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Congress of the United States

House of Representatives

109th Congress

Committee on Small Business

2361 Rayburn House Office Building
Washington, DC 20515-6315

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The Honorable Alan Greenspan
Chairman
Federal Reserve System
20th Street & Constitution Avenue
Washington, DC 20551

Dear Chairman Greenspan:

On Thursday, June 23, 2005 in testimony before the Senate Finance Committee on U.S-China economic relations, you were quoted as saying that a revaluation of China's currency, known as the renminbi or yuan, would have little positive impact on the U.S. trade deficit or U.S. jobs. "Some observers mistakenly believe that a marked increase in the exchange value of [China's currency] relative to the U.S. dollar would significantly increase manufacturing activity and jobs in the United States. I am aware of no credible evidence that supports such a conclusion."

While I am grateful you agreed with Treasury Secretary Snow that China should move to a more flexible currency for the benefit of its own economy, I wanted to let you know that there is a host of credible evidence demonstrating that an increase the value of China's currency would improve the state of manufacturing in the United States, particularly for small manufacturers. In fact, a witness on a subsequent panel at the very same hearing – Al Lubrano of Technical Materials from Lincoln, Rhode Island on behalf of the National Association of Manufacturers (NAM) – presented a comprehensive but succinct analysis of why a Chinese yuan revalution upward will have a positive benefit on U.S. trade and on our domestic manufacturing base. I am pleased to enclose a copy of his testimony. I particularly call to your attention the last four pages of his testimony (Appendix II) in which Mr. Lubrano includes for the record a NAM staff analysis to rebut arguments that a yuan revaluation will not affect U.S. trade (under the Trade section in the Policy Issue Information icon on http://www.nam.org).

In short, the largest trade factor affecting the manufacturing sector in recent years was the dramatic drop in U.S. manufactured goods exports from 2000 to 2003 because of the overvalued U.S. dollar, which peaked in 2002 and is still about 10 percent higher than when it first started its run-up in 1997. The U.S. trade deficit in manufactured goods deteriorated by $89 billion but about 80 percent or $69 billion is attributable to the collapse in U.S. manufactured goods exports.

Over the past couple of years, market forces have helped the dollar adjust to more realistic levels against all major economies of the world except one – China. This readjustment has helped U.S. manufacturers regain market share in those other countries and improve our overall exports, which is one key reason why the manufacturing sector is recovering in this nation. While I agree that currency adjustments may not affect large multinational companies, for U.S. small manufacturers, particularly for those that have no overseas plants, competing against a government-subsidized exchange rate is almost an impossible proposition. In sectors like machine tools, hand tools, mold making, plastics, fabricated metal products, metal finishers, and foundries – the foundation of any advanced society and overwhelming dominated by small business – there will be a significant benefit once the marketplace (not the Chinese government) sets the appropriate value of the yuan. The small manufacturers are also critical to our future economic health as, on a per-employee basis, small firms produce double the number of product innovations as large companies and garner more patents per sales dollar than big firms (source: Office of Advocacy, U.S. Small Business Administration).

Thus, I would respectfully encourage you and your staff economists to consult with NAM and representatives of other small business groups that maintain critical data that you may be missing (such as the Office of Advocacy and the Association for Manufacturing Technology), not just on this issue but on the overall importance of maintaining a healthy, growing small manufacturing base in this country for future innovation and job creation. I firmly believe that without a strong manufacturing base, along with mining and agriculture, we will cease to be a great nation, because most service-related jobs are tied directly or indirectly to these industries.

Sincerely yours,

Donald A Manzullo

Donald A. Manzullo
Chairman

APPENDIX II

NAM STAFF ANALYSIS OF ARGUMENTS THAT A YUAN REVALUATION WILL NOT AFFECT U.S. TRADE

First: A revaluation of the yuan will have no effect on U.S. trade deficit, production or jobs.

Not so. First of all, it has long been established in economics that changes in relative prices, whether from tariffs or from changes in exchange rates, have a strong determining influence on trade. Why else then do we bother expending a great deal of time and effort to negotiate away tariffs of 6 or 7 percent? The experience of the U.S. trade balance bears this out. As recently as 1997, the U.S. trade deficit was only $183 billion, or 2.2 percent of our GDP – and had been growing moderately, However, as the dollar appreciated 25 percent against other currencies in the following years, the U.S. trade deficit exploded – more than tripling. U.S. trade experienced a similar pattern in the first half of the 1980's – the previous time the dollar had become very overvalued.

