attention that it has needed despite the emergence of a much more competitive, globalized world. But this is not to diminish the fact that China is a significant problem and it is growing.

Mr. FALEOMAVAEGA. Ms. Lee.

Ms. LEE. Just a word. I would agree with you and with Mr. Vargo that China is not the only problem we face, and so there is no point acting as though if we address this problem we have solved everything. We have a lot of problems at home we need to take care of. But because it is not the only problem doesn't mean it isn't a problem. I would also just add that in terms of thinking about the high cost of manufacturing at home or cost of the regulation and so on, we see the broad picture of tax policy, health care, and labor costs that are all things that need to be addressed.

But we certainly don't want to see the United States think of itself as becoming competitive by getting rid of, let us say, public health and environmental regulations that are protecting our people that we put in place through a democratic process. We certainly don't want to see the United States become competitive by destroying trade unions because we are competing with a country like China that doesn't allow trade unions. We could also destroy our own democracy in order to become competitive.

So I just want to make sure that we keep the focus on the terms of competition in the global economy and not just whether we have higher costs or not, but why and which things are valuable for us to keep and which ones aren't.

Mr. FALEOMAVAEGA. Well, I don't want to disagree with what you just said, Ms. Lee. But I think the concern that I raise here is that let us not bash the Chinese and put the blame on them for our own economic problems. Even among our own economists there are disagreements in terms of what direction our country should be headed for as far as resolving some of the serious economic problems we now face.

I wanted to add to what Dr. Lardy had stated earlier, which I think is worth mentioning; that the trade imbalance between our country and China is not necessarily because of the exchange rate or even the protectionism that we seem to be getting through the media reports and all of that. But it is simply because China now has become the black hole, if you will, of all the manufacturers. Things that were done previously in other Asian countries, China has now become the focal point globally for every country, including ours, that wants to go there and set up shop because for whatever reason the climate for manufacturing is very positive.

Now, this doesn't take away from Ms. Lee's arguments about the serious problems of labor violations or the situation with human rights violations. But the fact is that this is what is happening. I would like to have Dr. Lardy elaborate on that, if I am wrong on that observation that you have made in your statement.

Mr. LARDY. No. Thank you very much, Congressman. I would just make a few points of amplification. Part of the underlying reality is that China has adopted a very liberal foreign investment environment. They have very few limitations on the extent of foreign ownership. Getting permission to set up either a joint venture or wholly foreign owned company is relatively easy to do. China has a relatively low wage but, more importantly, a very highly productive workforce. There are many other countries in the world that have much lower wages than China, but you don't see foreign manufacturers flocking there because they don't have a highly educated workforce with basic education and literacy. Additionally, they don't have the infrastructure to support the kind of manufacturing that is going on in China. By the end of the first half of this year, foreign companies had invested more than $480 billion, United States dollars, in China in the form of foreign direct investment, which is far more than any other emerging market, and a little bit over half of that has gone into manufacturing.

So, you know, we say we want them to have a market economy. Well, this is an area where they have really liberalized and they are making it very easy for foreign countries to do business in China.

Mr. FALEOMAVAEGA. One more quick observation.

Mr. LARDY. Thirty percent of their manufactured goods are now made by foreign companies.

Mr. FALEOMAVAEGA. My time is up, Mr. Chairman. I have one quick comment I think my friends should have mentioned: That for the Chinese community outside of China, I think the dollar value of their investments is well worth over $300 billion. Tremendous investments, and it isn't coming out of nowhere. This is another serious factor to consider in terms of where this money, where the capitalization comes into focus. Many industrious and successful business people of Chinese ancestry are investing in China, and this is part of the success of that country.

Thank you, Mr. Chairman.

Chairman HYDE. Thank you.

Mr. Blumenauer.

Mr. BLUMENAUER. Thank you. I was curious to have an elaboration. I had made an inquiry to Secretary Aldonas about what it is that you are doing. I noticed that, Ms. Lee, you referenced in your testimony some concerns about a lack of aggressive action on the part of the United States to use the tools from the WTO, and I didn't exactly hear the Secretary say we were moving with dispatch. It was, we were examining, we could. And I wondered if you or the other panelists would care to elaborate on that point a little bit. I still feel some discomfiture that we are not doing what we could do under the WTO structure.

Ms. LEE. Yes. Thank you very much, Mr. Blumenauer, for the question. It is clear that the Administration has failed to act on a number of fronts, whether it is even enforcing United States trade laws or using the WTO structure to its full extent to ensure that China does open its markets and cease to manipulate its currency. And I know that there is talk of a 301 case against China for unfair trade practices and currency manipulation, and we would hope that the Administration would support that case, would take it up and do a thorough investigation and come to some sort of concrete settlement.

We are also talking about bringing a 301 case with respect to the violation of workers rights. This is an unfair trade practice under U.S. trade law, to violate internationally recognized workers' rights. And certainly China is one of the most egregious violators of workers' rights, and it is one where there is a huge economic impact on the United States.

