

**BEFORE THE OFFICE OF THE
UNITED STATES TRADE REPRESENTATIVE**

)) THE CHINA CURRENCY COALITION))	Petition for Relief Under Section 301(a) of the Trade Act of 1974, as Amended, 19 U.S.C. §§ 2411 <u>et seq.</u>
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SUMMARY

The China Currency Coalition is a group of U.S. industrial, service, agricultural, and labor organizations that seek immediate elimination of the Chinese currency's undervaluation, which is estimated at 40 percent or more. Since 1994, China has pegged the yuan to the U.S. dollar. Over the last five years, the value of the yuan has averaged 8.2775 yuan to the U.S. dollar and has fluctuated in the range of ± 0.1 percent (*i.e.*, equal to roughly 1/100th of one U.S. cent). In the last year, the range has narrowed even further to ± 0.01 percent (*i.e.*, equal to about 1/1,000th of one U.S. cent) around the average of 8.2771 yuan per U.S. dollar.

China is the only major trading country in the world employing a conventional fixed-peg currency system. By definition, this regime requires an expansive role in the market by the Chinese government, because it alone can manage the imbalances in supply and demand caused by its determination to maintain a fixed price of the yuan contrary to market forces and given China's soaring volume of exports. China permits foreign direct investment that it favors, but otherwise has a labyrinthian array of currency controls on the holding and use by businesses and individuals of current- and capital-account inflows of foreign exchange. In effect, the Chinese government absorbs foreign currency by printing and circulating yuan in exchange. See Exhibit 1.

China's yuan presents an extreme and unique case of currency undervaluation and manipulation. While economists and academicians debate the extent of the yuan's undervaluation, there is a strong consensus that the yuan is significantly undervalued. See Chart on p. 19.

China's undervaluation of the yuan is fueling serious trade imbalances. First, China's official trade data significantly understate its global trade surplus and the degree of the yuan's undervaluation. See Section II.D. If China's import/export data are replaced by the corresponding export/import data of China's 40 largest trading partners (which have accounted for 88 to 95 percent of China's total trade since 1999), it is evident that the United States and the rest of the world are running substantially greater trade deficits annually with China than China's official trade data show and that these deficits have become progressively worse over the last several years especially. This conclusion is reached even after adjustments are made for transshipments through Hong Kong and after f.o.b./c.i.f. valuation inconsistencies are reconciled. Thus, the trade surplus of China with the United States catapulted from \$33.8 billion in 1995 (according to U.S. data) to \$124.9 billion in 2003 (again according to U.S. data). China's data

show, by contrast, a \$9.4 billion trade surplus in 1995 and a \$60.3 billion trade surplus with the United States in 2003. See Chart on p. 33. Likewise, in 1999 China reported a trade surplus of \$37.7 billion with its 40 trading partners (including the United States), but the data of those 40 trading partners indicate that China's trade surplus in 1999 was \$140.5 billion. In 2003, the corresponding figures were \$46.0 billion and \$210.9 billion, respectively. See Chart on p. 35. If trade between China and the United States is excluded from the calculations, China's trade surplus in 1999 was reported by China as \$14.2 billion, but was reported by the 40 trading partners as \$71.5 billion. In 2003, China reported its trade balance apart from the United States as a deficit of \$14.3 billion, while China's 40 trading partners computed China's surplus as \$86.0 billion. See Chart on p. 38.

Second, China's undervalued yuan has encouraged and facilitated foreign direct investment into China. Between 1994 and 2000, foreign direct investment increased by almost 21 percent. Between 2000 and 2003, foreign-direct-investment flows jumped by 31 percent, while contracted foreign direct investment grew during the same time by nearly 85 percent. See Chart on p. 41.

Third, China's undervalued yuan has also generated an accumulation of foreign-exchange reserves that is excessive. In 1995, the year after the yuan was pegged to the U.S. dollar, China's foreign-exchange reserves were \$73 billion. In 2000, China's foreign-exchange reserves were \$165 billion. Through July 2004, China's foreign-exchange reserves rose to \$483 billion, approximately one-third of China's Gross Domestic Product. Furthermore, China's accumulated foreign-exchange reserves, equivalent to 14-17 months of imports and 1,077 percent of short-term debt, are unreasonable and are far in excess of IMF prudential guidelines of 4-6 months and 180 percent of short-term debt, respectively.

Fourth, the increase in foreign-exchange reserves is requiring China to increase its money supply in order to purchase the foreign-exchange reserves and maintain the undervalued fixed-exchange rate of the yuan. China's money supply is growing by 17-20 percent a year, and the growth of the money supply is overheating China's economy, which is expanding at an annual rate of at least 9.7 percent over the first quarter of 2003.

In the absence of an orderly realignment of China's exchange rate to reflect underlying economic fundamentals, China's economy will continue to overheat, creating greater imbalances and pressures on an economy historically characterized by booms and busts, ultimately resulting in a financial crisis.

China's maintenance of an undervalued exchange-rate regime violates various international legal obligations of China at the expense of the United States. China's manipulation of the yuan constitutes a prohibited export subsidy (pp. 50-70) and frustrates the intent of and breaches basic principles of the World Trade Organization's General Agreement on Tariffs and Trade (pp. 71-77 and Attachment). At the same time, China's undervalued exchange-rate policy unjustifiably gives China an unfair competitive advantage over the United States and discriminates against U.S. exports of goods and services contrary to Articles IV and VIII of the International Monetary Fund's Articles of Agreement (pp. 77-84).

China's undervalued exchange rate burdens and restricts U.S. commerce. U.S. imports from China and the U.S. trade deficit with China are soaring, accounting for 56 percent of the increase in imports of manufactured goods over the last two years. If longer-term historical trends in exports and imports prevail, the annual U.S. trade deficit with China will more than double in five years from \$125 billion in 2003 to \$250 billion by the end of 2008. Should the more recent growth rates continue, the deficit will be even higher. See Chart on p. 92.

Moreover, U.S. domestic market share is being displaced by U.S. imports from China. According to a detailed import penetration analysis on a sector-by-sector basis, 60 percent of China's increased import penetration of the U.S. market for manufactured goods displaced domestic U.S. producers' share. This displacement is equivalent to a \$31-billion loss in U.S. domestic production. See p. 99. China's undervalued exchange rate results in extremely low prices on China's exports to the United States, unfairly pressuring domestic firms by undercutting their pricing power. The undervalued exchange rate also adversely affects U.S. exports. While U.S. exports to China rose by 28 percent in 2003, much of the increase occurred in raw and intermediate materials. In fact, China's imports from the United States were the slowest-growing compared with imports from China's largest foreign suppliers, which grew by 40 percent.

U.S. affiliates are not causing the surge in U.S. imports from China. About 50 percent of U.S. imports from China come from foreign-invested enterprises, the great bulk of which are non-U.S. companies. Moreover, relative wages are not a principal factor driving U.S. imports from China, because labor costs are a relatively small fraction of the total cost of manufacturing.

The China Currency Coalition seeks the immediate elimination of the undervaluation of the yuan. If China refuses to eliminate the undervaluation, the United States should seek authorization in the World Trade Organization to offset the undervaluation by across-the-board tariffs on imports from China and to take measures to offset the disadvantage to U.S. exports to China.

I. INTRODUCTION

This petition is presented by the China Currency Coalition pursuant to Section 301(a) of the Trade Act of 1974, as amended (19 U.S.C. §§ 2411 et seq.) ("the Trade Act"), and the regulations of the Office of the United States Trade Representative ("USTR") at 15 C.F.R. Part 2006 (2003). This petition requests that action be taken under Section 301(a) to provide relief

from the damaging effects on U.S. commerce due to manipulation of the yuan¹ by the Government of the People's Republic of China ("China").

A. The Petitioner

The China Currency Coalition is a group of U.S. industrial, service, agricultural, and labor associations that includes the AFL-CIO, American Iron and Steel Institute, American Textile Machinery Association – ATMA, Associated Industries of Massachusetts, The Committee on Pipe and Tube Imports, The Copper & Brass Fabricators Council, Inc., EXEL Industrial, the Industrial Union Council (composed of Bakery, Confectionary, Tobacco Workers and Grain Millers International Union (BCTGM), International Union of Electrical Workers/Communication Workers of America (IUE/CWA), International Association of Machinists (IAM), International Brotherhood of Boilermakers (IBB), International Brotherhood of Electrical Workers (IBEW), International Brotherhood of Teamsters (IBT), Graphics Communications International Union (GCIU), Paper, Allied-Industrial, Chemical & Energy Workers International Union (PACE), Sheet Metal Workers International Association, United Automobile Workers (UAW), United Food and Commercial Workers (UFCW), United Mine Workers of America (UMWA), United Steelworkers of America (USWA), and Union of Needletrades, Industrial and Textile Employees (UNITE)), MADE in USA Coalition, Metal Treating Institute, Metals Service Center Institute, National Council of Textile Organizations, National Tooling and Machining Association, Non-Ferrous Founders' Society, Precision

¹ The Chinese currency is commonly and traditionally referred to as the yuan, which is the convention used in this petition. The official name of the currency is the renminbi, of which the yuan is technically a denominational unit. In referring to a monetary amount in Chinese, the correct usage, for example, is "ten yuan renminbi," rather than "ten yuan" or "ten renminbi." In English, there is no distinction between denominational units and names, so petitioner has simply used yuan.

Metalforming Association, Rescue American Jobs, Specialty Steel Industry of North America, Spring Manufacturers Institute, Steel Manufacturers Association, U.S. Business and Industry Council, Vanadium Producers & Reclaimers Association, and Wood Machinery Manufacturers of America.

B. Statutory Basis for This Petition

As described in the balance of this petition, China's maintenance of an undervalued exchange-rate regime denies and violates international legal rights of the United States, is unjustifiable, and burdens and restricts U.S. commerce, contrary to 19 U.S.C. § 2411(a)(1).

C. Foreign Country That Is the Subject of This Petition

This petition addresses the acts, policies and practices of China.

D. Petitioner's Economic Interest

The members of the China Currency Coalition consist of U.S. industrial, service, agricultural, and labor associations whose businesses and jobs increasingly have been undercut and lost as the result of China's maintenance of an undervalued exchange-rate regime. By maintaining an undervalued exchange-rate regime that does not reflect market conditions, China unlawfully and unreasonably has been bolstering the Chinese economy at the expense of U.S. industry and production. Exports from the United States to China and to third countries have been stifled, even as Chinese-origin goods have inundated the United States and other markets abroad. The Chinese government's continued undervaluation of the yuan is at the center of this dangerous imbalance. The U.S. companies, farmers and workers in support of this petition submit that the health and continued well-being of the U.S. manufacturing base, as well as of related service providers and all they represent for the national security and standard of living of the United States, are at stake and threatened by China's mercantilism.

E. Requests for Other Relief

The China Currency Coalition has not filed and is not filing at this time for other forms of relief under the Trade Act of 1974 or under any other provision of law with respect to the acts, policies, and practices of China that are the subject of this petition. The China Currency Coalition reserves the right to file for other forms of relief under the Trade Act of 1974 or other provisions of law with respect to the acts, policies, and practices of China that are the subject of this petition.

F. Public Hearing

Petitioner hereby requests that a public hearing be held in this matter.

II. CHINA PRESENTS AN EXTREME AND UNIQUE CASE OF CURRENCY UNDERVALUATION AND MANIPULATION THAT HAVE RESULTED IN A HUGE CURRENT-ACCOUNT SURPLUS FOR CHINA TO THE DETRIMENT OF THE UNITED STATES AND THE GLOBAL ECONOMY

A. China's Importance In the Global Economy and Foreign-Currency Regime In Combination Are Having An Unparalleled Disruptive Influence

By the end of 2003, China was the United States' third largest trading partner in terms of overall trade volume and the source of the United States' largest bilateral trade deficit in its history. Indeed, it is almost certain that no two countries have ever produced such an unbalanced pattern of trade as that between the United States and China. Moreover, while the sheer magnitude of this imbalance is unprecedented in its own right, the speed at which it has developed and continues to deteriorate is cause for serious concern. Until now, global market forces have never managed to produce such a state of disequilibrium in trade patterns and financial flows. As detailed at length throughout this petition, the root causes of this extreme imbalance are China's emergence as an international trading powerhouse fueled by its maintenance of far-reaching policies to interfere with market forces to its advantage. While these gains have come largely at the expense of the United States, there is ample current

evidence, as well as historical precedent, to suggest that these policies are running tremendous risks not only to China itself, but also to the global trading environment and economy at large.

Understandably, myriad factors underpin this unparalleled shift in trade and investment flows between China and the United States. Nevertheless, China's foreign-currency regime, which relies on expansive controls, restrictions and intervention by its central government to thwart market-driven disciplines and normal adjustment patterns, is a primary if not predominant factor. China's manipulation of its foreign-exchange market has produced a massive and self-serving distortion in the global trading and financial system, primarily to the detriment of the United States. These effects are clearly manifest in China's soaring trade surplus, foreign direct investment inflows and foreign-exchange reserves, whereas, for the United States, the effects are evident in its burgeoning trade deficit and massive increase in foreign debt, an increasing proportion of which is now held by China.