Second, while it is not unusual to hear individuals say that trade deficits are the result of too little savings and too much investment in the United States, this is not actually a cause of the trade deficit. Savings minus investment, production minus consumption, and exports minus imports are three different descriptions of the same economic concept. They are identities. One does not cause another. The cause is external – such as a price maladjustment with other economies because exchange rates are not allowed to equilibrate differences in price levels.

Additionally, some say that the U.S. trade deficit is caused by the Federal Government budget deficit, so if the deficit with China were to be reduced, the deficit would simply be moved elsewhere until the budget deficit was reduced. A glance at Exhibit 5 shows this argument doesn't hold water. There is absolutely no relationship between the Federal Budget deficit and the trade deficit. For the economists reading this analysis, the coefficient of correlation is -.02, which is about as close as you can get to no relationship whatsoever.

Prices DO matter, and the NAM has heard from many companies that they can be competitive with Chinese products were there to be a 10-20% increase in Chinese prices. Granted, that will not happen across the board. Areas like many consumer electronics which have been produced little in the United States for over a decade and for which China serves largely an assembly function, will likely see little effect. But in sectors like machine tools, hand tools, mold making, plastics, machine tools, furniture, fabricated metal products, and other sectors where we are hearing a lot from our member companies, there will be real benefit when prices reflect market based currencies.

Those who say that there is no way to compete against Chinese wages have to remember that wages are a relatively small factor in the overall price of U.S. manufactured goods. Census Bureau data show that for all U.S. manufacturing, direct wages and benefits average only 11 percent of the cost of the final product. When Chinese prices are half or less of U.S. prices, factors other than wages are at work – such as an undervalued exchange rate.

Second: Production will only move to other low cost producers.

Not so. Another argument is that Chinese imports substituted for imports from other countries, not U.S. production, and if Chinese prices rose then other countries would once again begin supplying these products and U.S. producers would see no gain. This argument has considerable merit for electronic products – which used to be imported from Japan and other Asian countries and are now largely imported from China. However, it has no merit for the broad range of products made by NAM members who tell us that they are being displaced by Chinese products in industries such as fabricated metals, plastics, tools, and others. These products were previously made in the United States, not other Asian nations – and it is likely that some or much of their production would return to the United States if the price relationship with China were to change as a result of China's currency moving up in value, or at least that further loss of production would be slowed or halted.

Since 2001, for example, total import penetration of the U.S. manufactured goods' market grew 2.2 percent. China's import penetration grew 1.6 percent during this period, three quarters of the total increase. At the same time, import penetration from the rest of Asia fell only slightly – 0.2 percent. Thus it is obvious that increased Chinese import penetration has not been offset by decreased import penetration on the part of other Asian countries.

Additionally, it is important to note that to the extent there would be production shifts from China to other Asian nations, U.S. exports and the U.S. trade balance would be likely to benefit. The U.S. share of China's imports is considerably smaller than the U.S. share of the import markets of other Asian or Latin American markets. For example, for every dollar of goods Malaysia sells to the United States, it buys two-thirds more from us than does China. If a Central American nation sells something to the United States, it is likely to spend more than 40 cents of every dollar in the United States, whereas China at best would spend 8 cents in the United States. The locational origin of what we buy can have a significant effect on how much we sell.

Another factor not considered in this argument is that other Asian nations have also been suppressing their currencies so as not to have their products too expensive relative to Chinese products. With a Chinese revaluation, these other nations would no longer be constrained by China's undervaluation and would be able to pursue market-determination for their currencies as well. As Secretary Snow said in his remarks upon releasing the Treasury report in May, "China's rigid currency regime has become highly distortionary... concerns of competitiveness also constrain neighboring economies in their adoption of more flexible exchange policies." Bearing out this point, Kwon Tae Kyun of the Korean Ministry of Finance recently said that "It is better to do it [yuan revaluation] as early as possible. Currency and oil costs have always been the two major risks the Korean economy faced. The yuan's revaluation would clear one of them."

Third: There is very little Chinese value-added in Chinese exports, so a revaluation would have little or no effect.

No so. This is probably true for Chinese exports of electronics products, most of which are made in foreign-owned plants operating in export processing zones and assembling components largely made in other Asian countries. But it is not true for the rapidly growing range of Chinese products that are competing with U.S. manufacturing production in the broad range of sectors that are feeling the pinch of Chinese competition – including auto parts, metal products, industrial supplies, plastics products, and the like. These, for the most part, are not made in China's export processing zones and are principally of Chinese origin and value-added. These products have benefited the most from China's undervalued exchange rate and would be the ones most likely to be less able to compete with U.S. production once the exchange rate reflected economic fundamentals.

