6

The US Congress and the Chinese Renminbi

GARY CLYDE HUFBAUER and CLAIRE BRUNEL

In September 2003 Senators Charles Schumer (D-NY) and Lindsey Graham (R-SC) introduced the first congressional bill (S 1586) targeting the value of the renminbi, then RMB8.28 to the dollar. Schumer and Graham's blunt remedy would have authorized a 27.5 percent US duty on all merchandise imports from China, if negotiations did not succeed in revaluing the renminbi. The 27.5 percent figure represented Schumer and Graham's arithmetic average of two private estimates (40 and 15 percent undervaluation).

Since September 2003, senators and representatives, both Republicans and Democrats, have largely come to agree that something ought to be done about China's currency. Some three dozen new congressional bills with various sponsors have been floated to challenge Chinese commercial practices, and bills introduced since January 2005 have focused increasingly on the currency value.[1] Figures 6.1 through 6.3 portray the real effective exchange rate (REER), reserve accumulation figures, and bilateral trade statistics that fuel congressional discontent with China. There is little difference of opinion in Congress about the objective: sharp appreciation of the renminbi.[2] Rather, congressional differences center on which

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1. For a listing of bills through the mid-2006, see Hufbauer, Wong, and Sheth (2006).

2. The leading candidates for the Democratic presidential nomination are all in accord.

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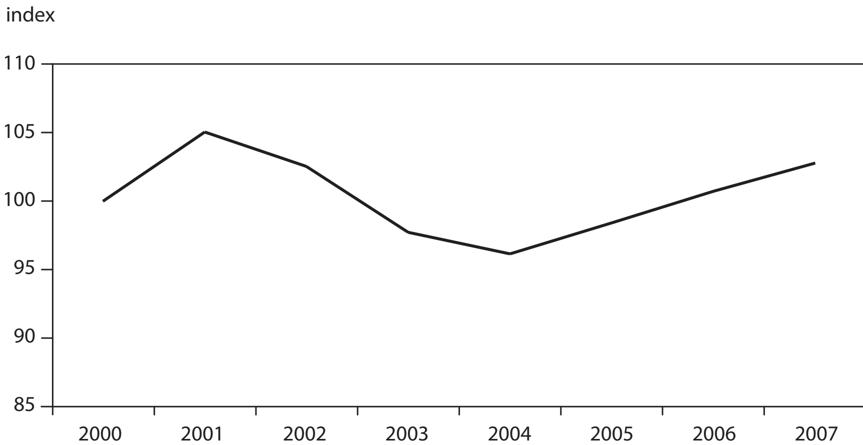
Figure 6.1 Real effective exchange rate of the renminbi, 2000–2007



Note: Higher number means renminbi appreciation. 2007 estimate is based on data from the first half of 2007.

Source: JPMorgan.

levers should be applied to move Beijing, which legislators should claim patrimony for the law that emerges, and which congressional committees should oversee subsequent developments.

While none of the proposed legislation has yet reached the desk of President George W. Bush, the White House has certainly taken notice. Treasury Secretaries John Snow and Henry Paulson have valiantly tried to persuade Beijing that exchange rate flexibility is in China's own interest as well as the interest of the United States and the world economy. In response, Chinese authorities introduced a very constrained float in July 2005, and slightly widened the permitted daily fluctuation in May 2007. The net result of China's moves is that the renminbi is now 7.49 to the dollar, an appreciation of 9.4 percent since September 2003. However, because the dollar has declined against most other currencies, in trade-weighted terms, the renminbi has appreciated only 6.2 percent since September 2003. By whatever metric the change in the renminbi is calculated, the extent of appreciation falls far short of congressional aspirations.

The predictable result was a fresh crop of congressional proposals in 2007,[3] of which three are prominent: the Senate Finance Committee bill (S 1607) sponsored by Max Baucus (D-MT), Charles Grassley (R-IA), Gra-

3. For a comprehensive list of all China-related legislation introduced in the first session of the 110th Congress as of December 14, 2007, see US-China Business Council, "110th Congress, First Session, Legislation Related to China," available at www.uschina.org (accessed December 18, 2007).

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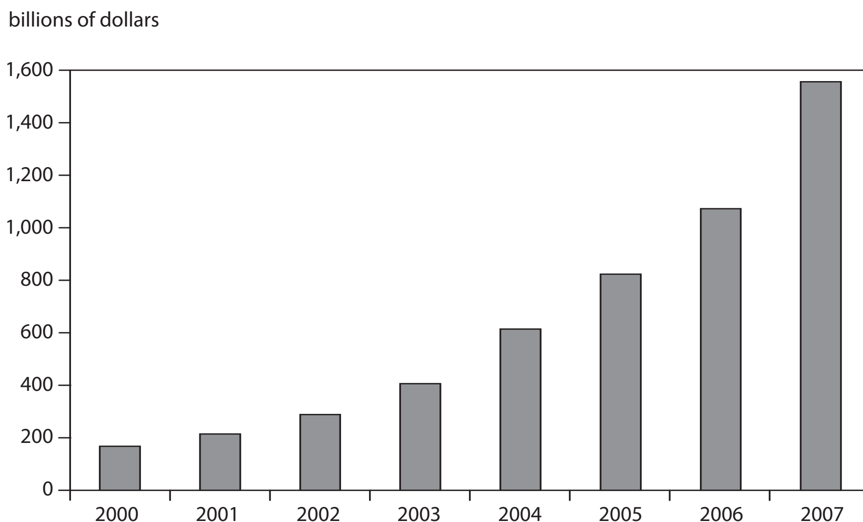
Figure 6.2 China's foreign exchange reserves, 2000–2007



Note: 2007 estimate is based on data from the first half of 2007.