China's command and control of its foreign-exchange market are standing characteristics consistent with China's close management of its broader economy. The extent and persistence of the Chinese government's interference in the foreign-exchange market have a long tradition of producing endless cycles of distortions and imbalances requiring even more extensive interventions. Until recently, China has borne the brunt of the resulting inefficiencies and volatility caused by such interference. In the last five years, however, as China has become more integrated with the global economy, these burdens and distortions increasingly have been migrating beyond China's borders, with the United States at the end of the path of least resistance.

China's control of the foreign-exchange market begins with its exchange-rate regime. While China has reported to the International Monetary Fund ("IMF") that it employs a

“managed-float” type of regime, in practice China’s regime is classified as a “conventional fixed-peg.”² This type of regime establishes a set parity value of the yuan vis-à-vis the U.S. dollar. Due to the very narrow range of fluctuation permitted by the Chinese government around this set parity value (± 1 percent or less), the peg (or value) is considered “fixed.”³

Among the many different types of regimes in use around the world, fixed-peg regimes, by their very nature, tend to require the greatest degree of governmental intervention and control by monetary authorities in order to maintain the relative value of the currency close to its parity value. Consequently, the use of fixed-peg regimes is extremely limited, and only 30 countries other than China employ such regimes.⁴ These countries generally have small, lesser-developed economies with trade and financial flows that are relatively minor and/or in balance. China stands out as a glaring exception, dwarfing the next two largest countries in this group – Malaysia and Saudi Arabia.⁵

² As outlined in detail in Exhibit 1, China’s failure to properly classify its foreign-exchange regime led the IMF in 1999 to alter its formal classification scheme by relying on its own staff’s assessments of the regime in use rather than that reported by individual members.

³ Over the last five years according to the Federal Reserve, the value of China’s currency has averaged 8.2775 yuan to the U.S. dollar with interim fluctuations in the range of ± 0.1 percent (*i.e.*, equal to roughly 1/100th of one U.S. cent). In the last year, the range has narrowed even further to ± 0.01 percent (*i.e.*, equal to about 1/1,000th of one U.S. cent) around the average of 8.2771 yuan per U.S. dollar. For purposes of this petition, reference is made to the effectively fixed rate at 8.28 yuan per U.S. dollar over this time period.

⁴ The countries that peg their currencies specifically to the U.S. dollar are, of course, even fewer in number and fall loosely into two groupings. The first comprises countries that are relatively dependent on the United States for a large portion of their otherwise limited overall trade. The second comprises countries with exports that are dominated by international commodities traded in U.S. dollars, such as oil producers. China fails to fit into either of these general groupings.

⁵ Malaysia experienced a currency crisis in 1997-1998 under a fixed-peg regime and is actively considering adopting a more liberal regime, while Saudi Arabia is the world’s largest oil exporter.

From a structural standpoint, therefore, China is essentially alone in its continued use of a fixed-peg regime given its size and integration with the global economy. All of the United States' major trading partners, including Japan, Mexico, Canada and the European Union, allow their respective currencies to float freely against the U.S. dollar such that market forces determine the respective currency values that prevail under different economic conditions. Only China holds firm to its conventional fixed-peg arrangement alongside comparatively minor trading partners and despite the unprecedented imbalances and distortions that have resulted.

It is emphasized that the use of a fixed-peg regime is not necessarily problematic or distortional in and of itself. As detailed both above and further in Exhibit 1, however, the use of fixed-peg regimes tends to be narrowly confined for good reason. The desirability of and need for exchange-rate adjustments increase in direct proportion to the volume of trade and investment flows, to the benefit of all sides in the web of trading and investment relationships around the globe. When trade and financial flows are relatively insignificant or balanced, they simply are not capable of generating significant distortions or persistent disequilibria among countries and between partners. Any comparatively minor imbalances that do arise typically are easily managed via the governmental interventions that are characteristic of fixed-peg regimes.

Once trade and financial flows exceed a certain point,⁶ however, significant distortions and disequilibria can arise and easily overwhelm a government's ability to sustain the extensive degree of on-going intervention required to maintain a relatively fixed rate of exchange. This intensive governmental involvement explains why all other countries with significant trade and financial flows tend to employ more liberal currency regimes. Once again, China stands in sharp

⁶ While there is no established ceiling or reference point, \$30-50 billion in annual trade with the United States appears to constitute a significant threshold, as detailed in Exhibit 1.

contrast, not just in terms of its nominal regime, but also in terms of the imbalances that have resulted and the extent of governmental intervention and control that have been essential to maintain this regime. China has fostered these imbalances via wide-ranging restrictions on the supply and demand (and ultimately the price) of the yuan and other foreign currencies in its economy, as summarized below.

By definition, China's conventional fixed-peg regime requires an expansive role in the market by the government, because it alone is in a position to manage the resulting supply and demand imbalances that stem from its determination to maintain a fixed price of the yuan in the face of market forces that would lead to a markedly different result. Moreover, the extent of the government's involvement in the market increases in direct proportion to the imbalances it creates by interfering in the first place. The measures employed by the Chinese government encompass both supply- and demand-side controls that effectively negate the pressures that would otherwise cause the value of the yuan to fluctuate, as the currency of every other major trading country does.

As Chinese exports and foreign-direct-investment inflows have ballooned in recent years, the supply of foreign exchange in China has likewise increased. Confronted with this huge influx of foreign currency, China's government must either permit more demand for foreign currency in its economy or create that demand artificially via its own intervention in the market to absorb the excess supply. The Chinese government has favored the latter approach through its restrictions on and even abolition of normal supply-and-demand forces,⁷ preferring to purchase

⁷ The primary authorized components of foreign-exchange supply within China are limited to export revenues, the repatriation of profits earned abroad and foreign direct investment inflows, all of which remain subject to some degree of limits or restrictions. Specifically, foreign companies are required to surrender foreign-exchange earnings above certain limits, while (...continued)

the ever-increasing surpluses of foreign exchange directly in order to remove those surpluses from the Chinese market.

As the Chinese government restricts holdings and authorized uses of foreign currency, the only alternative in the Chinese economy is to convert the foreign currency to yuan. Thus, the demand for yuan increases proportionally with the excess supply of foreign currency, which would normally lead to an increase in the value of the yuan. Instead, the Chinese government, having created the excess supply of foreign currency, has stepped in and mediated the corresponding excess demand for yuan by simply printing more yuan in order to absorb the surfeit of foreign currency and clear the market at the price desired and set by the government.⁸ As a result, China's official foreign-exchange reserves, along with the supply of yuan, have soared and, in turn, have produced overheated conditions in China's economy that threaten not only China, but also the nations with which it trades and competes.⁹

China's interference with market mechanisms is most evident in its labyrinthian array of restrictions on capital-account transactions that are likewise biased in its favor. While restrictions on foreign direct inflows have been liberalized, nearly every other aspect of China's capital account is subject to advance approval, licensing or certification, explicit limits, conditional requirements or outright prohibitions, as detailed in Exhibit 1. Paradoxically, the

(...continued)

domestic firms remain barred from retaining their foreign-exchange earnings altogether, with the exception of a partial exemption for several large, state-owned enterprises. Moreover, purchases of foreign exchange by private individuals and households remain subject to restrictions. Two other typically important sources of foreign-exchange supply – borrowing abroad and foreign portfolio investment (e.g., foreign purchases of Chinese bonds and securities) -- remain strictly limited, if not prohibited. See Exhibit 1.

⁸ Due to the broad restrictions on authorized uses of foreign currency in China, the primary authorized "use" of foreign currency is conversion into yuan through the government.

⁹ China's foreign-exchange-reserves growth is discussed further in Sections II.B. and II.C. of this petition.

Chinese government's interference in capital-account transactions is so extensive that there is a fundamental uncertainty in the market whether substantial capital inflows or substantial capital outflows would result if normal market conditions were permitted rather than systematically thwarted.¹⁰ Under the existing biased structure, however, China has clearly tipped the balance in its own favor by permitting certain types of foreign investment it favors (foreign direct investment) while prohibiting or limiting other types of foreign investment and lending. Meanwhile, China's government sharply restricts its own citizens and businesses from investing or lending abroad at the same time it is forced to do so by virtue of its massive accumulation of foreign-exchange reserves.

In conclusion, China is the only major trading country in the world that maintains a conventional fixed-peg system that, in turn, can only be sustained via broad restrictions on foreign-exchange supply and demand, along with direct governmental control of the foreign-exchange market. Taken as a whole, the system has produced unprecedented imbalances in trade and financial flows, particularly with respect to China's relationship with the United States. Moreover, as China's position in the global economy has elevated, there has been no movement by China toward more open and market-based disciplines, because the extent of these imbalances has necessitated even greater governmental interference and distortions.

¹⁰ In attempting to justify its maintenance of strict capital-account controls, the Chinese government has cited the risks of rapid and destabilizing capital inflows, as well rapid and destabilizing capital outflows. It is difficult to rationalize how both risks can exist simultaneously, although the paradox illustrates just how distorted China's market has become.

These problems are manifest in the substantial undervaluation of the yuan (see Section II.B., infra), China's soaring trade surpluses,¹¹ China's even more dramatic surplus in its "basic balance of payments,"¹² and, finally, China's rapidly escalating foreign-exchange-reserve holdings. While China has been reaping short-term benefits from this inequitable relationship, the United States has been suffering a trade deficit of historic proportions, which has been a significant factor in the unprecedented erosion of the U.S. manufacturing base (see Section IV., infra). Moreover, the economic effect on the United States to date, unfortunately, is minor compared to likely developments in just the next few years if this inequitable relationship is permitted to continue.

B. The Chinese Currency Is Significantly Undervalued

As outlined in Exhibit 1, China has a longstanding history of manipulating its official exchange rate in order to achieve various policy goals. In the 1970s, China's currency was considered significantly overvalued, as the government sought to favor the import sector in obtaining badly needed capital goods, at the cost of persistent severe losses by the export sector.¹³ The gross extent of the overvaluation was made evident in China's limited and temporary experiments with free-market forces over a 20-year period beginning in 1978, when the official exchange value of the yuan was 1.60 per U.S. dollar. During these two decades, each

¹¹ China's reported global trade surplus is substantially greater than is reported in China's trade statistics. See Section II.D., below, for a detailed analysis of the substantial discrepancy between the trade surplus as reported by China compared to that reported by China's major trading partners.

¹² China's basic balance of payments is roughly equivalent to its current-account balance plus its foreign-direct-investment inflows. See further discussion of this measure in Section II.B., infra.

¹³ See Guijun, Lin and Ronald M. Schramm, "China's Foreign Exchange Policies Since 1979: A Review of Developments and an Assessment," University of International Business and Economics, Beijing (May 2003).

time the government liberalized its stranglehold over the foreign-exchange market, the more the market-driven rate diverged quickly and substantially from the official rate.

On some occasions, the Chinese government would tolerate substantial differences between the devalued market-based rate and the overvalued official rate for extended periods of time. These differences were generally in the range of 50-60 percent, but often were even higher. On other occasions, China would devalue the official rate and “chase” the market rate periodically, usually with only limited success before significant divergences appeared again, leading the government either to tolerate the reemerging disparity or attempt to control it by imposing controls on the “market” rate.¹⁴

Finally, in 1994, China abandoned its dual-rate system by aligning the official exchange rate with the market rate via a massive 50-percent final devaluation (to 8.70 yuan per U.S. dollar). The Chinese government announced its intention to permit the exchange rate to float more freely based on market forces while still actively managing the rate as it deemed necessary. The reforms and devaluation in 1994 immediately improved China’s trade and investment competitiveness, which reversed the downward pressure on the yuan that had persisted practically without interruption since 1978. Within a matter of months, the yuan had appreciated by more than three percent to 8.44 yuan per U.S. dollar, leading the Central Bank to begin intervening in the exchange-rate markets to limit the rise in the yuan. In intervening aggressively in the market, China signaled its policy had officially changed to the promotion of exports and foreign direct investment. With the Chinese government limiting the yuan’s appreciation,

¹⁴ From 1981 through 1994, the Chinese government repeatedly devalued the official value of the yuan in response to its divergences from the more market-oriented unofficial value. In this time period, there were at least six major devaluations undertaken by the Chinese government, which led the yuan to fall in value from 1.54 yuan per U.S. dollar in 1981 to 8.70 yuan per U.S. dollar in 1994. See Guijun and Schramm.

exports and foreign direct investment both began to increase strongly in 1994, thus marking the latest chapter in the government's active involvement in and control over the foreign-exchange markets.

One year later at the end of 1995, the yuan had managed to appreciate by an additional two percent to 8.30 per U.S. dollar, despite continuing interventions by the Central Bank to limit the rise. The Central Bank's intervention was manifest in a notable jump in foreign-exchange reserves that, just a few years later, would prove to be merely an initial blip. Since the end of 1995, a span of more than eight years, China's exchange rate has hardly wavered despite continuing and significant current-account surpluses and foreign-direct-investment inflows (now increasing in the range of U.S. \$40-50 billion per year). However the Chinese economy is judged, the overwhelming improvements in its condition and performance between 1993 (shortly before the dual-rate system was scrapped) and today are exceptional by almost any measure – trade balance, current-account balance, basic balance, capital-account balance, and reserve position. Only one measure stands out in this respect from all the others – China's exchange rate with the U.S. dollar, which has increased (in other words, devalued slightly) by 0.4 percent since 1997.

While there is considerable debate as to the precise degree of the yuan's undervaluation, a strong consensus exists both among economists and academicians as well as policy makers that the yuan is undervalued by a significant margin, which also is perfectly consistent with China's history.

