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Testimony of Treasury Secretary Henry M. Paulson on the Report on International Economic and Exchange Rate Policies

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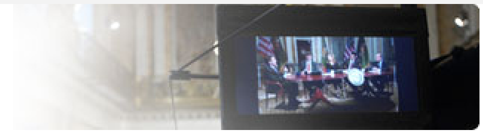
U.S. DEPARTMENT OF THE TREASURY

Press Center



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Before the Committee on Banking, Housing, and Urban Affairs

Mr. Chairman, Senator Shelby, and members of the committee, thank you for the opportunity to have this dialogue with you today on an issue of vital importance to American workers and the American economy.

As you know, the foreign exchange report recently issued by the Treasury reviews developments in international economics and the exchange rate policies of a number of our key trading partners.

Let me first take a few minutes to talk about the important and multi-faceted relationship we have with China. Getting it right is vitally important to the citizens of both our nations – and the world – and will be for many years to come. Since the economic relationship between our two countries is an important part of the overall relationship, I have focused intensely on China from the day I was confirmed. It is my job to press for opportunities for American businesses and American workers. The successful management of our economic relationship with China will benefit the United States, and China, greatly.

The United States and China share many strategic interests. These range from national security, to economic growth and trade, to the health of our environment. As a growing leader on the world stage, China must be a full participant in the rules-based world economy.

Recognizing this, the President and Chinese President Hu established the Strategic Economic Dialogue (SED) to manage the economic relationship between our two nations on a long-term basis. The SED should help us make progress on fundamental long-term structural economic issues, as well as on very pressing short-term issues. It is not a scripted ceremony. It is a serious, focused discussion of the economic issues that matter most.

The SED provides a mechanism through which, for the first time in our relationship, our government can speak with a single voice on economic issues to the highest levels of the Chinese government, on a regular basis. The Dialogue is goals-based and designed to keep both sides moving forward on the goals we establish. By meeting regularly, we can actively monitor the progress we're making. By making progress on critical, immediate issues such as currency reform, we will build confidence to deal with important longer term economic issues such as the structural challenges China faces.

China's currency policy is a key factor in our economic relationship. China does not yet have the currency policy we want it to have and that it needs. Treasury's foreign exchange report clearly states that China's cautious approach to exchange rate reform exacerbates distortions in its domestic economy and impedes the adjustment of international imbalances. I look forward to discussing the report with you during this hearing.

We are actively pressing the Chinese to introduce greater currency flexibility and undertake wider market reform. We are seeing some results. China abandoned its pegged exchange rate in July 2005, and began to introduce some flexibility. Since last July, the pace of appreciation has been more than three times as fast as it had been in the first year after the initial renminbi reform. Foreign currency trading, once conducted entirely by the Chinese government, is now conducted almost entirely by commercial banks. China has introduced financial instruments to hedge foreign exchange risk. And the Chinese government has begun to allow increased fluctuations in the currency.

This is welcome progress, but we need to see much more. Although China is moving faster, it is still not moving fast enough.

Nor is currency flexibility enough. A major objective of my two remaining years as Treasury Secretary will be pressing the Chinese government to advance toward the goal of a renminbi whose value is freely set in a competitive marketplace, based upon economic fundamentals.

I will work with the Chinese government to develop the market infrastructure they need for a freely floating currency. This involves several key steps. First, the government should progressively widen the band that limits the daily movement of the exchange rate. Widening the band will help businesses and financial institutions learn to operate with a fluctuating currency. Second, the central bank should progressively reduce its intervention in the foreign exchange markets. Third, China must develop the fundamental components of a capital market – a bond market and a yield curve – to absorb inflows and outflows of foreign exchange and provide ways to hedge against exchange risk. And fourth, China's central bank must set clear policy targets to avoid inflation and thereby provide confidence in the value of the Chinese currency.

I want to be clear: Increased flexibility in the short run is absolutely necessary, but it is not sufficient. My goal is to make significant progress toward a fully market-determined, floating Chinese currency.

The message I delivered to Chinese decision-makers in the first meeting of our Strategic Economic Dialogue in December is that they are not moving quickly enough to make their currency more flexible. While they agree they need to introduce currency flexibility and move to a floating exchange rate, they are not moving quickly enough for the United States or the rest of the global community. And they are not moving quickly enough for their own good.

The Chinese leaders believe there is risk in moving too quickly, when in fact, as I argued to them, the greater risk is in moving too slowly. China may in some respects be a developing country, but it is also a large and powerful country. The international community will run out of patience with China unless the pace of its reform accelerates.

Reform of China's currency policy is a crucial issue for China and for the United States. And, Mr. Chairman, the need for reform in the Chinese economy goes beyond currency. Currency movement alone will not eliminate the distortions in the Chinese economy nor significantly reduce China's trade surplus. China needs to restructure its economy so that household consumption – rather than exports and excess investment – powers growth. This is the only way China can grow without generating huge trade surpluses.

To do this, Chinese policy must address the reasons why Chinese households feel compelled to save so much and spend so little. Only 20 percent of the 800 million people who live in rural areas have health insurance. The basic government pension covered only 17 percent of Chinese workers in 2005. And only 14 percent of the population is covered by unemployment insurance. China must invest in its people by strengthening the health care system and the social safety net. And Chinese households need financial products that insure against risk and finance major expenditures. The Strategic Economic Dialogue addresses all of these issues.

I believe that the openness of the U.S. economy to competition and our participation in international trade are key to economic growth, higher wages, and increased opportunities for U.S. workers. And we are pressing China to follow our example of openness. I am working to ensure that China's growth and expanding market create maximum opportunities for the United States.

China must live up to its WTO commitments. It must protect and vigorously enforce intellectual property rights. It must increasingly open its markets to foreign competition – for its own good as well as for ours. And it must introduce greater transparency in regulation and observe the rule of law. Through the Strategic Economic Dialogue, and through the various economic dialogues that we have with China, the Administration will continue to press very hard in all of these areas.

Mr. Chairman, America's economy and workers benefit significantly from our trade with China. China is our fourth-largest export market. Our exports to China have increased more than 350 percent over the last decade – six times the growth of our exports to the rest of the world. And nearly half of our exports to China are capital goods, including high-value-added goods such as civilian aircraft, electrical machinery, and medical devices.

I believe strongly that a healthy Chinese economy, growing without large external imbalances, is of vital interest to the people of the United States, to the people of China, and to the global economy as a whole. More currency flexibility in the short term and a fully market-determined, floating RMB in the intermediate term are essential to accomplish that goal. So is restructuring the Chinese economy so that domestic consumption demand – not exports – fuels China's growth. Broad structural changes are necessary to have a major impact on our trade deficit with China.

The next round of the SED will take place here in Washington in May. I understand that your constituents are very concerned about the impact of our relationship with China on their jobs and their livelihoods. I want to work with you as I prepare for these discussions. China is a big and important part of the world economy. It needs a currency whose value is determined in an open, competitive marketplace, and an economy that supports more balanced, stable growth.

I look forward to working with the members of this distinguished committee on the many important issues we have before us. And I now welcome your questions.