Source: People's Bank of China, online statistics.

ham, Schumer, and others; the Senate Banking Committee bill (S 1677) sponsored by Christopher Dodd (D-CT) and Richard Shelby (R-AL); and a House of Representatives bill (HR 2942) sponsored by Timothy Ryan (D-OH) and Duncan Hunter (R-CA).

If jurisdictional disputes can be settled—a big if—then the House and Senate may approve some amalgam of these bills before the 110th Congress adjourns its first session in December 2007. The Treasury report on currency, which by law should have been presented to Congress on October 15, 2007, was delayed, possibly until after the December 2007 US-China Strategic Economic Dialogue (SED). The new International Monetary Fund (IMF) managing director, Dominique Strauss-Kahn, who took office on November 1, 2007, will inevitably be drawn into the currency debate. Congress may well take advantage of the shift in leadership at the Fund and the December SED meetings to assert its own views. The House is likely to move first, as the Senate is locked in a jurisdictional struggle between its banking and finance committees. Congressional sponsors will attempt to draft veto-proof legislation enacted by two-thirds majorities in both the House and Senate.

Table 6.1 summarizes the details of the three referenced bills. Essentially, the bills have five moving parts. First, while they differ in covering a wider or narrower range of currency practices, all the bills eliminate "intent" in determining whether or not a currency is manipulated or mis-

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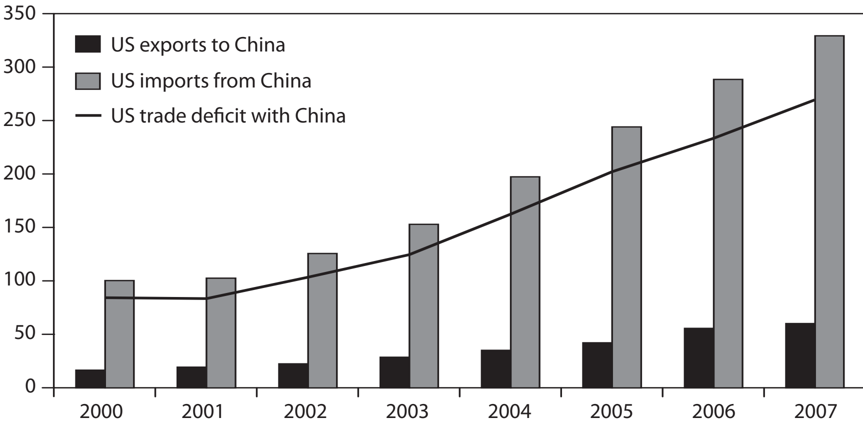
Figure 6.3 US-China bilateral merchandise trade, 2000–2007



Note: 2007 estimate is based on data from the first half of 2007. US bilateral trade figures differ significantly from those published by China.

Source: US Census Bureau.

aligned.[4] Second, they instruct the Commerce and Treasury departments to invoke unilateral and multilateral trade remedies if China does not revalue. Third, they instruct the Treasury to present a more forceful case in the IMF. Fourth, they enunciate various deadlines for action, ranging up to 360 days. Fifth, some of the bills allow a presidential waiver. For the purposes of this short review, we discuss four important questions:

- Will the process of congressional enactment and subsequent implementation be a helpful lever to persuade Beijing to revalue the renminbi?
- What will come from engaging the World Trade Organization (WTO) in exchange rate questions, either directly through a General Agreement on Tariffs and Trade (GATT) Article XV(4) frustration case or through an Agreement on Subsidies and Countervailing Measures (ASCM) prohibited subsidy case, or indirectly through US countervailing and antidumping (AD) duty cases?

4. In its June 2007 semiannual currency report, Treasury suddenly added an "intent" test to determine whether a currency is manipulated and found that no intent could be ascribed to China (these reports are mandated by legislation enacted in 1988). Before 2007, Treasury drew upon a shifting basket of touchstones to determine manipulation. See Henning (2007).

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Table 6.1 Three leading congressional bills on China's currency