1. Economists' Views On the Yuan's Undervaluation

In evaluating the degree to which a currency may be undervalued, economists rely heavily on two measures of the relative supply and demand for a given currency -- whether

foreign-exchange reserves are accumulating and the size of the basic balance of payments. Each of these key measures indicates a high degree of undervaluation of the yuan.

As discussed in greater detail in Sections II.A. and II.C. of this petition, a country's foreign-exchange-reserve holdings can be assessed directly from its balance-of-payments data. A country's official foreign-exchange reserves fluctuate along with its combined current- and capital-account positions. Consequently, if a country's combined current and capital accounts are in surplus, as is overwhelmingly the case for China, there is a net inflow of foreign currency that is reflected by an increase in its official reserves. In effect, more foreign currency is flowing into the country than out of the country, leading to an accumulation of foreign currency in the form of official reserves. Increasing official reserves are a clear sign of currency undervaluation, as explained below.

In China's case, the tremendous increases in U.S. dollars flowing into the country from both its trade surpluses with the United States and its foreign-direct-investment inflows from the United States are met with tight controls by the Chinese government, which has sharply restricted authorized uses of U.S. dollars. The primary authorized "use" of U.S. dollars is conversion into yuan, which means that there is constant selling of U.S. dollars and buying of yuan in China. In order to forestall an unwanted appreciation of the yuan vis-à-vis the U.S. dollar, the Chinese government intervenes in the market and purchases any amount of U.S. dollars by "selling" (i.e., printing) any amount of yuan required to keep the value of the yuan narrowly fixed versus the U.S. dollar. Consequently, the Chinese government's intervention in the market to buy U.S. dollars at a fixed price indicates that U.S. dollars are in excess supply at the prevailing rate of exchange; otherwise, the market would clear on its own and make

unnecessary that the government be the demander of last resort. Thus, China's soaring official foreign-exchange reserves clearly confirm the undervaluation of the yuan.

Given that official reserve positions can fluctuate or be skewed temporarily by factors unrelated to underlying supply-and-demand forces, economists often rely on a second measure -- the country's basic balance of payments -- as further confirmation of relative currency valuations. Before turning to this additional indicator, however, it must be emphasized that China's massive accumulation of foreign-exchange reserves cannot be described either as a fluctuation or temporary in nature. Indeed, these huge reserves are a direct product of the Chinese government's interference in the foreign-exchange market and its refusal to permit market forces to mediate supply and demand. As a result, the government has created a gaping imbalance between supply and demand that it must neutralize in order to keep the yuan from appreciating.

A country's basic balance of payments is a subset of its overall balance of payments. The so-called "basic balance" is the sum of the country's current account (mainly its trade balance) plus the non-short-term portion of its capital account. In relation to the overall balance of payments, the basic balance ignores short-term financial and portfolio flows, as well as net purchases or sales of official reserves by monetary authorities. Due to China's strict capital-account controls, however, the non-short-term portion of its capital account is confined almost entirely to foreign-direct-investment inflows. Consequently, China's basic balance is essentially the aggregate of its current account and foreign-direct-investment inflows.

Economists rely on the basic balance as a straightforward gauge of a country's financial relationship with the rest of the world. China's basic balance has been consistently positive for many years and is excessive relative to its Gross Domestic Product ("GDP"). Combining

China's trade surplus, which annually has averaged nearly U.S. \$40 billion (according to China's data) to as much as U.S. \$176 billion (according to the data reported by China's major trading partners, as detailed in Section II.D., below) and China's U.S. \$40-50 billion of annual foreign-direct-investment inflows results in an estimated basic balance annually in the range of U.S. \$80 billion on the low end to U.S. \$200 billion on the high end. China's basic balance, therefore, represents at least 5 percent of its GDP according to China's own data. While this figure is astonishing in its own right, the data from China's major trading partners suggest that the ratio between China's true basic balance and its GDP is likely several times higher.

According to both these key measures, therefore, the yuan is clearly undervalued, and, as noted previously, the many economists who have attempted to measure the degree of undervaluation have reached the same consensus.¹⁵ While their estimates vary considerably due

¹⁵ Recent studies attempting to measure the extent of the yuan's undervaluation include:

Earnest H. Preeg, "Exchange Rate Manipulation to Gain an Unfair Competitive Advantage: The Case Against Japan and China. Manufacturers Alliance/MAPI, Oct. 2, 2002, (Rev. Version) at www.mapi.net. See also Ernest H. Preeg, "Exchange Rate Manipulation to Gain an Unfair Competitive Advantage: The Case Against Japan and China," in C. Fred Bergsten and John Williamson, eds., *Dollar Overvaluation and the World Economy*, Institute for International Economics (Washington, D.C. 2003).

Morris Goldstein, Testimony before the Subcommittee on Domestic and International Monetary Policy, Committee on Financial Services, U.S. House of Representatives, Oct. 1, 2003; see also Morris Goldstein and Nicholas Lardy, "Two-Stage Currency Reforms for China," *Asian Wall Street Journal*, Sept. 12, 2003.

John Williamson, "The Renminbi Exchange Rate and the Global Monetary System," outline of a lecture at the Central University of Finance and Economics, Beijing, China, Oct. 29, 2003; available at the website of the [Institute for International Economics](http://www.iiie.com) (www.iiie.com).

Jim O'Neil and Dominic Wilson, "How China Can Help the World," Goldman Sachs Economic Research Group, *Global Economics Paper 97*, Sept. 17, 2003.

Dropsy, Vincent, "China's Accession to the WTO, Real Exchange Rate Changes and Their Impact on U.S. Trade with Greater China," Department of Economics, California State University, Fullerton, March 2001.

(...continued)

to the difficulties in precisely measuring equilibrium currency values, a general conclusion nonetheless has emerged that the yuan is, in fact, undervalued and that the undervaluation is significant.¹⁶

The tabulation below summarizes the estimates of the undervaluation of the Chinese yuan, measured utilizing data as recent as the fourth quarter 2003.

Analyst	Publication	Date of Publication	Percent Yuan Undervalued
Preeg	MAPI	Sept. 2002	40%
Goldstein	Testimony to Congress	Oct. 2003	15-25%
Williamson	IIE Lecture	Oct. 2003	Over 25%
O'Neill & Wilson	Goldman Sachs Rpt.	Sept. 2003	10-15%
Big Mac Index	Economist	Apr. 2003	56%
World Bank	PPP Level	2000	75%
Dropsy	China's Accession to the WTO, Real Exchange Rate Changes and Their Impact on U.S. Trade with Greater China	Mar. 2001	100% (estimated real exchange rate needed for zero trade balance, as of 1999)
Yang and Bajoux-Besnainou	Is the Chinese Currency Undervalued?	Nov. 2003	27.99% based on PPP and using 1985 as fixed base year
Bhalla	Chinese Mercantilism: Currency Wars and How the East Was Lost	July 1998	10-15% as of 1998
Anderson/UBS	The Complete RMB Handbook	Oct. 2003	Nearly 25% in real terms

The CRS study, although it serves as a good summary of current undervaluation estimates, is critical of all, in general citing their reliance on non-empirical assumptions to fix an

(...continued)

Yang, Jiawen and Isabelle Bajoux-Besnainou, "Is the Chinese Currency Undervalued?" Occasional Paper, Center for the Study of Globalization, The George Washington University, November 2003.

Bhalla, Surjit S., "Chinese Mercantilism: Currency Wars and How the East Was Lost," Indian Council for Research on International Economic Relations, Working Paper No. 45, July 1998.

Anderson, Jonathan, "The Complete RMB Handbook," UBS Investment Research, Asian Economic Perspectives, Oct. 27, 2003.

¹⁶ A recent study by the Library of Congress' Congressional Research Service ("CRS") cautions that "{a}lthough it is certain that the yuan would appreciate if the central bank were not increasing its foreign reserves, there is no direct way to determine how much it would appreciate." Wayne Morrison and Marc Labonte, "China's Exchange Rate Peg: Economic Issues and Options for U.S. Trade Policy," CRS Report for Congress, Dec. 5, 2003.

equilibrium point as to China's current-account balance and the difficulty of deriving such an equilibrium point in the presence of the comprehensive capital controls exercised by the Chinese authority. See CRS at CRS-9.¹⁷ Indeed, a recurring theme in the relevant analyses of China and the role of its exchange rate in its recent trade performance and balance-of-payments position centers on the lack of reliable benchmarks against which objective measurements can be made, not to mention inferences drawn as to causes, effects or even basic trends. In short, extensive and pervasive Chinese governmental interference in markets, both in the past and present, coupled with often dubious statistical data available on the Chinese economy and financial markets, makes even general conclusions and assessments haphazard at best. Consequently, rather than focus unduly on one particular analysis or methodology, it is perhaps more instructive to view the less disputable results. Not even CRS disputes that the yuan's exchange rate has remained frozen for more than eight years despite a massive increase in the supply in U.S. dollars vis-à-vis the yuan, now reflected in China's large and rapidly growing foreign-exchange holdings and investments in U.S. governmental debt instruments.

Thus, technical critiques of the imprecision of the extent of the yuan's undervaluation are not the focus of this discussion. The purpose here is to establish (a) that there is a widespread consensus among economists that the yuan is undervalued and (b) that the various estimates cited, even acknowledging some imprecision, generally are ranged closely and find significant undervaluation of the yuan. Placed within the context of currency movements, which typically fluctuate by only a fraction of a percent or two over many months, all of the estimates listed above indicate that the yuan is significantly undervalued. These estimates also show how the

¹⁷ It should be noted that the CRS report, while critical of the various academic efforts used to estimate the yuan's undervaluation, offers no alternative calculation or methodology.

rumored contemplation by China of a five-percent upward revaluation would be totally inadequate and likely to lead only to increased speculative pressure on the yuan.¹⁸

2. **The Administration's and Other U.S. Government Officials' Views On the Yuan's Undervaluation**

In addition to the estimates by the private sector just reviewed, it is important to note that the Administration itself has already acknowledged the Chinese government's distorting interference in the foreign-exchange markets and recognized that the yuan is significantly undervalued to the serious and increasing detriment of the U.S. economy. Many other U.S. governmental officials have echoed these same sentiments. A sample of the more prominent of these comments is summarized below.

In testimony to the House Ways and Means Committee on October 30, 2003, Treasury Under Secretary for International Affairs John Taylor said, "To maintain this fixed exchange rate, the central bank of China has had to intervene in the foreign exchange market.... Recently the central bank has intervened very heavily in the markets to prevent the yuan from appreciating. Since the end of 2001, dollar buying has been so great that the foreign reserves held by the Chinese government have risen by \$171 billion to \$384 billion (as of end-September 2003)." As of the end of July 2004, China's foreign reserves had increased to \$483 billion.

In an interview with the Associated Press ("AP") published on November 21, 2003, Treasury Secretary John Snow emphasized that the Administration's ultimate goal was to have market forces determine the value of the yuan. "Clearly, we want to hold their feet to the fire," Secretary Snow told the AP. "We are interested in seeing real movement, real action," he said.

¹⁸See "How Beijing May Loosen Up," Business Week Online, Feb. 23, 2004 (www.businessweek.com).

Most importantly, Secretary Snow told the AP that, as an interim step, the Administration would favor a decision by China to revalue its currency to a level more closely reflecting its fair value.

In testifying before the Senate Budget Committee on February 13, 2004, Secretary Snow said, in referring to the value of China's currency, "We were straight with them. We said, 'this system doesn't hold together. It doesn't work. It's not right for the world economy. It's not right for the world trading system and you need to move to a flexible sort of exchange rate that allows the market to set the value rather than having you arbitrarily establish the value.'"

Clearly, these remarks confirm Secretary Snow's and the Administration's recognition of the gross inconsistency between China's foreign-exchange policies and its economic relationship with the rest of the world. In an interview with Charlie Rose broadcast by the Public Broadcasting System on February 25, 2004, Secretary Snow paraphrased his own dialogue with the Chinese government. "Premier Wen, it's in your interest to move to a flexible exchange rate. You are now becoming a big sic big part of the world trading system. And, as part of the world trading system, it's important that you play by the rules of the game – fulfill your WTO commitments, open your markets, deal with this piracy of intellectual property, which is a problem." According to Secretary Snow, the Chinese government itself acknowledged these inconsistencies. When asked how the Chinese government reacted to his urgings, Secretary Snow paraphrased its response as follows: "We intend to be and are and will be a responsible citizen of the globe. We know we are no longer an isolated economy. We are now one of the great economies of the world. We have responsibilities and we're going to live up to them."

Even more recently, Secretary Snow testified on March 25, 2004, before the House Committee on Financial Services that “{t}his Administration has stressed that China needs to move to float its currency as soon as possible.”¹⁹

While the Treasury Department appropriately has taken the lead role on these issues, the extent of the problem has not escaped the White House’s attention. In a CNBC interview reported by the British Broadcasting Corporation on September 5, 2003, President George W. Bush said, in a thinly-veiled reference to China, “We expect our trading partners to treat our people fairly -- our producers and workers and farmers and manufacturers -- and we don’t think we’re being treated fairly when a currency is controlled by the government.”