China's trade data differentiate between exports (and the related import inputs) from processing zones, both by state-owned enterprises and foreign-invested enterprises. What these data show is that 55 percent of China's 2004 exports were either "process with assembly" or "processed with imported materials." The import content of these exports was 67 percent – meaning that the domestic content was only 33 percent.

The remaining 45 percent of China's exports were neither processed in assembly zones nor produced with imported components, and can be viewed as 100 percent domestic content (other than the costs of imported energy, etc. that is true with all countries). Thus, combining the 55 percent having 33 percent local content and the 45 percent having 100 percent local content shows that the overall local content of China's exports may be estimated at 63 percent. That proportion of China's export value would be affected by upward movement of its currency.

Fourth: Most imports from China are produced in U.S.-owned plants and a revaluation would directly harm U.S. firms.

While popular, this argument is absolutely false. U.S. Census Bureau data show that only 27 percent of U.S. imports from China are "related party trade" – i.e., are imported by one part of a company from another part of the same company. "Related party trade" covers all imports within the same corporate family, including those by foreign owned companies. Thus, 27 percent of U.S. imports from China are imports of U.S. companies from their Chinese subsidiaries, imports into the United States by Japanese affiliates from their Chinese branches, etc. Since most investment in China is not from the United States, but from Taiwan, Korea, Hong Kong, and Japan, a minority of related party trade is likely to be due to U.S. companies – but the Census Bureau data related party trade data do not distinguish trade by the country of parentage.

In addition, the Commerce Department's investment data show that the overwhelming amount of U.S. investment in China is for the purpose of supplying the domestic Chinese market. Very little of this production is shipped to the United States.

Fifth: U.S. interest rates will rise if China stops buying massive amounts of Treasuries to keep its currency artificially cheap.

Not so. An argument frequently heard is that if China moves away from its currency peg, it will stop buying Treasury bonds and interest rates will increase, housing prices will fall, and all manner of economic strife will be visited on the U.S. economy and citizenry. To see that this is not so, it is only necessary to quote two of many officials who have been asked that question.

Federal Reserve Chairman Alan Greenspan at the Economic Club of New York said, "The effect of a reduction in the scale of intervention, or even net sales, on U.S. financial markets would likely be small...Accordingly, any incentive for monetary authorities to sell dollars, in order to preserve market value, would be muted,"

U.S. Treasury Assistant Secretary for International Affairs, Randal Quarels said that the U.S. Treasury securities market "is the broadest, deepest, most liquid active capital market in the world, and will remain so. It's very unlikely that that sort of rebalancing would have significant effects on the U.S. Treasury market, the U.S.'s ability to finance itself."

To amplify Chairman Greenspan and Assistant Secretary Quarels remarks, the Treasury market trades roughly $600 billion a day, so if China were to stop purchasing an additional $20 billion a month – not all of which is in dollars, there would be little effect. Moreover, when Japan intervened heavily from December 2003 to March 2004 – increasing its reserves $156 billion in that period – more than $50 billion a month – and then suddenly stopped in April 2004, there wasn't a blip in the market. No one even noticed.

Sixth: A revaluation will hurt China

To the contrary, the Chinese economy will be helped by a revaluation and movement toward a flexible currency. One need only look at recommendations from the International Monetary Fund, the U.S. Treasury Department, Alan Greenspan and a number of Chinese sources among many others, who say that greater flexibility in China's exchange rate system is very much in China's self-interest. The current 10-year old peg is encouraging huge speculative inflows of capital betting on a revaluation, which in turn grows the Chinese money supply and encourages further uncreditworthy bank lending which only adds to the build-up of nonperforming loans and weakens the Chinese banking system. A key component of China's eventual move to a market-determined currency will be a functioning, solvent banking system and dampening speculative inflows through a significant revaluation would be a positive step towards that goal.

Those saying that it is China's own interest to make moves to a flexible currency are too numerous to cite here, but include Treasury Secretary Snow, Federal Reserve Chairman Greenspan, the Canadian Central Bank, the European Central Bank, the World Bank, the International Monetary Fund and a host of other economists. As Secretary Snow said, "China's rigid currency regime has become highly distortionary. It poses risks to the health of the Chinese economy, such as sowing the seeds for excess liquidity creation, asset price inflation, large speculative capital flows, and over-investment."