So those are two concrete areas where the Administration could act and yet has not really indicated its willingness to do so. What we have seen instead are these polite requests, diplomatic ventures where the answer from the Chinese government seems to be pretty clearly: No, thanks.

Mr. VARGO. Mr. Blumenauer, could I add to that? Because we share that concern. However, it is also necessary to understand that China's obligations, for example, under the WTO are being phased in. They did not all kick in at once. And I think that there is a natural tendency to give China some initial time to see how they were doing. In our own NAM survey of our members, for example, last year we had very little—very few complaints came back. This year we had a lot. And I think that the Administration's demeanor on this is about to change, and I know Ambassador Zoellick is over in China now, Secretary Evans is going over later. And it is our expectation that we will see the Administration get very vigorous in enforcing the problems that are becoming obvious.

Mr. BLUMENAUER. Thank you. I wondered, Mr. Chairman, if we could have any of our witnesses supply an assessment of how much of this huge trade deficit is just merely a shifting from other suppliers that we would have had in Indonesia or Thailand, or to the extent to which this is actually a loss of American manufacturing jobs. I know it is not an easy question. I hear different assessments. But the extent to which any of our panelists could point us in the direction at some point with their assessment or sources that they think are particularly useful, this is something that I am having trouble sorting out and I would find helpful.

Chairman HYDE. I think all of our panelists can take a shot at it if they would like.

Mr. VARGO. Could I begin? It is both. Certainly when you look in the electronics area and you look at the decreasing share of Japan's sales into the United States and Korea's and Mexico paralleling China's increase. But in other industries, this is not so. We have no statistical analysis. But I can tell you from the phone calls and the pain we are hearing from a lot of our member companies, it is both. It is not exclusively a substitution for other imports, and it is not 100 percent at the expense of American producers.

Chairman HYDE. Ms. Lee.

Ms. LEE. Just one word on that topic. I don't have the numbers in front of me. But even to the extent that China is taking export share away from other developing countries, that also creates some concerns for us. If you have a more democratic developing country with a strong trade union movement and that country is losing jobs to China because China is not democratic, because China is so repressive of workers rights, that becomes a problem for every developing country in the world, as well as for American workers. So it is something which is distorting the entire global economy and putting a lot of pressure for that kind of competition in countries. We hear it from our trade union counterparts in South Africa or Brazil or Malaysia or Bangladesh. They all have to ask themselves, "How do we compete with China?" And they are coming to the conclusion that they need to compete with China by also repressing independent trade unions and by also cutting back on dissent and free speech, and so on. So that is also very troubling to us.

Mr. BLUMENAUER. And I appreciate your comment, Ms. Lee, and I would concur that it is not a benign effect. But in the meantime, if any of our panelists can help us track just the factual shift, it would help in terms of the analysis.

Ms. LEE. Sure.

Mr. LARDY. I would just offer a comment. If you look at the areas where our deficit is the largest, the biggest product categories of deficit, they are areas where there has been very little production in the United States for quite a long time. I would start with footwear, which is a huge deficit category. We buy about 80 percent of our footwear from China. We used to buy 80 percent from South Korea and Taiwan. A second huge category is toys and sporting goods, and so forth. This is a very heterogeneous product, but, again, we used to buy most of our toys from Hong Kong and to some extent Taiwan and South Korea. Those industries have moved lock, stock, and barrel to China, and we now buy most of our toys from mainland China.

The same thing I would argue in broad terms is probably true in consumer electronics and IT hardware. Dell has never manufactured a notebook computer, they have always bought them from

Taiwanese companies; until 3 years ago they were made entirely in Taiwan, now they are being made for the most part in China. The same Taiwanese companies are making them, and the product looks the same, but they are getting a lower cost and consumers are benefiting.

I would point out, this is a very good example of where China is a huge importer. China imported $30 billion worth of semiconductors last year to feed its electronics industry. So it really is more of an assembly operation. High value added parts and components are coming in from other countries and the final product is going where the big consumer markets are, which is North America and Europe.

Chairman HYDE. I want to thank the panel for very constructive testimony. I apologize for the paucity of attendees, but the time was such that everyone was fleeing to the airport. But your statements are all a part of the record. They will be resources for us as we tackle the very difficult problem of trade with China, and you made a great contribution.

And, Ms. Bianco, your sector of this is not going to be ignored.

Ms. BIANCO. Thank you.

Chairman HYDE. You have lighted at least a good-sized candle.

Ms. BIANCO. Thank you, Mr. Chairman. I appreciate it. It is kind of difficult. We were originally told we had 7 minutes for our speech, and we had it all made and then it got cut to 5. So I apologize for the very quick rush. I do want to appeal to this Committee to please take time to look at this Iraqi international offset. It is good for America, it is good for Iraq. It is going to save tax dollars, plus it is going to put tax dollars back into the coffers. And I want to appeal to all Members of this Committee to please contact Mr. Bremer. He has these contracts. Let us get this executed and get this show on the road.