Item	Ryan-Hunter (House): Currency Reform for Fair Trade Act of 2007 (HR 2942)	Schumer-Grassley-Graham-Baucus (Senate Finance): Currency Exchange Rate Oversight Reform Act of 2007 (S 1607)	Dodd-Shelby (Senate Banking): Currency Reform and Financial Market Access Act of 2007 (S 1677)
Overview	■ Many countries intervene in currency markets leading to misaligned currencies: e.g., the renminbi is undervalued by 40 percent or more. ■ Undervaluation, regardless of intent, acts as an export subsidy and a nontariff barrier against imports; a misaligned exchange rate should be defined as a countervailable subsidy, for both market and nonmarket economies (NME).	■ Replace the term "manipulation," and its connotation of intent with "fundamentally misaligned," which could result either from government policy or from market forces. ■ Revise US antidumping law so that the export price is adjusted to account for undervaluation, thereby augmenting the penalty duty.	■ "Manipulation" is an unfair trade practice, and strategic dialogue with China has not worked. ■ Currency manipulators need to be identified and addressed, with no regard to intent. ■ The United States should promote market access for financial firms in China.
Procedures	■ Treasury should consult with the Federal Reserve and the newly formed Advisory Committee on International Exchange Rate Policy and submit a report to Congress twice a year identifying misaligned currencies and engage in bilateral negotiations with those countries. ■ In the case of "fundamental and actionable misalignment," the Treasury should seek the support of the IMF and other countries; the United States should oppose any change of rules at the IMF that would benefit a misaligned country; it should oppose multilateral bank financing and Overseas Private Investment Corporation (OPIC)	■ Treasury should consult with the Federal Reserve and the new Advisory Committee on International Exchange Rate Policy to identify "fundamentally misaligned" currencies twice a year and consult with those governments. ■ If misalignment is driven by explicit government policy, then Treasury must designate that currency for "priority action;" consult with that country; seek advice and support from the IMF and other countries; and oppose any IMF rule change that would benefit that country. ■ If there is no result in 180 days, the United States should stop all federal purchases of	■ Treasury should submit a plan of action to Congress within 30 days of finding manipulation and engage in bilateral and multilateral negotiations. ■ Treasury must seek IMF consultation with the country and use its IMF voting power against this country if necessary. ■ If there is no result after nine months, the Treasury has the authority to file a WTO Article XV (4) case. ■ Congress can originate a joint resolution of disapproval when Treasury does not cite manipulation.

(table continues next page)

Table 6. 1 Three leading congressional bills on China's currency *(continued)*

Item	Ryan-Hunter (House): Currency Reform for Fair Trade Act of 2007 (HR 2942)	Schumer-Grassley-Graham-Baucus (Senate Finance): Currency Exchange Rate Oversight Reform Act of 2007 (S 1607)	Dodd-Shelby (Senate Banking): Currency Reform and Financial Market Access Act of 2007 (S 1677)
	loans to companies in that country; and the United States should take misalignment into account for NME status and antidumping cases. ■ If there is no result in 360 days, the United States should initiate a WTO dispute settlement case and consider remedial intervention.	that country's goods and services; reflect the undervalued exchange rate in antidumping duties; request the IMF to consult with the misaligned country; and oppose multilateral bank financing and OPIC loans to US companies operating in that country. ■ If there is no result in 360 days, the United States should initiate a WTO dispute settlement case and consider remedial intervention.	
Waiver	■ None	■ Presidential waiver if the actions in the bill can have damaging consequences for vital economic or security interests. ■ Congress can override the waiver through a joint resolution of the House and Senate.	■ Presidential waiver if the actions in the bill can have damaging consequences for vital economic or security interests.
Definitions	■ Fundamental and actionable misalignment: "the situation in which an exporting country's prevailing real effective exchange rate is undervalued relative to the exporting country's equilibrium real effective exchange rate and the secretary of Treasury determines that	■ Fundamentally misaligned: "significant and sustained undervaluation of the prevailing real effective exchange rate, adjusted for cyclical and transitory factors, from its medium-term equilibrium level." ■ Fundamentally misaligned currency for priority action: "if the country that issues	■ Manipulator: A country that has "a material global current account surplus and has significant bilateral trade surpluses with the US and has engaged in prolonged one-way intervention in the currency markets."

	(i) the amount of the undervaluation exceeds 5 percent and has consistently exceeded 5 percent on average in the 18-month period preceding the date of the calculation; and (ii) the undervaluation is a result of protracted, large-scale intervention in the currency exchange markets; excessive reserve accumulation; restrictions on or incentives for the inflow or outflow of capital that is inconsistent with the goal of achieving currency convertibility; or any other policy or action by the country that issues the currency."	the policy is engaging in protracted large-scale intervention in one direction in the currency exchange market, accompanied by partial or full sterilization; engaging in prolonged official or quasi-official accumulation of foreign assets for balance of payments purposes; introducing or substantially modifying for balance of payment purposes a restriction on, or incentive for, the inflow or outflow of capital that is inconsistent with the goal of achieving full currency convertibility; or pursuing any other policy or action that, in the view of the Secretary, warrants designation for priority action."
Special committees	■ Creation of an Advisory Committee on International Exchange Rate Policy—consisting of 7 members (3 Senate appointees, 3 House appointees, and 1 presidential appointee)—to advise the secretary of Treasury, Congress, and president on international exchange rate matters. The committee can submit a report disagreeing with the Treasury.	■ Creation of an Advisory Committee on International Exchange Rate Policy—consisting of 9 members (8 Senate Finance and Banking Committees appointees and 1 presidential appointee)—to advise the secretary of Treasury, Congress, and president on international exchange rate matters.
WTO compliance	■ GATT Article XV(4) would take WTO into IMF turf; exchange rate needs to "frustrate" another GATT article for Article XV(4) to apply; the WTO would probably look to the IMF to declare "manipulation." ■ For Agreement on Subsidies and Countervailing Measures (ASCM): Need to prove financial contribution from the government to a specific enterprise or industry (as well as other tests).	

- What are the consequences of legislation that gives Congress a larger oversight role over exchange rate questions at the expense of the Treasury and the Federal Reserve?
- What are the chances of mirror legislation abroad that might, in the future, target the dollar as an undervalued currency?

Legislation as a Lever?