Moreover, in remarks at the Owens Community College outside Toledo, Ohio, as reported in the “Washington Trade Daily” on January 21, 2004, the President made the Administration’s position abundantly clear. He bluntly said, “We expect countries like China to understand that trade imbalances mean trade is not balanced and fair. They have got to deal with their currency.” Thus, the President has underscored, in no uncertain terms, that a clear link exists between the value of the yuan and the huge U.S. trade deficit with China and that China’s manipulation of its currency is harming the U.S. economy.

The opinion of the President and Treasury Secretary is echoed by other policy makers across the political spectrum. The U.S.-China Economic and Security Review Commission, a bi-

¹⁹ USTR’s 2004 National Trade Estimate Report on Foreign Trade Barriers (April 1, 2004) similarly observes at page 58 that “{t}hroughout 2003, the Administration urged China, both bilaterally and in multilateral fora, to move toward a flexible, market-based exchange rate regime and to reduce controls on capital flows.” At the same time, USTR comments that China’s new leadership has not announced a timetable to implement a more liberalized, market-oriented currency regime and that “{s}erious engagement with China on this issue will continue in 2004.” Id.

partisan group mandated by law to examine China's economic policies, recommended as early as last fall that:

The Treasury Department should make a determination in its foreign exchange rate report to Congress that China is engaged in manipulating the rate of exchange between its currency and the U.S. dollar to gain an unfair competitive trade advantage and immediately enter into formal negotiations with the Chinese Government over this matter.²⁰

Even Alan Greenspan, the assiduously non-controversial Chairman of the Federal Reserve Board of the United States, agreed as early as last summer that the yuan was undervalued. See "Transcript: Greenspan on China Foreign Exchange Peg to Dollar," as quoted in The Market Wire, Market News International, July 17, 2003.²¹

Congress in particular has expressed growing frustration over the continued undervaluation of the yuan and its resultant negative impact on U.S. jobs, especially in manufacturing. This congressional focus on Chinese undervaluation as a major culprit in continued U.S. job losses is most clearly illustrated by the introduction of numerous bi-partisan bills and resolutions calling for the imposition of broad tariff increases or other restrictions on imports from China, *specifically*, in the words of one prominent bill (S. 1586), "in an effort to reduce China's unfairly undervalued currency advantage."²² S. 1586 was the first legislation to be introduced during the 108th Congress (on September 5, 2003) in response to China's currency

²⁰ U.S.-China Economic and Security Review Commission, written testimony of Roger W. Robinson, Jr., Chairman, and C. Richard D'Amato, Vice Chairman, submitted to Hon. Ted Stevens, President Pro Tempore U.S. Senate, and J. Dennis Hastert, Speaker of the House, Oct. 14, 2003.

²¹ In response to a follow-up question on whether it would be beneficial to revalue or float the yuan, Greenspan opined, "I think that from an economic point of view it's going to become increasingly evident that is what is going to have to happen. . . ." Id.

²² Senators Announce Bipartisan Effort to Force China to Stop Currency Manipulation; download from website of Sen. Charles Schumer, Sept. 11, 2003.

and foreign-exchange policies. The bill, sponsored by Senator Schumer (D-NY), has attracted broad, bi-partisan support across the Senate, as reflected by its thirteen co-sponsors – Senators Bunning (R-KY), L. Graham (R-SC), Dole (R-NC), Durbin (D-IL), Bayh (D-IN), Clinton (D-NY), Dayton (D-MN), Dodd (D-CT), Enzi (R-WY), Kohl (D-WI), Levin (D-MI), Specter (R-PA) and Stabenow (D-MI). Not surprisingly, these Senators’ constituents are concentrated in many of the core manufacturing states in the country and are among those most seriously hurt by the imbalanced trade with China.

S. 1586 authorizes action if negotiations with China regarding its undervalued currency and currency manipulations are not successful. According to the Federal Reserve, on the day the bill was introduced, the value of the yuan was 8.2770 per U.S. dollar; seven months later, the value of the yuan was 8.2769 per U.S. dollar. Thus, despite ongoing negotiations and an estimated U.S. \$80 billion in accumulated trade deficits with China in the interim, China’s exchange rate with the U.S. dollar has increased in value by 1/10,000th of one yuan, or by 0.001 percent. In terms of U.S. dollars, the “appreciation” has equaled \$0.000001 – not even a penny for the thought. The remedy proposed by S. 1586 is an across-the-board 27.5 percent ad valorem tariff on all imports of goods from China, thus implying the co-sponsors’ judgment regarding the extent of the undervaluation.

While S. 1586 was the first measure introduced, it was quickly followed by many others seeking to address China’s undervalued and/or manipulated currency, as follows:

<u>Bill/Resolution</u>	<u>Date Introduced</u>	<u>Dated Passed</u>
S. 1592	September 8, 2003	--
H.R. 3058	September 10, 2003	--
H. Con. Res. 285	September 17, 2003	--
S. Res. 219	September 9, 2003	September 26, 2003
H.R. 3269	October 8, 2003	--
S. 1758	October 20, 2003	--
H.R. 3364	October 21, 2003	--
H. Res. 414	October 29, 2003	October 29, 2003
S. Res. 262	November 6, 2003	--

C. China's Exchange-Rate Regime Constitutes Currency Manipulation

On a fundamental level, the value of a nation's currency at any time, as with any other financial asset, is a function of the relative supply and demand for that currency. Also as with any other financial asset, however, the value of a currency does not necessarily reflect its theoretical fair value or equilibrium at any given point in time. In fact, the value of a currency is likely to be above or below its theoretical fair value at any point in time, as the market dynamically searches out equilibrium values through the opposing actions of buyers and sellers, as well as the balancing of the future expectations of market participants.²³ Nevertheless, over time and if permitted, asset values tend to converge toward their fair values or, at a minimum, their market-clearing values. Simply put, when supply exceeds demand for an asset, its price tends to fall, and vice-versa.

Relative prices or values cannot perform their normal, market-clearing function if they are not permitted to fluctuate. By definition, prices or values can remain fixed only if supply and

²³ In fact, it could be argued that given the extent and persistence of the yuan's undervaluation, it might be necessary for the yuan not only to move toward its fair value, but even to move to a comparable degree of overvaluation in order to elicit fully the adjustment in trade and financial flows needed to correct the gross imbalances that China's undervalued currency has helped to generate.

demand are in balance. If prices are not permitted to fluctuate, then differences in supply and demand cannot be mediated, and imbalances between the two will result. In a balance-of-payments context, a country running persistent bilateral trade deficits (such as the United States) will tend to experience depreciation of its currency vis-à-vis the currencies of its trading partners (as the supply of its currency increases in foreign-exchange markets), unless there is an offsetting demand for its currency.

In the case of the United States, the outflow of U.S. dollars through the current account (via the trade deficit) has been offset by inflows through the capital account (via foreign direct investment and portfolio investment), as foreigners return U.S. dollars to the United States by purchasing U.S. real and financial assets. In the case of China, by contrast, current-account inflows (due to its tremendous trade surpluses, especially with the United States) have not been matched by offsetting capital-account outflows (due to extensive Chinese governmental restrictions). In fact, China, like the United States, is also experiencing net capital inflows, as foreign investors have poured money into China seeking higher returns (due in significant part to the undervaluation of the yuan).

Consequently, the situation with China is unusual in that both its current and capital accounts are in surplus, meaning that the supply of foreign exchange in China is increasing. At the same time, as detailed above in Section II.A., the authorized uses of foreign exchange in China are strictly controlled and restricted by the government. Taken together, therefore, the supply of foreign exchange in China's market is increasing at the same time the uses of (or demand for) foreign exchange are constrained by governmental regulation. Clearly, market forces would dictate that the excess supply of foreign currency in China's market should lead the

relative value of foreign currency lower, thereby increasing the value of the yuan.²⁴ This shift would occur as a result of Chinese market participants converting their foreign-currency holdings (which have limited authorized uses) to yuan (which can be freely used).

The unusual situation in China, with surpluses in both its current and capital accounts, becomes even more anomalous under its foreign-currency regime, which holds the value of the yuan fixed, at least in relation to the U.S. dollar (in which China's surpluses are primarily denominated). Thus, the Chinese market for foreign exchange is characterized by excess supply, restricted demand and a fixed price. In effect, the Chinese government has set the three basic elements of market forces into conflicting and irreconcilable directions, which have, in turn, produced a significant disequilibrium in China's trade and financial flows with the United States. With prices fixed, private market participants have no reason to alter their actions (i.e., relative supply-and-demand preferences), leading to a persistent excess supply of foreign exchange in China's market.

As with any fixed-exchange-rate regime, the Chinese government is able to keep the value of its currency fixed by intervening in the foreign-exchange markets to mediate typically temporary and limited supply-and-demand imbalances as they arise in order to negate pressure on the value of the currency.²⁵ Once again, the unusual aspect of China's regime is not that the government intervenes in the market, but that the government intervenes in such an extensive,

²⁴ Note that exactly this adjustment has occurred since the end of 2001 with respect to the value of the U.S. dollar versus the currencies of the United States' other major trading partners with which it has significant trade deficits. For example, the value of the U.S. dollar has fallen by more than 20 percent versus both the Japanese yen and euro in that time frame. In contrast, the value of the U.S. dollar versus the yuan has actually appreciated by 0.004 percent in the same period.

²⁵ Section II.A. discusses the countries that employ fixed-peg exchange regimes and emphasizes how these countries typically have relatively insignificant or balanced trade flows, in sharp contrast to the situation with China.

persistent and one-sided fashion that completely thwarts normal market forces. Rather than act merely as a temporary mediator of supply-and-demand imbalances as fixed-peg regimes require, the Chinese government directly controls supply-and-demand forces, including extensive capital-account controls, while its central bank is, by far, the largest participant in the country's foreign-exchange market. Thus, as the Chinese government oversees ever-growing foreign-exchange surpluses through its mercantilist policies, the central bank must step in to absorb the resulting surpluses, becoming a persistent net buyer of foreign currency, rather than a mere "trader." The end result is a massive increase in China's foreign-exchange reserves that are the end product of what clearly is a carefully orchestrated manipulation of the foreign-currency markets by the Chinese government and monetary authorities.

The general relationship between foreign-currency values (or exchange rates) and official reserve levels reflects the normal workings of this market-equilibrating mechanism, as illustrated in Exhibit 2, Charts 1 and 2. Chart 1 illustrates the relationship between Australia's total foreign exchange reserves and exchange rate, indexed over the period 1990-2003. Chart 2 illustrates the same data for the United Kingdom. Although the indices plotting the trend in foreign-exchange reserves held by these trading partners and their exchange rates vis-à-vis the U.S. dollar are not perfectly congruent, over time exchange rates and foreign-exchange-rate trends adjust to each other for these trading partners, preventing a persistent disequilibrium that would indicate manipulation of the currency for mercantilist advantage.

Exhibit 2, Chart 3 illustrates the corresponding indexed data for China's total reserves compared to its exchange rate to the U.S. dollar. China, whose trade surpluses -- both with the United States and the rest of the world -- are large, persistent, and growing, has completely interfered with normal market mechanisms, as detailed above. As the chart clearly shows,

China's actions have caused a tremendous and still-expanding disequilibrium to develop. The contrast between the reserve/exchange-rate relationship in China and that in Australia or the United Kingdom is so striking that it is impossible to rationalize without looking specifically to the government's interference, i.e., China's policy-oriented orchestration of this desired result.

The intent of these policies is evident in China's accumulation of large and growing U.S. dollar reserves and U.S. government and other dollar-denominated debt instruments. These reserves are greatly in excess of IMF requirements. Despite rapidly increasing foreign-exchange reserves, China's rate of exchange between the yuan and the U.S. dollar has remained virtually unchanged for extended periods of time, serving artificially to depress the prices of its exports to the United States, while increasing the prices of its imports from the United States, and thereby prejudicing domestic companies whether competing in the United States, China, or other international markets. These repeated and market-contradictory interventions to maintain the increasingly unrealistic value of the yuan vis-à-vis the U.S. dollar are nothing less than an explicit manipulation of China's currency by the Chinese monetary authorities.

D. Chinese Trade Statistics Greatly Understate China's Balance of Trade With the United States As Well As Its Overall Current-Account Surplus

In comparing two countries' bilateral trade data, it must be noted that they rarely agree precisely. Imports by one country will almost never match the exporting partner-country's data. In order to reconcile these differences, trade statisticians commonly use each country's import statistics as a starting point.²⁶ The significant volume of re-exports through Hong Kong further

²⁶ In fact, some countries rely on trading partners' import data as a basis for their official export data (i.e., Canada's official exports to the United States are based on official U.S. imports from Canada).

complicates comparisons between U.S.-China bilateral trade data. In discussing this concern, Chao-Dong Huang and Simon Broadbent observe in their paper, *Trade with China: Do the Figures Add Up?*, “It might be expected that misattribution of exports will be more of a problem than imports, since it is probably easier to determine origin than destination.”²⁷

China only recently began an attempt to identify the final destination of its goods re-exported through Hong Kong, as many Chinese exports bound for the United States (and other countries) are still not accounted for according to their ultimate destination.²⁸ A recent study notes that the Chinese Maritime Customs has begun the effort to identify the final destination of goods traveling through Hong Kong, but has had limited success to this point in doing so. Therefore, the study contends, U.S. import data are more reliable than Chinese export data:

For the Chinese data, it is not clear whether and how much of the re-exports to and from Hong Kong are included.... On the import side, we do know that the U.S. Customs traces the ultimate countries of origin of all imports, including re-exports. Thus, we treat official U.S. data on imports as including both direct and indirect imports, so no adjustments need to be made with respect to the issue of re-exports {of China-origin goods by Hong Kong}.²⁹

It can be concluded from the studies cited that partner-country data on imports from China are far more reliable than Chinese data on exports from China, especially given the significant discrepancies between the two, as discussed below.