Chairman HYDE. Very well. And as they say—yes, Mr. Vargo.

Mr. VARGO. Mr. Chairman, I know I speak for the entire panel when I say we want to echo the sentiments that your colleagues have expressed. We are very much looking forward to working with you in the next Congress.

Chairman HYDE. Well, thank you very much. It was worth waiting for. Thank you. The Committee stands adjourned.

[Whereupon, at 4:25 p.m., the Committee was adjourned.]

APPENDIX

Material Submitted for the Hearing Record

Prepared Statement of the Honorable Adam B. Schiff, a Representative in Congress from the State of California

Mr. Chairman, any discussion of the economic relationship between the United States and China must include consideration of the effect of international intellectual piracy on the American economy. Piracy continues to have a devastating impact on our creative industries. It is an issue that must be dealt with, both at home and abroad.

Consider the facts: Computer users illegally download more than 2.6 billion copyrighted files every month. At any given moment, more than five million users are online offering an estimated one billion files for copying through various peer-to-peer networks. About 25% of the total number of files available on unauthorized peer-to-peer services are hosted outside the United States. Recording industry officials point to an estimated loss of $600 million in 2002 within its industry due to piracy.

Piracy also has a devastating impact on the movie industry. During the 1999 release of the film *Star Wars: Episode 1—The Phantom Menace*, pirated copies of the film infiltrated the Asian market while the film was still in U.S. theatres. When the film opened in Asian theaters, attendance was way below expectations. Home entertainment retailers also lost vital business in the home video market due to the availability of pirated copies.

What is happening in China? Certainly it is no surprise that China's impact on the U.S. economy is significant. And certainly, intellectual property theft in China is having a considerable effect on the American economy.

An August 2003 New York Times story reported that pirated discs in China can cost as little as $1. Given that there is a much broader selection of titles in the pirated world than in legitimate video and DVD stores, the business of pirated bootlegs becomes exceedingly lucrative.

These factors led to China becoming the single largest concentration of pirated CD plants a decade ago. At one point, more than 2 dozen plants were operational while only one plant was necessary to meet all the nation's legitimate business needs. These plants were working 3 shifts a day, producing pirated CDs mostly for export.

In 1996, steps were taken to change this situation. Facing the imposition of U.S. sanctions of $1 billion a year, Chinese officials took action. Half of the plants were shut down, equipment was confiscated, and a new system was put in place for the remaining plants in an attempt to deter future piracy.

While the export of such pirated work has been curtailed, the proliferation of pirated materials continues to be a growing problem in China. The facts remain alarming: In all categories of intellectual property, 90% is pirated in China. For music alone, the numbers are even worse.

In China, unauthorized copies of "Harry Potter and the Sorcerer's Stone" were being sold by DVD peddlers on the street just four days after the movie opened in the United States and Britain. Other blockbusters have hit the streets even before release.

Chinese officials have expressed concern over the situation but have not taken significant steps to address the problem. Individual members of the Chinese government have attempted to find ways to stabilize the situation, but are hindered by a lack of manpower and a dearth of legal avenues to pursue.

While Chinese officials have seized over two hundred million pirated CDs over the past two years, there have been no criminal proceedings against the perpetrators, and thus the problem continues to grow.

According to the United States Trade Representative's *Special 301 Report*, *"Although China has revised its IP laws and regulations to strengthen administrative enforcement, civil remedies and criminal penalties, violations of IPR are still rampant. China remains one of the last countries in the world that fails to use, in practice, its criminal law to go after commercial copyright pirates and trademark counterfeiters."* Inadequate criminal deterrence and market access barriers that restrict the ability of US—companies to enter the music, entertainment software and filmed entertainment markets—exacerbate the piracy problem.

The bottom line is that in excess of $3 billion annually in potential worldwide revenue is lost due to piracy.

Earlier today, my colleagues Joe Biden, Gordon Smith, Bob Goodlatte, and I launched the Congressional International Anti-Piracy Caucus in an effort to stem this growing problem of global theft of intellectual property. Our bipartisan and bicameral group will work to keep Members and staff informed and updated on the serious problem of global piracy and look for ways to address this issue. With advances in technology, we will promote new and inventive techniques to combat piracy.

Earlier this year, I took part in a Congressional Delegation trip to Asia with several other Members of Congress. Asia leads the world in broadband penetration, and its citizens are among the most Internet-savvy in the world. However, the digital marketplace in copyrighted works in several countries has significant piracy problems and often times the legal infrastructure is outmoded for a world of e-commerce.

During my trip, I had the opportunity to personally raise a number of key copyright issues with high-ranking government officials. I urged government officials to enact Copyright Act amendments to align their law with global minimum standards contained in related WIPO treaties. In addition, I urged government officials to promote a workable framework for obtaining the cooperation of service providers in fighting online piracy.

This Committee has an obligation to continue monitoring and combating this troubling situation. It is only by repeatedly raising the issue with foreign leaders and applying additional pressure that we will begin to see any progress.