By contrast with earlier drafts, the current bills deliberately stretch out the period for China to revalue before consequences are felt. Since WTO litigation and IMF deliberations could easily take a year or more, the bills contemplate an action horizon of two to four years. Moreover, the Senate bills allow the president to invoke a national interest waiver—subject to congressional override in the finance committee bill—thereby holding out the possibility for China to escape any penalties. In short, the bills are akin to turning the screw rather than slamming the hammer. Congress, however, will keep a watchful eye while the screw is turned: Designated congressional committees, chiefly the Senate and House finance and banking committees, will closely monitor the administration's actions, the value of the renminbi, and the path of China's bilateral and multilateral trade balances.

On July 31, 2007 Secretary Paulson, joined by Commerce Secretary Carlos Gutierrez and United States Trade Representative (USTR) Ambassador Susan Schwab, speaking in Beijing, declared that new legislation would jeopardize their efforts to persuade China to move quickly toward a market-determined exchange rate.[5] Moreover, congressional bills have attracted sharp criticism from prominent economists—including Nobel laureates—and respected columnists, such as Nicholas Kristof of the *New York Times*.[6] But administration opposition and ill-considered comparisons to the Smoot-Hawley tariff are not likely to derail the congressional locomotive.

A crucial question in the fall of 2007 is whether the prospect of legislation will persuade Beijing either to accelerate its appreciation of the renminbi or to allow more flexibility. As a stand-alone measure, a new US law might have little effect. Powerful forces within China stoutly oppose revaluation, particularly export industries that operate on thin profit margins and discount the offsetting effect that appreciation would exert on the prices they must pay for imported inputs. Wu Xiaoling, former deputy governor of the People's Bank of China (PBC), explained that an appreci-

5. Mark Drajem, "Paulson Calls China Currency Legislation the 'Wrong Approach,'" Bloomberg, July 31, 2007.

6. Pat Toomey, "Economists Against Protectionism," *Wall Street Journal*, August 1, 2007; Nicholas Kristof, "The New Democratic Scapegoat," *New York Times*, July 26, 2007, A18.

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ation of the renminbi would not decrease the dependence of the Chinese economy on exports and that internal restructuring is indispensable to boost consumption and move smoothly toward more flexibility.[7]

But prospective US legislation is not a stand-alone measure. Any new law looks likely to be enacted at a time when multilateral forces are gathering to confront China. Rodrigo de Rato, erstwhile IMF managing director, set in motion a review of the 1977 guidelines to Fund Article IV that was concluded in June 2007. The review proposed a more assertive IMF posture toward the renminbi. New managing director Strauss-Kahn will likely amplify de Rato's initiative. President Nicolas Sarkozy of France has added a fresh European voice to calls for revaluation.[8] Other European leaders, noting the rapid appreciation of the euro against the dollar and the possibility that the euro will top $1.50, will likely become more eager for Asian currencies to absorb part of the global adjustment burden. The next US president seems certain to accede to the thrust of congressional complaints, especially as both Republicans and Democrats are prominent sponsors of new legislation. Finally, the textile, clothing, and steel industries can be counted on to push the currency bills (Cooney 2007).

Taking a page from scholarship on economic sanctions to achieve political goals, the evidence suggests that multilateral pressure is somewhat more likely than unilateral pressure to change the target country's policies in a desired direction (Hufbauer et al. 2007). It seems possible that China, faced with a growing coalition, will accelerate the path of renminbi flexibility and appreciation, in hopes of softening the final bill and preventing the nascent US-EU alliance's crystallization into a solid front.

Engaging the WTO?

A theme among several bills is to engage the WTO in the currency dispute, directly or indirectly. The direct approach has two prongs: a US case brought to the WTO under GATT Article XV(4), alleging that China's undervalued renminbi "frustrates the intent of the provisions of [the GATT]" and a US case brought to the WTO under Article 3 of the ASCM, alleging that the undervalued renminbi amounts to a "prohibited [export] subsidy."

The indirect approach would characterize the undervalued renminbi as a subsidy for purposes of the US countervailing duty (CVD) law or would use the "corrected" value of the renminbi to calculate the margin in an AD case. Under the CVD and AD remedies, an affected US industry could bring a case to the US Department of Commerce on the subsidy determi-

7. "A Warning on Chinese Currency," *Washington Trade Daily*, October 22, 2007.

8. George Parker and Mark Schieritz, "Sarkozy Pushing for Tougher Line on China," *Financial Times*, July 23, 2007, 2.

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nation and to the International Trade Commission on the injury determination; an affirmative finding by both agencies would lead to the imposition of a CVD or AD duty on imported Chinese merchandise, calculated to reflect the extent of renminbi undervaluation. Thereafter, China could mount challenges in both US courts and the WTO.

Elsewhere, my colleagues and I have written that the United States would face an uphill battle, in legal terms, in bringing a GATT Article XV(4) case (Hufbauer, Wong, and Sheth 2006, 17–20). Certainly one can argue that prolonged undervaluation of a major currency threatens the world trading system. But a GATT Article XV(4) case faces a fundamental obstacle: When the Bretton Woods institutions were founded, exchange rate issues were assigned to the IMF and trade questions to the GATT. While each institution intrudes to some degree into the business of the other, the intrusions are at the margins, not the core. If the WTO were to declare that China's exchange rate practices violate the GATT without a prior but contemporaneous IMF determination that the renminbi's value threatens the world trading system, a considerable part of the Fund's mandate would migrate from Washington to Geneva. That prospect would prompt a collective gasp of horror in finance ministries and central banks worldwide.