The demonstrated unreliability in the reporting of trade statistics by China casts uncertainty on any policy decisions based on them, including devising estimates of the extent to

²⁷ Huang, Chao-Dong and Broadbent, Simon, *Trade with China: Do the Figures Add Up?* National Institute of Economic and Social Research: London, April 1997.

²⁸ Feenstra, Robert C., et. al., *The U.S.-China Bilateral Trade Balance: Its Size and Determinants*. National Bureau of Economic Research, Working paper 6598: Cambridge, MA, 1998.

²⁹ Fung, K.C. and Lau, Lawrence J., *Adjusted Estimates of United States-China Bilateral Trade Balances: 1995-2002*, Hiebs Working Paper 1063, April 22, 2003.

which the yuan is undervalued. Trade statistics as published by China – and by China’s satellite, Hong Kong – grossly understate China’s actual balance-of-trade surplus and, hence, the seriousness of the effects of the yuan’s undervaluation.

The analysis below reveals a wide and growing disparity between official Chinese and U.S. data on trade flows between the two countries in recent years.³⁰ Comparisons show large and increasing differences, especially between China’s exports to the United States (according to China) and U.S. imports from China (according to the United States). These discrepancies have increased dramatically in recent years, from \$20.7 billion in 1995 to \$59.1 billion in 2003.³¹ See Exhibit 3, Table 1 and Chart 1. On the U.S. export-China import side of the equation, there is also a consistent and growing divergence *in the opposite direction*, with U.S. exports to China (as reported by the United States) trailing the corresponding figures on Chinese imports from the United States (as reported by China). The discrepancy was \$3.7 billion in 1995, declined to \$2.2 billion in 1998, but then jumped to \$5.5 billion in 2003. See Exhibit 3, Table 1 and Chart 2. With these two sets of trade statistics increasingly diverging from one another, the overall divergence, or “reliability gap,” between the U.S. and Chinese data has widened precipitously, from \$24.4 billion in 1995 to \$64.6 billion in 2003. A comparison of these data is provided in the table below.

³⁰ The complete analysis, including a methodological discussion, is contained in Exhibit 3. All references to tables and charts in this section, therefore, pertain to Exhibit 3.

³¹ There is, of course, a “lag” (typically 4-6 weeks) between the recording of an “export” from the exporting country and the recording of an “import” by the importing country. Such lags, however, would be smoothed out over time; further, any reporting lag cannot begin to explain the large and growing disconnect evident here.

China's Trade Surplus with the United States, 1995 – Mar. 2004			
<i>By Source, in billion USD</i>			
	China Data ³²	U.S. Data ³³	Divergence
1995	9.4	33.8	24.4
1996	11.3	39.4	28.1
1997	17.2	49.5	32.3
1998	21.8	56.9	35.1
1999	23.5	68.9	45.4
2000	30.9	84.2	53.3
2001	29.4	84.1	54.7
2002	44.1	104.2	60.1
2003	60.3	124.9	64.6
2003 (Jan. - Mar.)	10.1	24.9	14.8
2004 (Jan. - Mar.)	13.0	30.6	17.6

As shown, despite the significant understatement evident in the Chinese data, the reported surplus with the United States nonetheless increased more than six-fold from \$9.4 billion in 1995 to \$60.3 billion in 2003. The corresponding U.S. data show a nearly four-fold increase in the Chinese surplus over the same period, rising from \$33.8 billion in 1995 to \$124.9 billion in 2003. In absolute dollar terms, the increase in the surplus over the period according to the Chinese data equaled \$50.9 billion, which significantly trailed the increase according to the U.S. data, which equaled \$91.1 billion. As a result, the divergence between the two sets of data increased by more than \$40 billion over the period, reaching a peak of \$64.6 billion in 2003.

The unreliability of the Chinese government's import and export data also is demonstrated by a comparison of China's trade statistics with the corresponding data reported by the major trading partners accounting for the great bulk of China's trade, by the following method:

³² See Exhibit 3, Table 1A.

³³ See Exhibit 3, Table 1B.

For exports *from* China:

- The value of Chinese exports (f.o.b. basis), according to Chinese trade statistics³⁴
- The value of imports from China (f.o.b. basis), as reported by 40 partner countries³⁵

For imports *into* China:

- The value of Chinese imports (f.o.b. basis), according to Chinese trade statistics³⁶
- The value of exports to China (f.o.b. basis), as reported by 40 partner countries

The results of this exercise are similar, but on a correspondingly larger scale, to the results of the bilateral comparison of Chinese and U.S. trade statistics. Overall, use of partner-country data shows that the Chinese government's published data significantly understate exports from China to the world and overstate Chinese imports from the world. Consequently, China's balance-of-trade, according to the Chinese government's data, is distorted from both sides, presenting an increasingly inaccurate and understated total for China's global surplus. As an additional check,

³⁴ Some studies have pointed to China's trade with Hong Kong as a source of inaccuracy in the analysis of Chinese foreign-trade statistics, due to the inclusion of trade otherwise properly attributed to China within the exports and imports reported by Hong Kong ("Hong Kong re-exports"). See Exhibit 3, Table 10 for country-specific evaluation of the discrepancy between the reported surplus for each trading partner using China-reported data versus partner-country, mirror trade data. Note that individual partner-country data shown in Exhibit 3, Table 10 are not adjusted for trade through Hong Kong. In the data employed here, Hong Kong's statistics are reported separately from China's, then adjusted to account for these so-called "re-exports" and "re-imports" to and from the mainland. See Exhibit 3, Table 2 (China's adjusted trade with the United States), Exhibit 3, Tables 5 and 6 (China's adjusted trade with partner countries), and Methodological Explanation at pages 1-2.

³⁵ GTIS Global Trade Atlas, Partner Country Data. Where applicable, import values reported on a c.i.f. basis are deflated by five percent, to approximate values on an f.o.b. basis. For a further explanation of valuation, see Methodological Explanation at pages 3-4. Also, for a list of the 40 partner countries, see Exhibit 3, Table 7.

³⁶ The value of imports into China is reported on a c.i.f. basis. Therefore, they have been deflated by 5 percent to approximate f.o.b. values.

the same partner-country data were compiled using the U.N. Comtrade Database.³⁷ The results confirmed a large discrepancy in the Chinese data and are closely correlated with the Global Trade Atlas database. See Exhibit 3, Table 3, the results of which are summarized as follows:

China's Global Trade Surplus, 1999 – Mar. 2004			
<i>By Source, in billion USD</i>			
	China Data ³⁸	40 Partner Data ³⁹	Percent Divergence
1999	37.7	140.5	273%
2000	35.4	171.5	385%
2001	35.3	169.7	381%
2002	45.1	189.3	319%
2003	46.0	210.9	358%
2003 (Jan. - Mar.)	3.3	44.4	1,245%
2004 (Jan. - Mar.)	-2.2	53.1	NC

³⁷ Exhibit 3, Tables 3 through 6 analyze China's balance of trade by making several different adjustments, as necessitated by the source data, and by using several different sources of data. The different adjustments are reflected in each different table, as follows: Exhibit 3, Table 3 converts any c.i.f. import values to an f.o.b. basis using a 5-percent deflator; Exhibit 3, Table 4 converts any c.i.f. import values to an f.o.b. basis using a 10-percent deflator; Exhibit 3, Table 5 adjusts partner-country data for Hong Kong re-export trade and converts any c.i.f. import values to an f.o.b. basis using a 5-percent deflator; and, Exhibit 3, Table 6 adjusts partner-country data for Hong Kong re-export trade and converts any c.i.f. import values to an f.o.b. basis using a 10-percent deflator.

Moreover, each of the tables contains five subparts, A through E, to reflect the different source data as follows: (A) IMF data; (B) China's data for all countries; (C) China's data for 40 partner countries; (D) 40 partner-country data for China; and, (E) U.N. (Comtrade) data for the 40 partner countries.

³⁸ See Exhibit 3, Table 3B. The table reflects China's overall trade surplus for all countries, as reported by China. A separate analysis of China's trade surplus with the selected 40 partner countries, as reported by China, is contained in Exhibit 3, Table 3C. See also Exhibit 3, Table 8, which compares the China-reported data for these 40 countries with the China-reported data for all countries.

³⁹ See Exhibit 3, Table 3D. Note that these 40 partner countries were selected because (1) they account for the bulk of China's total trade (i.e., 88 to 95 percent of the total in the period analyzed); and, (2) their corresponding trade statistics are reported on a consistent basis for each year in the period, thereby enabling valid comparisons over time. The data shown in Exhibit 3, Table 3C compare the trade between China and the 40 selected partners, as reported by China, with the corresponding trade with China, as reported by these same countries. See also Exhibit 3, Table 9, which compares the selected partner-reported trade data for China with all partner-reported trade data for China.

The large and growing trade surplus of China, as well as the large and growing discrepancy between China-reported exports and imports and their *converse* – trading-partner imports from and exports to China, respectively – is present whether the data are adjusted by five percent to approximate f.o.b. values or by ten percent, the deflator employed by the IMF.⁴⁰

Finally, the China-generated data remain grossly understated compared to partner-country *converse* data, even if the latter are adjusted to account for so-called Hong Kong re-exports of goods originating on the Mainland. This re-export trade – in which goods are exported from Mainland China to Hong Kong, then re-exported to the rest of the world – has been blamed as the source of much of the discrepancy between Chinese and partner-country trade figures.⁴¹ However, Hong Kong’s data that identify the value of total re-export trade – both Hong Kong’s exports to and imports from the Mainland – do not explain the data discrepancies, as shown below.

⁴⁰ See Exhibit 3, Table 4 for adjustments using the 10-percent deflator. A 5-percent adjustment to import values reported on a c.i.f. basis is preferred, because that figure approximates the actual difference between f.o.b. and c.i.f. import data as reported in official U.S. trade data with Asia. See Methodological Explanation at page 4. Even with use of the IMF’s 10-percent adjustment, the divergence between China’s data and partner-country data ranges from 183 percent to 241 percent, 1999-2003. See Exhibit 3, Table 4, comparing Table 4B and Table 4D.

⁴¹ The re-export trade with Hong Kong presents issues of double-counting and misattribution, because China’s exports through Hong Kong are reported as both Hong Kong imports from China and partner-country imports from China. See G. Hufbauer and D. Rosen, “American Access to China’s Market: The Congressional Vote on PNTR,” Institute for International Economics,” No. 00-3, April 2000, at 5; but also see K. Bronfenbrenner, et al., “Impact of U.S. – China Trade Relations on Workers, Wages, and Employment,” Submitted to the U.S. - China Security Review Commission/U.S. Trade Deficit Review Commission, June 30, 2001. The latter study cites empirical work on the quantity of Hong Kong’s re-export trade (both from and to the Mainland) done by the Hong Kong Census and Statistics Office. See also Methodological Explanation at pages 1-3.

China's Global Trade Surplus, Adjusted for Hong Kong Re-Export Trade, 1999 – Mar. 2004 <i>By Source, in billion USD</i>			
	China Data ⁴²	40 Partner Data ⁴³	Percent Divergence ⁴⁴
1999	37.7	119.6	217.0%
2000	35.4	148.7	320.0%
2001	35.3	151.9	330.0%
2002	45.1	175.2	288.0%
2003	46.0	203.0	341.0%
2003 (Jan. - Mar.)	3.3	42.7	1,194%
2004 (Jan. - Mar.)	-2.2	51.7	NC

In sum, there is a large and growing difference between what China reports as its trade surplus with the world and what China's forty largest trading partners report as China's surplus in their own trade statistics when aggregated. These China-world trade surpluses are becoming more pronounced and show consistent under-reporting by China no matter which one of several calculation methodologies is used. China's own export data are still grossly understated even if adjusted for so-called Hong Kong re-export trade. Based on the selected trading partners' data when adjusted for Hong Kong's re-exports, China's surplus has increased from \$119.6 billion in 1999 to \$203.0 billion in 2003, an astounding 70 percent increase over just four years. More importantly, the surplus was three to four times larger than that reported by China over the same period. Notably, the under-reporting by China does not vary significantly when compared to the Chinese data as reported to the IMF. See Exhibit 3, Table 5, comparing Tables 5A and 5D.

⁴² See Exhibit 3, Table 5B.

⁴³ See Exhibit 3, Table 5D. Exhibit 3, Table 5 employs the 5-percent c.i.f. deflator and, further, deflates Hong Kong's re-exports to the world by 25 percent and re-exports to China by six percent, to account for mark-ups in Hong Kong on the re-exports, as reported in Bronfenbrenner, et al.; (citing the Hong Kong Census and Statistics Office). Exhibit 3, Table 6 presents these same data using the 10-percent c.i.f. deflator employed by the IMF.

⁴⁴ For a full explanation of the methodology used to adjust trade data for Hong Kong's re-export trade, see Methodological Explanation at pages 1-3.

Not only is the Chinese government’s version of its balance-of-trade at significant odds with its trading partners’ data, but these discrepancies are worsening over time. The most salient fact for this analysis is that the Chinese government’s balance in each year greatly understates its trade surplus with the rest of the world.