To be sure, in October 2006 the Fund declared in its staff report concerning Article IV consultations with China that the renminbi is undervalued.[9] But this was a staff report, not a direct pronouncement of the managing director or the executive board. Moreover, the Fund staff did not allege that the currency is "manipulated," the legal term for an offensive practice under Article IV. Nor did the Fund staff use language that would put China in the dock for upsetting world trade. If senior Fund officials are prepared to criticize China in plain language, mere anticipation of such criticism, combined with pressure from the European Union and the United States, would likely foster a new exchange rate regime by Beijing.

9. The report states that ". . . since the previous peak in the renminbi's real effective value in early 2002, the currency has depreciated, while such factors as a substantial net foreign asset accumulation and a sharp rise in China's productivity relative to partner countries over the period since 2001 would be expected to have contributed to a real appreciation of the currency. . . . It is especially difficult to pinpoint a change in fundamental determinants [of savings behavior] that would explain the doubling of the [current account] surplus in relation to GDP in 2005 and that would suggest that the surplus at its present level could be considered to be a new 'normal' level of the savings-investment balance for China. In addition, gross official reserves have risen from $219 billion in 2001 to $930 billion at end-May 2006. . . . All of these developments point to the currency as being undervalued and that this undervaluation has increased further since last year's Article IV consultation." (IMF 2006). In October 2007, the Group of Seven (G-7) countries released the following statement: "We welcome China's decision to increase the flexibility of its currency, but in view of its rising current account surplus and domestic inflation, we stress its need to allow an accelerated appreciation of its effective exchange rate." See "Text of G-7 Communiqué," *MarketWatch*, October 19, 2007. Again, this language from the G-7 (not the IMF) does not amount to an explicit condemnation of China for bad behavior.

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If China did not move, the IMF's lead members might collectively devise a financial solution to prompt good behavior without resorting to WTO-authorized trade measures. Only as a last resort, in our opinion, would the Fund give a green light to the WTO to authorize trade sanctions.

Other more technical weaknesses of the hypothetical GATT Article XV(4) case can be pointed out,[10] but in any event, debating the pros and cons of a case could easily occupy the WTO's dispute settlement mechanism for two years or longer. We are left with the conclusion that an Article XV(4) case can best be justified as a lever to prompt more forceful action by the IMF, if only to preserve its turf, and as one means of focusing Beijing's attention on the currency question.

Congressional legislation also contemplates a US case in the WTO characterizing the undervalued renminbi as a "prohibited [export] subsidy," citing Article 3 of the ASCM. For the United States, this case would entail another uphill legal battle. First, to be characterized as a subsidy under the ASCM, a public measure must entail a "financial contribution" from the government (ASCM Article 1.1). One can argue that an undervalued exchange rate extends a financial contribution to exporters and imposes a financial penalty on importers. But public budgets have seldom if ever characterized changes in the exchange rate as a form of public revenue or expenditure. If trade negotiators had meant to ignore budget conventions and characterize an undervalued exchange rate as a subsidy, they would have said so in the ASCM or predecessor agreements as far back as the 1960s.

Second, to be actionable under either the WTO or national CVD laws, a subsidy must be "specific" as defined in ASCM Article 2. The basic idea is that the public financial contribution should confer a benefit on an enterprise, industry, or group of enterprises and industries. Changes in exchange rates and interest rates would seem to be the opposite of specific policies, as they rank among the broadest measures that a government can employ to influence the economy.

Considering just the tests of financial contribution and specificity,[11] a strong policy argument can be made that the ASCM never intended to intrude on the Fund's mandate as the arbiter of exchange rates. However, as with a WTO case under GATT Article XV(4), a WTO case under ASCM Article 3 might focus Beijing's attention on the tensions that an undervalued renminbi fosters, even if the case does not rest on the strongest legal foundation.

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10. These are explored in Hufbauer, Wong, and Sheth (2006). Besides these technical difficulties, it should be remembered that every undervalued currency implies that some other currency is overvalued. China might respond to a US Article XV(4) case against the renminbi with its own Article XV(4) case against the dollar.

11. Other tests of a more technical nature need to be met for a practice to be designated as a prohibited export subsidy. See Hufbauer, Wong, and Sheth (2006, 20–24).

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Congressional legislation might also authorize penalty duties against an undervalued renminbi in the context of US CVD and AD determinations. Compared with a WTO case, national CVD and AD cases would alter the sequence between legal argument and commercial penalty. In the WTO, even in a winning case, legal arguments can easily take three years before a countermeasure is authorized against the respondent country. In a national CVD or AD case, however, after six months of legal argument, penalty duties are often applied. In practical terms, the burden is on the exporter to disprove the allegation of unfair trade practices. The exporting country (China) could contest penalty duties in US courts, and if it prevailed, the duties collected would be refunded; in the meantime, however, US imports of the affected merchandise would certainly be reduced, perhaps sharply.

China could also challenge a CVD or AD determination in the WTO. Against a CVD determination, China could cite the ASCM tests of financial contribution and specificity. Against an AD determination, China could argue the absence of authority in the GATT Agreement on the Implementation of Article IV for calculating the dumping margin using a corrected exchange rate; China could also argue the absence of precedent in prior antidumping cases. To us, it appears that the legal arguments against AD penalties are weaker than the arguments against other trade penalties we have reviewed. Still, China might eventually prevail, but WTO relief is not retroactive: Penalty duties collected in the meantime—perhaps two or three years' worth—would never be refunded.

We are left to conclude that trade remedy measures, sought in the WTO or under US laws, can best be justified as levers to prompt more forceful IMF action and focus Beijing's attention on the currency question.

Giving a Larger Voice to Congress?

Apart from whatever influence congressional legislation might exert on the Chinese renminbi in the contemporary debate, another consequence is that Congress—more specifically, the Senate and House finance and banking committees—would establish a claim for more and larger chairs at the exchange rate table. In the Ryan-Hunter and Senate Finance Committee bills, this claim is reinforced by the proposed establishment of a new Advisory Committee on International Exchange Rate Policy, with several members designated by the Senate or House. The congressional assertion of a larger role in exchange rate matters can be seen as part of the enduring contest between the president and the Congress over their respective powers in the arena of foreign affairs. President Bush is clearly on the defensive in terms of war powers and trade agreements, and currency relations could be added to the list.

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The different congressional bills also reflect a power struggle within the Senate regarding which committee should have jurisdiction over the currency issue. The discord is reflected in definitions of offensive undervaluation that should elicit action—specifically, the distinction between manipulated and misaligned currencies. Manipulation, with its emphasis on one-way central bank intervention and its antecedents in IMF Article IV, would more clearly confer jurisdiction to the Senate Banking Committee.

On the other hand, "misalignment," with its emphasis on trade consequences, would confer at least some oversight authority to the Senate Finance Committee. Misalignment is a broader concept, as it encompasses undervaluation resulting from market forces as well as central bank intervention, thus potentially sweeping in the Japanese yen and other Asian currencies as well as the Chinese renminbi.[12] The auto industry and Michigan congressmen strongly support the misaligned currency concept because of the role that Japanese auto firms play in the US market.[13]

The clear losers from giving congressional committees more and larger chairs at the exchange rate table would be the Treasury and the Federal Reserve, which for decades have enjoyed almost exclusive authority over exchange rate questions, usually exercised behind closed doors.[14] In legislative specifics, the Senate Banking Committee bill would guide Treasury's hand in dealing with the IMF and would constrain Treasury's latitude in composing its semiannual exchange rate report to Congress. The Senate Finance Committee bill would give the USTR a role in bringing cases to the WTO and the Commerce Department a second-string role after the Treasury in determining the extent of undervaluation in CVD and AD cases. Both provisions would erode Treasury's primacy within the administration and would confer oversight responsibilities to the congressional finance and banking committees (Henning 2007).

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12. At around 107 yen to the dollar (January 23, 2007), the yen is arguably misaligned, as Japan continues to run huge current account surpluses. However, because the Japanese authorities have not intervened in the exchange market for the past three years, it is hard to say the yen is manipulated; yen undervaluation largely reflects the eagerness of Japanese households and firms to earn higher returns by placing their capital abroad.

13. In an interesting twist, while the Senate Finance bill headlines the term misalignment, when defining priority action countries, the bill reverts to the concept of manipulation, namely countries that are "engaging in protracted large-scale intervention in one direction in the currency market." Perhaps the drafters understand that other countries could say that the dollar is misaligned, as the value is far from a rate that would be consistent with a current account deficit under 3 percent of GDP. By creating a priority action category, they may hope to avoid scrutiny of the dollar if other countries enact mirror legislation.

14. Mandated in 1988, the semiannual Treasury currency reports represent the first significant congressional intrusion into the secretive realm of Treasury and Federal Reserve diblierations. See Henning (2007).

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Those with long memories will hear an echo from earlier episodes when Congress shifted responsibility for trade negotiations from the State Department to the USTR in 1963 and responsibility for administering the US CVD and AD laws from Treasury to the Commerce Department in 1979. The earlier events reflected congressional dissatisfaction with the commercial vigor of the State Department as a negotiator and the Treasury Department as an enforcer. At the same time, both changes enlarged Congressional oversight.

From the perspective of a smoothly functioning international system, more and larger congressional chairs at the exchange rate table will raise questions. The beauty of the post-Smithsonian system is that a small number of finance ministers and central bankers, sometimes joined by senior Fund officials, can quickly respond to exchange rate crises. If the enlarged congressional voice is only heard in exceptional circumstances and does not impede crisis management, it would be hard to criticize the new arrangement.

On the other hand, if congressional committees use their seats at the exchange rate table to pressure foreign countries over collateral grievances—bilateral trade balances, investment regimes, labor rights, carbon emissions, and the like—they could severely disrupt the international system. On present evidence, there is no indication of such tendencies. Moreover, if four congressional committees—Senate Finance, House Ways and Means, Senate Banking, and House Banking—collectively share the congressional seat, it seems less likely that collateral grievances will intrude on deliberations.

Mirror Legislation Abroad?

When Congress enacts legislation affecting foreign commerce, it often overlooks the likelihood that its handiwork will be mirrored abroad in ways that do not favor US economic interests. Secretary Paulson has warned against a global cycle of protectionist legislation at a time of growing US exports. The most memorable and regrettable experience was the Smoot-Hawley Tariff Act of 1930, but other ricochet examples can be cited: CVD and AD penalties, Buy America provisions, cabotage limits on maritime and air traffic, and agricultural import quotas to reinforce domestic farm subsidies. If Congress enacts legislation that guides the administration's hand, ultimately leading to penalty trade measures, it seems likely that the European Union, China, and perhaps Japan will fashion their own exchange rate laws that might, at some future date, target trade remedies against an undervalued dollar. After all, if the United States eventually balances its prolonged run of current account deficits and capital account surpluses with a prolonged run of opposite signs, important trading partners will likely consider the US dollar undervalued.