Finally, even when the trade surplus with the United States is set aside, the result is a lower worldwide surplus for China – but a large and growing surplus nonetheless.

China’s Global Trade Surplus (Excluding U.S. Trade), 1999 – Mar. 2004			
<i>By source, in billion USD</i>			
	China Data ⁴⁵	Partner Data ⁴⁶	Divergence
1999	14.2	71.6	57.4
2000	4.5	87.3	82.8
2001	5.9	85.6	79.7
2002	1.0	85.0	84.0
2003	-14.3	86.0	100.3
2003 (Jan.- Mar.)	-6.8	19.5	26.3
2004 (Jan.- Mar.)	-15.2	22.5	37.7

These data show that China’s surplus with the rest of the world is growing right along with its even more significant and quickly rising surplus with the United States alone.

As these discrepancies persist and become larger, the fundamental integrity of the Chinese government’s data becomes more and more open to question. If the extent of China’s large and growing trade surplus were accurately reported, it might go a long way to account for the continuing but otherwise inexplicable “gaping hole” in the global balance-of-payment statistics as reported by the International Monetary Fund. See Ruskin, A., “A Truer Measure of China’s Trade Surplus,” *The Financial Times*, October 29, 2003.

⁴⁵ See Exhibit 3, Table 3B minus Exhibit 1, Table 1A.

⁴⁶ See Exhibit 3, Table 3D minus Exhibit 1, Table 1B.

A series of straightforward conclusions must be drawn from this comparison of China's published foreign trade statistics with the corresponding data compiled by China's trading partners: (1) China's data consistently and egregiously understate its balance-of-trade surplus with the world; (2) the understatements are becoming more pronounced over time; (3) China's data are too unreliable to use as a basis for methodologies estimating undervaluation of the yuan or to evaluate whether China's policies to support the yuan's peg to the U.S. dollar constitute currency manipulation; and, (4) as glaring as these discrepancies are, in reality they are even greater, as the data as presented do not take into account the widely-recognized illegal transshipment and false-invoicing of Chinese textiles through Hong Kong, an amount estimated at several billion dollars per year.⁴⁷ Inclusion of these data would increase China's surplus and the resultant disconnect even further.

A final conclusion compelled by these discrepancies is vitally important. To this point, the international monetary system's principal policeman, the IMF, appears to have relied on China's trade statistics to assess determinations of whether China manipulates its currency to keep the yuan significantly undervalued. See "IMF Concludes 2003 Article IV Consultation with the People's Republic of China." IMF Public Information Notice (PIN) No. 03/136, at 6. Given the IMF's reliance on these inaccurate and understated current-account surpluses, it is easy to understand why the IMF concluded as follows:

Most Directors noted that there is no clear evidence that the renminbi is substantially undervalued at this juncture. Directors also felt that a currency revaluation would not by itself have a major impact on global current account balances – particularly given China's relatively small share in world trade.

Id. at 2.

⁴⁷ See Bronfenbrenner, 2001, at 69.

The preceding analysis illustrating the unreliability of the Chinese government's trade statistics directly undercuts China's claim that its large and growing trade surpluses with the United States are counter-balanced by trade deficits with the rest of the world. Reliance upon the data showing the true level and trend of China's worldwide trade surpluses leads to the conclusion that China's huge and growing worldwide trade surpluses fulfill the requirements for an affirmative determination of currency manipulation.

E. Capital Inflows Are Also Increasing, Exacerbating China's Surplus In the Capital Account

As previously discussed, when a country runs a current-account surplus, ordinarily it will generate an offsetting capital-account surplus in order to maintain a balance-of-payments equilibrium.⁴⁸ In the case of China, however, both the current- and capital-account surpluses are increasing.⁴⁹ As the following table shows, foreign direct investment ("FDI") into China increased by almost 21 percent between 1994 and 2000, then by 31 percent between 2000 and

⁴⁸ What is important to the IMF and other policy makers is a country's overall balance of payments. The balance of payments is made up of the current account (trade) and the capital account (net capital inflows and outflows). The basis of the international monetary system is that countries remain in balance in their overall balance of payments. For example, a country running a large trade surplus should allow increasing net capital outflows to move toward a total balance-of-payments equilibrium over time. China has for some time pursued policies (such as the undervaluation of the yuan and strict capital controls) that result in growing surpluses in both the current account and capital account. This large and growing disequilibrium threatens the stability of the global monetary system. A description of the basic equilibrium framework is found in T. O'Herron's Terms of Trade, IAS Publishing, Washington, D.C. 1999, pp. 20, 37.

⁴⁹ See Exhibit 4. A surplus in a country's current account (a trade surplus) should normally be automatically offset by a decrease in a country's capital account. The basis of the international monetary system is that countries remain in balance in their overall balance of payments. However, China's large and growing trade surplus (shown in Exhibit 4 as a global deficit) coupled with China's large and growing foreign-exchange reserves (also illustrated in Exhibit 4) frustrates the natural tendency of the market to reach equilibrium. China's policies (undervaluation of the yuan and the imposition of strict capital controls) have resulted in large, growing surpluses in both its current and capital accounts that threaten to destabilize the global monetary system.

2003 as growth accelerated. In 2002, FDI in China exceeded investment in any other country in Asia, as well as in the United States for the first time.

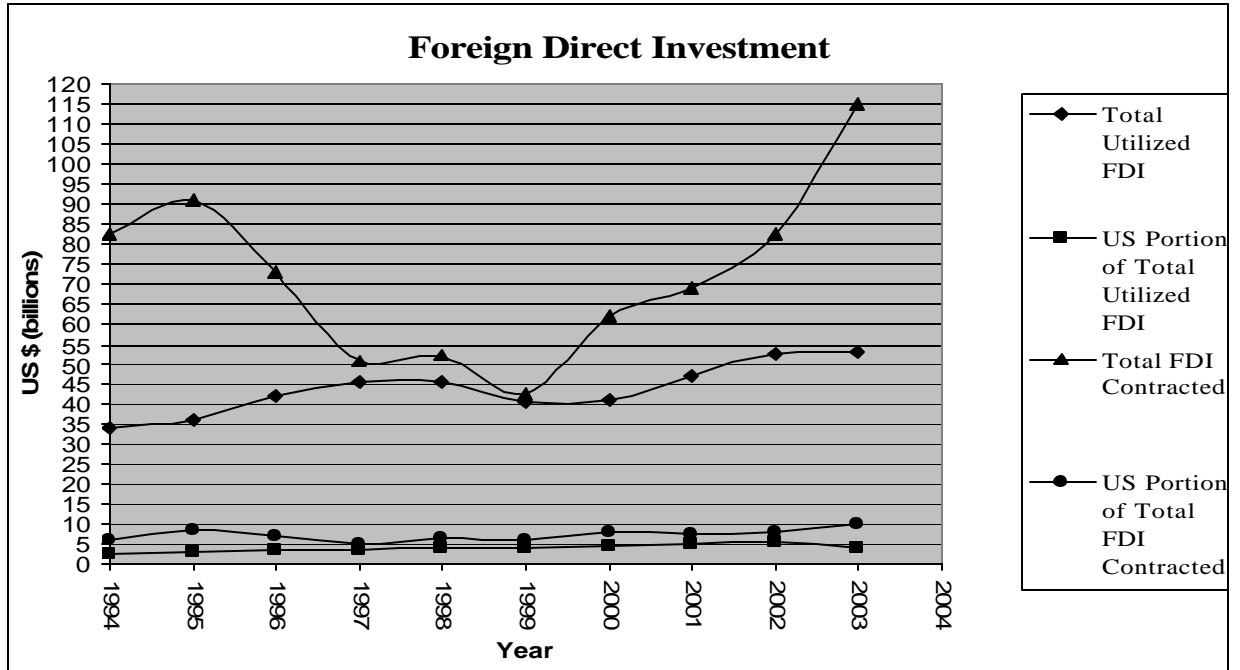
Foreign Direct Investment (FDI) in China
Utilized and Contracted
(billion U.S. dollars)

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Total Utilized FDI	33.77	35.72	41.73	45.26	45.46	40.32	40.72	46.85	52.74	53.51
Of which: U.S.	2.49	3.08	3.44	3.24	3.90	4.22	4.38	4.86	5.40	4.20
Total FDI Contracted	82.68	91.28	73.28	51.00	52.10	41.22	62.38	69.19	82.77	115.07
Of which: U.S.	6.01	8.47	6.92	4.94	6.48	6.02	8.00	7.51	8.20	10.16

Source: Ministry of Commerce

These data demonstrate that China’s policy of maintaining an undervalued exchange rate has resulted in increased foreign-direct-investment flows even during the period when China’s current-account surplus has been increasing. Inflows have increased, especially over the 2000-2003 period, reflecting “bargain-basement” assets in China as valued in the increasingly undervalued Chinese yuan. With China’s currency pegged to the U.S. dollar as the U.S. dollar has depreciated against other major currencies, foreign-direct-investment flows into China from other sources have accelerated. Conversely, U.S. direct-investment flows into China declined in 2003, after increasing each year since 1997.

Similarly, contracted foreign direct investment has also increased, particularly since 2000. As shown in the graph below, not only has contracted foreign direct investment grown by 84 percent over that span, but the rate of this increase has been accelerating. The acceleration in contracted foreign direct investment means that foreign-direct-investment flows will continue at least over the next few years.



Source: Ministry of Commerce

As discussed in detail in Section II.B.1., above, these increased foreign-direct-investment inflows are an important component in China’s overall basic balance-of-payments surplus. With China’s basic balance-of-payments surplus increasing, a corresponding surplus of foreign currency arises that normally would be expected to put upward pressure on the yuan. Instead, as noted previously, the Chinese government continuously intervenes in the market to prevent that outcome. This governmental interference maintains the low value of the yuan, which, in turn, provides an artificial support for continued high levels of investment inflows.⁵⁰

Thus, China’s control of its exchange rate has helped spur, and then sustain, foreign-direct-investment inflows, which clearly are of interest to the Chinese government from a policy

⁵⁰ In a recent report in the *Washington Post*, it was noted that “{r}apid foreign investment is forcing the country’s central bank to step up purchases of foreign currency to maintain the fixed exchange rate of the yuan, also known as the renminbi. Last year, China’s foreign reserves grew more than 40 percent, to \$403 billion, according to the government.” See Peter S. Goodman, “China Regulator Warns of Investment Bubble,” *Washington Post*, Feb. 27, 2004, at E-1.

standpoint. In contrast to the tight controls and outright prohibitions on most other forms of foreign lending and investment in China, foreign direct investment is subject to far fewer restrictions. In addition, the undervalued exchange essentially provides a “discount” for such investment. With the government limiting the ways in which foreigners can invest in China and then providing this “discount,” the resulting high level of investment is not surprising.

As is true with many other manifestations of China’s currency manipulation, the initial “success” of the manipulation in this context – spurring foreign direct investment – in turn spawns further manipulation. While China’s policy is intended to be self-serving, in the process it distorts the allocation of resources across the globe, embeds or structuralizes imbalanced trade flows and, if permitted to such an extent, ultimately could prove to be destabilizing to China. “China’s senior currency regulator warned Thursday {February 26, 2004} that the billions of investment dollars surging into the country may be generating a potentially dangerous bubble....”⁵¹ Along the same lines, the governor of the People’s Bank of China was reported more recently as saying that building a market-driven trading system for China’s currency is now a “top priority.”⁵²

The key implication of these data, however, is that the volume of foreign direct investment in China has been sufficient by itself to support or trigger a revaluation in the yuan. With annual inflows increasing above \$50 billion, they now represent 4 to 5 percent of China’s GDP. Thus, even if the other component in China’s basic imbalance – its burgeoning trade-driven, current-account surplus – were somehow brought back to balance, the sustained level of high foreign-investment inflows is sufficient in its own right to keep upward pressure on the

⁵¹ Id.

⁵² Richard McGregor, “China Shifts Rhetoric on Renminbi Trading System,” Shanghai Financial Times, Apr. 19, 2004.

yuan and, therefore, provide a continuing basis and need for the Chinese government's intervention in the market.

F. China's Currency Regime Poses A Threat to the International Financial System

China's policy of maintaining an undervalued exchange-rate system is creating financial instability that will eventually disrupt global financial markets unless China appreciates its currency in line with underlying economic fundamentals. The threat to the international financial system is exacerbated by the size of China's economy, China's volume of global trade, and the amount of foreign direct investment commitments and flows into China. China's accelerating accumulation of foreign-exchange reserves is creating disequilibrium in the international financial system, will tend to cause inflation and over-investment in China, and will lead to the conditions for another international financial crisis.

As described in detail in Exhibit 1, under its fixed-exchange-rate system with tight capital controls, China has sacrificed its fuller integration into the world economy and monetary independence in favor of exchange-rate stability. The inappropriateness of this exchange-rate regime is perhaps best illustrated by the enormous lengths to which the Chinese government must extend its interference in the market in order to achieve these monetary policy goals. Moreover, China's adherence to these goals -- no matter what their cost or how superficially they are achieved -- is even more revealing.

The type of closely controlled exchange regime employed by China ordinarily is confined to countries with relatively minor and/or balanced trade and investment flows with the rest of the world. This situation is due to the fact that large and imbalanced flows can quickly overwhelm such a closely-controlled system, although this danger has yet to prove a deterrent to China. In its dogged pursuit of exchange-rate stability, the Chinese government has had to intervene to

purchase ever-greater volumes of foreign exchange (especially U.S. dollars) each year. Nevertheless, while these purchases have succeeded in keeping the yuan's value stable against the U.S. dollar, they completely run counter to the trend in the rest of the world, where the U.S. dollar generally has fallen significantly in value. Thus, when the U.S. dollar fluctuates against other foreign currencies, China's achievement of exchange-rate stability with the U.S. dollar directly undermines achievement of exchange-rate stability with respect to all other currencies that float against the U.S. dollar. In other words, the actual exchange-rate stability achieved is limited to the U.S. dollar. By virtue of achieving stability with the U.S. dollar, China faces potentially less stability with respect to other currencies.

The other policy goal of monetary independence likewise is undermined by China's maintaining a fixed exchange rate in the face of such large imbalances in its trade and investment flows. As discussed generally in Section II and Exhibit 1, rather than permit the yuan to increase in value, the Chinese government has chosen instead to offer any amount of yuan needed to absorb any supply of foreign currency. Consequently, as shown in the table below, as larger and larger foreign-currency surpluses have flowed into the Chinese market, the government has had to flood the market with more and more yuan. Thus, if China wishes to maintain exchange-rate stability in the face of such foreign-currency inflows, it does so at the cost of its control over its domestic money supply. Along with this rapid growth in the money supply, however, there is increasing evidence that the Chinese government has fostered a speculative over-investment boom and the foundation for much higher inflation in the future. If not corrected, these trends will coalesce in an unstable bubble that, due to the size of China's economy and volume of trade, will adversely affect international trade and financial markets.

Money Supply
(Billion Yuan)

	2000	2001	2002	2003
Money	5,454	6,168	7,266	8,645
% increase	--	13.1%	17.8%	19.0%
Quasi Money	8,142	9,472	11,412	13,710
% increase	--	16.3%	20.5%	20.1%

Source: IMF International Financial Statistics

As previously discussed, China's undervalued exchange-rate policy discriminates against U.S. exports of goods and services. By maintaining an undervalued exchange rate against the U.S. dollar, China discriminates against U.S. products to China's benefit. Prices of Chinese goods and services in the U.S. market are lower than what would prevail under an exchange rate that reflected underlying economic fundamentals. Conversely, U.S. products in China are priced higher than what would prevail with an exchange rate that reflected underlying economic fundamentals. In addition, the fixed undervalued exchange rate discriminates against other IMF countries. As the U.S. dollar depreciates against other currencies, the exchange rate with China does not change, and the advantage that China has through its undervalued exchange rate remains the same. Other currencies adjust simultaneously to the yuan and the U.S. dollar because the exchange rate is fixed, but those currency adjustments must be greater than what would be required under market conditions because the yuan is undervalued and unable to appreciate against the dollar.

While China's undervalued exchange rate clearly discriminates against the United States and other IMF members, judging from the results of Article IV consultations, this discriminatory currency practice has not been authorized by the Fund. The Article IV consultations that were made public in 2000 concluded, "... Directors suggested that the authorities move ahead

gradually with a more flexible implementation of the current arrangements, involving the widening of the trading band around a reference rate based on a basket of currencies.”

Since that review, China has not implemented either expanded flexibility through increases in the trading band or adopted a basket of currencies as a reference rate. In short, the yuan has shown no flexibility since that review, and China’s foreign-exchange reserves have continued to accelerate to about \$483 billion (as of end-July 2004), or a third of China’s GDP.

Once again, in the IMF Article IV consultations made public in 2003, Executive Directors have urged China to adopt greater flexibility in its exchange-rate regime.⁵³

Directors considered that the rapid build-up of foreign exchange reserves indicates some pressure on the exchange rate and imposes costs on the Chinese economy, especially difficulties in preventing excessive monetary expansion. In this context, Directors observed that increased flexibility of the exchange rate over time would be in the best interest of China. In particular, it would allow more room to pursue an independent monetary policy, help cushion China's economy against adverse shocks, and facilitate adjustment to the major structural reforms that are underway. Directors

⁵³ In the 2003 Article IV consultations, there apparently was some confusion over the extent of the undervaluation of China’s yuan. According to the report:

Most Directors noted that there is no clear evidence that the renminbi is substantially undervalued at this juncture. Directors also felt that a currency revaluation would not by itself have a major impact on global current account imbalances -- particularly given China's relatively small share in world trade.

The confusion over the degree of undervaluation is related to the underlying data. The fundamental conclusion of the Executive Directors was based on China’s own foreign trade data, which substantially underestimate China’s bilateral and global trade surplus. As set forth in Section II.D, when China’s imports and exports are calculated on the basis of data from China’s trading partners, China has a global trade surplus of almost \$150 billion more annually than what China calculates. Had the Executive Directors considered China’s actual trade surplus, a conclusion of substantial undervaluation would have been evident. Given that China has not been more forthcoming in introducing flexibility into its exchange-rate regime, Executive Directors apparently have begun to become more vocal in their opposition to China’s undervalued fixed-exchange-rate regime and its impact on global trade and finance.

considered that China could, in a phased manner, introduce more flexibility to its exchange rate without causing major disruptions to its economy. Most Directors stressed that a move toward flexibility should be carefully planned and sequenced with ongoing structural reforms that are crucial to its success, and emphasized the need to move speedily with these reforms.

In short, the IMF's Executive Directors have recommended in the last two reviews that China introduce greater flexibility into its exchange-rate regime. All Directors have believed that China's undervalued fixed-exchange-rate regime imposes significant costs on China's economy, particularly greater risks associated with monetary expansion, thus urging greater flexibility.

G. Summary

As the foregoing statistical evaluation and assessment delineate, China's undervaluation and manipulation of the yuan are unequalled by the currency policies of the other nations of the world. In terms of the extensiveness of its controls and intervention in the market and the deleterious consequences for the global economy, China's exchange-rate regime is the antithesis of an open, mutually beneficial, and market-driven international system.

III. CONTRARY TO SECTION 301(a) OF THE TRADE ACT, CHINA'S MAINTENANCE OF AN UNDERVALUED EXCHANGE-RATE REGIME VIOLATES CHINA'S OBLIGATIONS AND DENIES THE UNITED STATES RIGHTS AND BENEFITS TO WHICH THE UNITED STATES IS ENTITLED UNDER INTERNATIONAL LAW

A. China's Maintenance of An Undervalued Exchange-Rate Regime Is In Breach of Basic Principles of the World Trade Organization and Its Agreements

1. Background

Since entry into force of the General Agreement on Tariffs and Trade in 1947 (“GATT”),⁵⁴ the global trading system has been structured to minimize and, to the extent possible, avoid mercantilism and “beggar-thy-neighbor” policies by the nations of the world against each other. Underlying this international economic structure has been the widely shared conviction that all countries stand to gain as tariff and non-tariff barriers to international trade are reduced.

As set forth in Section II above, China’s undervaluation of the yuan presents an exceptional and unique instance of currency manipulation.⁵⁵ The World Trade Organization (“WTO”) and the global trading system cannot afford to have this manipulation continue. In ways both stark and sometimes subtle but no less damaging, China’s undervalued exchange-rate regime is seriously weakening the rules-based international trading system and has already

⁵⁴ General Agreement on Tariffs and Trade, Oct. 30, 1947, 61 Stat. A-11, T.I.A.S. 1700, 55 U.N.T.S. 194.

⁵⁵ When a country pegs its currency to another country’s currency and does not make adjustments for severe market fluctuations, its currency maintains a value that is different from that which would result from natural market forces. This phenomenon is called currency manipulation, which is a form of discriminatory currency arrangements. Sir Joseph Gold defines discriminatory currency arrangements as “arrangements by a member to discriminate through its exchange system for the benefit, or to the detriment, of another member or members.” See Sir Joseph Gold, Exchange Rates in International Law and Organizations 252, 281 (ABA Sec. of Int’l Law and Practice 1988).

caused and will only lead in the future to further economic deterioration globally and in the U.S. economy, in particular, if allowed to continue.

2. **China's Maintenance of An Undervalued Exchange-Rate Regime Is A Prohibited Export Subsidy That Violates Articles 1 and 3 of the WTO Agreement on Subsidies and Countervailing Measures, Articles VI and XVI of the GATT, and China's WTO Obligations Concerning Agricultural Products**

a. **Overview**

China's maintenance of an undervalued exchange-rate regime constitutes a prohibited de facto export subsidy within the meaning of Articles 1, 2 and 3 of the WTO Subsidies and Countervailing Measures Agreement ("SCM Agreement"), Articles VI and XVI of the GATT, and China's WTO obligations concerning agricultural products. This prohibited export-subsidy scheme is unjustifiable, it burdens and restricts United States commerce, and it denies and violates the United States' rights under WTO Agreements.

Export subsidies like China's currency-manipulation regime are so disfavored in international law that they are explicitly prohibited by the WTO Agreements, particularly Article 3 of the SCM Agreement. As Ambassador Zoellick stated in his January 11, 2004 letter to WTO trade ministers, "{e}xport subsidies distort trade more than any other measure." While he was referring in that instance to agricultural export subsidies, the principle applies to all export subsidies, which are viewed as the most damaging form of subsidy. Moreover, China's currency-manipulation regime is an export subsidy that benefits each and every export sale of a Chinese product to the United States to a substantial degree, which likely makes it the largest, or one of the largest, impermissible export-subsidy programs ever provided.

Export subsidies are viewed as indefensible due to their "beggar-thy-neighbor" nature, and the WTO Agreements accordingly go so far as to require that remedies for prohibited export subsidies be implemented on an expedited basis under Article 4 of the SCM Agreement.

Moreover, such subsidies are essentially the only trade practice with a WTO-sanctioned remedy that is not restricted by the trade effects caused by the measure implemented.

While currency-manipulation subsidies have infrequently been the subject of dispute settlements under the GATT, both the GATT and the current WTO Agreements explicitly and repeatedly recognize that certain currency practices violate common subsidy disciplines. China's undervalued fixed-exchange-rate regime manifests the essential features of an unfair subsidy practice by virtue of involving governmental action to:

- (1) maintain a fixed exchange rate on current accounts;
- (2) impose non-convertibility of capital accounts;
- (3) direct massive bank purchases of U.S. dollars; and
- (4) utilize other measures described in other sections of this petition to maintain its undervalued fixed-exchange-rate regime.

These measures by China encourage massive and increasing exports to the United States from China of unfairly low-priced manufactured and agricultural goods beyond levels that would occur absent these policies in a rational, market-based system under current economic conditions. As demonstrated below, China's currency-manipulation scheme satisfies each of the elements required to show the existence of a prohibited export subsidy. As such, in accord with Article 3.2 of the SCM Agreement, China, as a WTO Member, must eliminate this subsidy program.

b. China's Undervalued Exchange-Rate Regime Is Proscribed Under the SCM Agreement and GATT Articles VI and XVI

The following paragraphs demonstrate that: (1) export subsidies are prohibited by the SCM Agreement and GATT Articles VI and XVI; (2) currency manipulation is explicitly contemplated by the SCM Agreement as a prohibited export subsidy in certain situations; (3) China is not exempt from prohibitions on export subsidies; (4) China's undervalued exchange-

rate regime satisfies all of the prerequisites under Articles 1, 2, and 3 of the SCM Agreement and consequently is an unlawful export subsidy; and (5) the conclusion that China's undervalued exchange-rate regime is a proscribed export subsidy is underscored by the fact that several of the tools or programs employed by the Chinese government to manipulate the yuan are identified by the SCM Agreement's Illustrative List separately as prohibited export subsidies.

i. Export Subsidies Are Prohibited Under the SCM Agreement and Articles VI and XVI of the GATT

From its origin in 1947, the GATT and its related Agreements have recognized and worked to prohibit the trade-distorting nature of subsidy programs designed to support and artificially facilitate exports from one Contracting Party or Member State to another.⁵⁶ Article XVI of the GATT specifically recognizes that export subsidies “. . . may cause undue disturbance to . . . normal commercial interests, and may hinder the achievement of the objectives of this Agreement.” See GATT, Article XVI:2 (emphasis added).

Article XVI goes on to provide that “as from 1 January 1958 or the earliest practicable date thereafter, contracting parties shall cease to grant either directly or indirectly any form of subsidy on the export of any product other than a primary product which subsidy results in the sale of such product for export at a price lower than the comparable price charged for the like product to buyers in the domestic market.” Article XVI:4 (emphasis added). GATT Article VI acknowledges that export subsidies may also be subject to countervailing duties. A number of

⁵⁶ The WTO Agreements constitute a single treaty that is to be interpreted so as to permit the GATT's provisions and the WTO Agreements to coexist. See Appellate Body Report, Korea -- Definitive Safeguard Measure on Imports of Certain Dairy Products, adopted Jan. 12, 2000, WT/DS98/AB/R, para. 75 (applying this concept to GATT Article XIX and the WTO Safeguards Agreement).

decisions in dispute settlements under the GATT further illustrate the disfavor in which export subsidies have been, and continue to be, held.⁵⁷

The SCM Agreement amplifies upon and extends the GATT's provisions on subsidies and substantially strengthens the disciplines covering export subsidies, first, by explicitly prohibiting such subsidies under Article 3 of the SCM Agreement. Article 3.2 of the SCM Agreement states succinctly that WTO Member States "shall neither grant nor maintain" prohibited export subsidies.⁵⁸ As indicated in the Appellate Body's report in United States -- Foreign Sales Corporation,

In fact, as we have observed previously, the *SCM Agreement* contains a broad package of new export subsidy disciplines that 'go well beyond merely applying and interpreting Articles VI, XVI and XXIII of the GATT 1947.' . . . {T}he *SCM Agreement* establishes a much broader prohibition against *any* subsidy which is 'contingent upon export performance.' To say the least, the rule contained in Article 3.1(a) of the *SCM Agreement* that all subsidies which are 'contingent upon export performance' are prohibited is significantly different from a rule that prohibits only those subsidies which result in a lower price for the exported product than the comparable price for that product when sold in the domestic market.⁵⁹

In its first Annex, the SCM Agreement also includes an "Illustrative List" that provides examples of certain types of prohibited export subsidies. Although this list is long, it is simply

⁵⁷ See, e.g., Appellate Body Report, EEC -- Subsidies on Export of Wheat Flour, SCM/42, Mar. 21, 1983, unadopted, paras 5.5-5.7, cited in MTN.GNG/NG10/W/3 (Mar. 17, 1987).