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How should the possibility of mirror legislation be factored into the congressional debate? One recommendation, not likely to gain traction on Capitol Hill, is simply to set aside trade measures that would penalize an undervalued exchange rate and instead concentrate new legislation entirely on IMF deliberations. A more plausible recommendation is to limit trade measures to situations in which four criteria are met: the country is a major commercial power, the foreign currency is manipulated through persistent one-way official intervention as determined by the Fund; the country is running large current account surpluses on a global basis, and the country's official reserves substantially exceed an adequate level for prudential purposes.

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Comment
The Politics of Trade Frictions

STEPHEN S. ROACH

China is the scapegoat du jour for all that ails the American middle class. At least that is the conclusion that can be drawn from spending any time these days in Washington. Unfortunately, the US body politic has long had a penchant for such scapegoating when it comes to trade policy. Remember the Japan bashing of the late 1980s? And just three years ago there was an outcry over India, as it became a lightning rod for concerns about the new threat of white-collar offshoring. Meanwhile, the Doha Round is dead, bilateral free trade agreements are going nowhere, Congress has allowed fast-track presidential negotiating authority to lapse, and opinion polls show an American public with a serious distaste for trade liberalization and globalization.

The politics of congressional-led China bashing fit into the current inflammatory climate all too neatly. While there is always a certain amount of bluster in Washington, this time the threats seem serious and worrisome. By my count, over 18 pieces of antitrade legislation have been introduced in the first nine months of the 110th Congress. In almost all cases, the target—either explicitly or implicitly—is China.

Nor has this outbreak of China bashing appeared out of thin air. In the previous two years, the 109th Congress floated some 27 anti-China proposals. The difference between the two sessions of Congress is troubling. In the end, the 109th Congress was all talk and no action. By contrast, two bills passed major Senate committees in 2007—finance and banking—with overwhelming bipartisan majorities. The risk, in my view, is that the

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110th Congress could well pass one of the measures currently in the legislative hopper with a large enough bipartisan margin to withstand the threat of a presidential veto.

Gary Hufbauer provides an insightful assessment of the potential ramifications of the three leading anti-China approaches currently under consideration in Congress—two very similar efforts in the Senate and a somewhat different approach in the House. It is difficult to say which, if any, of these versions will prevail in the end or what type of hybrid might emerge from a conference committee. But it is important to lay bare the assumptions embodied in Congress's penchant for China bashing to understand where the approach is coming from—and what unintended consequences it may well trigger.

First and foremost, the debate is grounded in very legitimate concerns over the increased economic insecurity of middle-class American workers. Real wage stagnation is at the top of the list. In the second quarter of 2007, inflation-adjusted median weekly earnings for full-time US workers were unchanged from levels prevailing seven years ago in the second quarter of 2000. Yet over that same period, productivity in the nonfarm business sector recorded a cumulative 18 percent increase. Contrary to one of the basic axioms of economics, American workers have not been paid their just reward as measured by their productivity contribution.

As voters, workers are holding their elected representatives accountable for the extraordinary disconnect between real wages and productivity, and politicians are scrambling to come up with both reasons and solutions. At the top of the political answer column is trade and globalization. Congress is presuming that the United States' record foreign trade gap—namely, an $838 billion deficit on merchandise trade in 2006—has been a decisive factor in squeezing both jobs and real wages of middle-class American workers. That supposition has dictated the politically expedient solution—of attacking the external imbalance by going after the so-called bad citizens among US trading partners.

That is, of course, where China enters the equation. The US bilateral trade deficit with China accounts for by far the largest slice of the overall imbalance: 28 percent of the total US merchandise trade deficit in 2006 and about 31 percent of the cumulative shortfall in the first eight months of 2007. Carrying the label of the Great Currency Manipulator seals China's fate in the eyes of Congress and many economists, some of whom attended and even hosted the conference that produced this volume. End of story for China bashers.

Not quite so fast. It does not take a rocket scientist to figure out that the United States has a multilateral trade problem. At least 40 countries were in deficit with the United States in 2006. Yes, China has the largest of the United States' bilateral trade deficits. But is that because of its currency policy? Or is it an outgrowth of a China-centric supply chain constructed by US multinationals desperately in search of efficiency solutions in an in-

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creasingly competitive world? Or does it reflect the simple and possibly related fact that China happens to produce—or assemble, to be more accurate—a broad cross-section of products that satisfies the tastes, pricing, and aspirational wants of over-extended American consumers?

Either way, the congressional math of the blame game is fatally flawed. Omitting the figures for China still leaves a US trade deficit of over $600 billion in 2006, a number nearly three times as large as the shortfall with China. So even if Congress fixes the Chinese piece of the US trade deficit—a dubious assumption, as I note below—that still leaves a rather large remainder for the US trade gap. What is the policy to address that? Is Congress telling us that China is merely first in line—that, one by one, it will go down the list of US trading partners and impose trade sanctions until the deficit has been eliminated?

It follows that the so-called currency fix that Congress is now contemplating is equally preposterous, assuming that pressure on a bilateral cross rate will solve a multilateral deficit. Such a fix will simply send a relative price signal that will shift the mix of the deficit elsewhere, most likely to a higher-cost producer. That is akin to rearranging the deck chairs on the Titanic. It is also the functional equivalent of a tax hike on middle-class Americans, the very group of US citizens the Congress is trying to protect.

The multilateral characteristics of the US trade deficit are the smoking gun to this problem. And it is painfully clear what the root cause is: an extraordinary lack of US domestic saving. According to US Department of Commerce statistics, the United States' net national saving rate—the combined saving of individuals, businesses, and governmental units, adjusted for depreciation—averaged a mere 1.4 percent of national income over the five years ending in 2006. That is the lowest national saving rate for a five-year period in modern US history and apparently the lowest saving rate for the hegemonic power in modern world history. Lacking in domestic saving, the United States must import surplus saving to grow and run massive current account and trade deficits to attract the capital.

That, I am afraid, is the real end of the story. If the United States wants to fix its trade deficit and relieve the concomitant pressures that are bearing down on middle-class workers, it must address its seemingly chronic saving deficit. I am highly critical of my macro brethren, several of whom are sitting in this room today, who only pay lip service to this critical aspect of the problem when appearing alongside me as expert witnesses in offering congressional testimony on these key issues.

Of course, in Washington, it has long been easy to duck the facts and weave a good yarn. China bashing is largely a by-product of that predilection. But it is actually far worse than that. Who is really to blame for inadequate saving, the root cause of the US trade deficit? In my opinion, Washington is at the top of that list, with its penchant for budget deficits, consumption incentives, and an asset-based saving mindset that has been

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underwritten by the Federal Reserve. The same Washington is utterly incapable of taking a deep look in the mirror and accepting responsibility for problems such as these. It is much easier to indulge in scapegoating and point the finger elsewhere. As underscored above, China is but the latest in a long line of such targets. Just ask Japan what it was like some 20 years ago—or India just a few years ago.

China bashing is also emblematic of a deeper problem that grips the United States body politic: an unwillingness to embark on the heavy lifting of education reform and other investments in human capital that are required to enable American workers to compete and prosper in today's increasingly competitive world. Instead of investing in a hard-pressed work force, Washington apparently believes more in shielding US workers from low-wage talent pools in the developing world.

The doubling of the world's labor supply that has occurred in the past two decades has evoked a response of fear and protectionism, putting the United States at grave risk of becoming more insular and inward looking. Yet over the long sweep of US economic history, its workers have actually done best when they are pushed to their limits by a risk-taking, entrepreneurial, and innovative society. By blaming others for our own shortcomings—especially on the saving and human capital fronts—the United States runs the very real risk of losing its most special edge, an indomitable economic spirit. By shirking its responsibility for putting US saving policy on a sound path, Congress is, instead, veering toward the slippery slope of protectionism.

Finally, a word about China, where I spend an awful lot of my time these days. China is a living miracle of economic development. The world has never seen anything like the transformation of the Chinese economy that has occurred over the past 15 years. This extraordinary development trajectory is based primarily on a steadfast commitment to market-based reforms—something that Washington as the bastion of capitalism should applaud, not criticize.

But China also has a new strength—one that takes a page from right out of the United States' own experience—as dynamic private companies are now springing up all over China. Of the 21 new Chinese companies that Morgan Stanley brought public in 2007, fully 19 of them were private. For China, the newfound spirit of its privately employed workers and businesspeople is contagious and very reminiscent of that which has long been central to the American dream.

Like any economy, China has its share of problems and risks, many of which have been emphasized in this conference volume. Structural imbalances, environmental degradation, and income disparities are all openly debated in China, especially now as the Party Congress convenes in Beijing. Currency policy has long been a topic of discussion in official Chinese policy circles as well. But despite its remarkable progress, China is still a very poor country with many important issues to deal with.

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Therein lies a critical difference between the two perspectives. Washington's penchant for the quick fix singles out the Chinese currency as a lightning rod in the great middle-class globalization debate. China, by contrast, views the currency issue not as an end in and of itself, but as one of many pieces in a broad mosaic of financial reforms. These are two very different perspectives, which have now boiled over in the form of trade frictions.

Ironically, in contrast to US intransigence on the saving issue and the multilateral trade deficit it has spawned, China is making important progress in relieving this source of tension. As China puts its financial system increasingly on a market-based footing, its leaders have given every indication the currency regime will follow. The shift to a managed float in July 2005 was an important first step in that direction. At the same time, China is taking dead aim at the imperatives of a consumer-led growth dynamic, a very different economic structure that will boost imports and thereby reduce its destabilizing trade surplus.

China is considering the timing and sequencing of these moves with due deliberation, but mainly with an eye toward keeping its embryonic financial system stable. There are clear risks in this approach, excess liquidity and asset bubbles being the most obvious. But these are China's risks to accept and manage rather than our place to dictate the terms of engagement. China's pace may not fit US political imperatives, but that is not China's fault.

Globalization is not easy, and the win-win mantra long offered by the economics profession does this mega trend a great disservice. It oversimplifies the problems and overlooks the inherent tensions of a globalization that is now occurring at hyper speed, enabled by the new connectivity of information technology. Globalization is full of opportunity and challenge as well as fear and risk. But in the end, globalization is nothing more than trust—trust in economic partners to act out of collective interests in making the world a better and more prosperous place. I fear that a China-bashing Congress has lost sight of this noble objective at great peril.

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