⁵⁸ While this petition focuses in the first instance on the export-oriented nature of the subsidy provided, China's currency manipulation can also be seen as a scheme that functions "in fact" as an import-substitution program prohibited by SCM Articles 3.1(b) and 3.2 and by Article III of the GATT 1994. The currency scheme artificially overvalues imported goods and undervalues domestic goods, resulting in a subsidy "in fact" to domestic goods relative to imported goods. See Appellate Body Report, Canada -- Certain Measures Affecting the Automotive Industry, adopted June 19, 2000, WT/DS139/AB/R, WT/DS142/AB/R, paras. 135-146.

⁵⁹ Appellate Body Report, United States -- Tax Treatment For "Foreign Sales Corporations," adopted Mar. 20, 2000, WT/DS108/AB/R, para. 117 (citation omitted) (italics in original).

illustrative of prohibited export subsidies -- it is not comprehensive. In fact, the list contemplates the existence of other programs that function as export subsidies in addition to those listed, as exemplified in its final “basket” category, which sweeps in as prohibited export subsidies “{a}ny other charge on the public account constituting an export subsidy in the sense of Article XVI of GATT 1994.” See SCM Agreement at Annex I.

ii. **Certain Forms of Currency Manipulation Violate the SCM Agreement and Article VI of the GATT**

From the beginning, the GATT has confronted and addressed concerns that various types of foreign-exchange subsidy programs violate the GATT’s subsidy disciplines. For example, the addenda to Articles VI:2 and VI:3 of the GATT state that “{m}ultiple currency practices can in certain circumstances constitute a subsidy to exports which may be met by countervailing duties By ‘multiple currency practices’ is meant practices by governments or sanctioned by governments.” GATT, Ad. Article VI, paras. 2-3, note 2 (emphasis added). In the same vein, a 1960 GATT report under Article XVI:5 stated that “. . . there was a clear obligation to notify to the CONTRACTING PARTIES multiple exchange rates which have the effect of a subsidy.”⁶⁰ Thus, currency subsidies that include the required elements to find an export subsidy are impermissible or actionable. In this case, because the subsidy is so closely tied in design and action to act as an export subsidy, particularly with regard to exports to the United States, the subsidy is prohibited by GATT and the WTO SCM Agreement.

Furthermore, the SCM Agreement’s “Illustrative List of Export Subsidies” mentions certain prohibited export subsidies that involve foreign-exchange programs and related credit programs that could potentially affect foreign-currency exchange issues. See SCM Agreement at

⁶⁰ See Panel Report, Review Pursuant to Article XVI:5, L/1160, adopted May 24, 1960, BISD 9S/188, 192, para. 13.

Annex I Such practices include “currency retention schemes” (item b)⁶¹ and programs that cover the long-term operating costs and losses of foreign-exchange programs (item j).⁶² Thus, the SCM Agreement and Article VI of the GATT clearly contemplate that foreign-exchange mechanisms can be manipulated to provide subsidies, particularly to exports, the latter aspect of which is not surprising given the close nexus between the use of exchange rates and export activities.

iii. **China Does Not Qualify for Any Exception to the Prohibition In Article 3 of the SCM Agreement on the Use of Export Subsidies**

A few, very limited exceptions exist to the rule prohibiting export subsidies, but China’s written commitment to eliminate export subsidies (expressed repeatedly during its WTO accession process) makes it ineligible for these exceptions. Moreover, China would not qualify for these exceptions even if it had not declared itself ineligible for them during the accession process.

Article 27 of the SCM Agreement, for example, carves out limited exceptions to the prohibition on export subsidies for certain developing country members. Under Article 27.2(a) and Annex VII of the SCM Agreement, certain listed developing-country members are exempt from the prohibition on export subsidies in Article 3.1(a), and other countries were exempted from that provision for a period of eight years from the date of entry into force of the WTO Agreement. Under Article 27.3 of the SCM Agreement, the provisions of Article 3.1(b) did not

⁶¹ “Currency retention schemes or any similar practices which involve a bonus on exports.” SCM Agreement at Annex I(b).

⁶² “The provision by governments (or special institutions controlled by governments) of export credit guarantee or insurance programmes, of insurance or guarantee programmes against increases in the cost of exported products or of exchange risk programmes, at premium rates which are inadequate to cover the long-term operating costs and losses of the programmes.” SCM Agreement at Annex I(j). Item (j) is discussed in more detail below.

apply to developing countries and least-developed countries for five and eight years, respectively, from the WTO Agreement's entry into force.

During the negotiations leading up to its accession to the WTO, China explicitly stated that it only reserved the right to benefit from four provisions of Article 27, none of which involves an exception to the prohibition on export subsidies.⁶³ China reserved the right to benefit from Article 27 subsections 27.10, 27.11, 27.12 and 27.15. The first three of these provisions pertain to findings of de minimis subsidies in countervailing duty proceedings, while Article 27.15 allows an interested developing-country Member State to request the WTO's SCM Committee to review and examine whether a specific countervailing duty measure is consistent with Articles 27.10 and 27.11 as applicable to that developing-country Member State.⁶⁴

Most important, as recorded in the Report of the Working Party on the Accession of China, China committed to --

eliminate all export subsidies, within the meaning of Article 3.1(a) of the SCM Agreement, by the time of accession. To this end, China would, by accession, cease to maintain all pre-existing export subsidy programmes and, upon accession, make no further payments or disbursements, nor forgo revenue, or confer any other benefit, under such programmes. This commitment covered subsidies granted at all levels of government which were contingent, in law or in fact, upon an obligation to export.

⁶³ See Report of the Working Party on the Accession of China, WT/ACC/CHN49, at 33-35 (Oct. 1, 2001).

⁶⁴ The SCM Agreement contains two additional exceptions to the export-subsidy provisions under Articles 28 and 29, but neither applies here because China committed to eliminate export subsidies entirely. Moreover, both provisions include subsidy "notice" provisions and so implicitly reference Article 25, the section of the SCM Agreement that deals with notifications of subsidies by each Member State to the WTO. China, however, has not given any such notifications regarding its currency-subsidy regime.

WT/ACC/CHN/49, at 33. The Chinese government also “. . . confirmed that China would eliminate, upon accession, all subsidies contingent upon the use of domestic over imported goods, within the meaning of Article 3.1(b) of the SCM Agreement.” Id.

China’s final Accession Protocol reflects these commitments:

10. Subsidies

1. China shall notify the WTO of any subsidy within the meaning of Article 1 of the Agreement on Subsidies and Countervailing Measures ("SCM Agreement"), granted or maintained in its territory, organized by specific product, including those subsidies defined in Article 3 of the SCM Agreement. The information provided should be as specific as possible, following the requirements of the questionnaire on subsidies as noted in Article 25 of the SCM Agreement.

* * *

3. China shall eliminate all subsidy programmes falling within the scope of Article 3 of the SCM Agreement upon accession.

Accession of The People's Republic of China, Decision of 10 November 2001, WT/L/432 (23 November 2001).⁶⁵ China’s accession to the WTO Agreements occurred on December 11, 2001.

⁶⁵ In addition to failing to eliminate its export-subsidy program on foreign exchange, it is useful to understand that China is involved in other subsidy practices that demonstrate its disregard for its WTO accession commitments and compliance with other WTO subsidy disciplines. For example, the WTO’s second review in late 2003 of China’s accession and membership in the WTO indicated that the Chinese tax system offers incentives contingent upon export volumes that exceed established thresholds. The WTO’s review concluded that this arrangement is a violation by China of Article 3 of the SCM Agreement and Section 10 of China’s Accession Protocol. See Protocol on the Accession of the People’s Republic of China, WT/L/432, Section 10 at para. 3 (China WTO Accession Protocol); Chair’s Report to the Council for Trade in Goods on the Transitional Review of China, G/SCM/111, paras. 9, 38, 41, 44 (Nov. 18, 2003) (Second Transitional Review). China also was found to have continued subsidies to state-owned enterprises despite having explicitly committed to discontinue such subsidies. Second Transitional Review at 9, 38, 41, 44; China WTO Accession Protocol at Annex 5B. Moreover, China has failed to submit annual notifications of its subsidies during the past two years in violation of Article 25 of the SCM Agreement.

As a prohibited export subsidy under the GATT Agreement Article VI, this currency scheme must be eliminated by the Chinese government. Moreover, WTO dispute settlement decisions clearly demonstrate that the agreements inform the GATT articles, but do not -- absent express language to the contrary -- override the provisions of the Articles. Thus, nothing in Article 1 of the SCM Agreement negates the identification of currency manipulation as an export subsidy. The currency subsidy's violation of the SCM Agreement, as described below, confirms and strengthens the conclusion that this scheme is a prohibited export subsidy.

iv. **China's Maintenance of An Undervalued Exchange-Rate Regime Meets All of the Pertinent Criteria Under Articles 1, 2, and 3 of the SCM Agreement and Consequently Is An Unlawful Export Subsidy**

The Chinese government's currency manipulation constitutes an impermissible export subsidy under Articles 1.1, 1.2, 2.3 and 3 of the SCM Agreement, because the program involves a financial contribution, bestows a benefit, and is specific.

(a) **Financial Contribution**

As relevant, Article 1.1 of the SCM Agreement indicates that a subsidy exists if there is a direct or potential direct financial contribution by a government (or an intermediary), where governmental revenue that is otherwise due is foregone or not collected, the government provides goods or services other than general infrastructure, or the government makes payments

to a funding mechanism, and a benefit is thereby conferred. See SCM Agreement, Article 1.1.⁶⁶

Very importantly, governmental financial contributions are not limited to the direct provision of funds, but include as well indirect payments and measures that have an effect that is equivalent

⁶⁶ Article 1.1 of the SCM Agreement reads:

Article I

Definition of a Subsidy

1.1 For the purpose of this Agreement, a subsidy shall be deemed to exist if:

(a)(1) there is a financial contribution by a government or any public body within the territory of a Member (referred to in this Agreement as "government"), i.e. where:

- (i) a government practice involves a direct transfer of funds (e.g. grants, loans, and equity infusion), potential direct transfers of funds or liabilities (e.g. loan guarantees);
- (ii) government revenue that is otherwise due is foregone or not collected (e.g. fiscal incentives such as tax credits);
- (iii) a government provides goods or services other than general infrastructure, or purchases goods;
- (iv) a government makes payments to a funding mechanism, or entrusts or directs a private body to carry out one or more of the type of functions illustrated in (i) to (iii) above which would normally be vested in the government and the practice, in no real sense, differs from practices normally followed by governments;

or

(a)(2) there is any form of income or price support in the sense of Article XVI of GATT 1994;

and

(b) a benefit is thereby conferred.

SCM Agreement, Article 1.1 (footnote omitted).

to that of a direct payment.⁶⁷ Thus, a currency-manipulation program that directly or indirectly provides financial contributions or services will qualify as a subsidy if the other elements of the subsidy test also are satisfied.

The Chinese government's foreign-exchange scheme provides to Chinese exporters and their exports to the United States a financial contribution within the meaning of the SCM Agreement. The Chinese government requires its citizens to exchange their dollars for local currency, sets the rate of exchange by fiat, and prints the money to fund the transaction. By directing the conversion of U.S. dollars at an extremely undervalued rate of 8.28 yuan for each U.S. dollar, the Chinese government provides a financial contribution and service within the meaning of Article 1.1(a)(1)(iii) of the SCM Agreement.⁶⁸ China's management of this exchange-rate process in this manner encourages increased exports to the United States by Chinese manufacturers and increases employment for Chinese workers at the expense of U.S. manufacturers and U.S. workers.

More specifically, China's maintenance of the pegged-exchange rate and the severe undervaluation of 8.28 yuan to the U.S. dollar have made Chinese products increasingly attractive and more affordable in the United States and in other foreign markets by giving the U.S. dollar a purchasing power far greater versus the yuan than what normal commercial forces

⁶⁷ See, e.g., Panel Report, Brazil – Export Financing Programme for Aircraft, decided Apr. 14, 1999, WT/DS46/R, adopted as modified by Appellate Body Report, Aug. 20, 1999, para. 7.68 (when a governmental action gives rise to a benefit, a subsidy is conferred irrespective of whether any payment occurs); Second Report on Anti-Dumping and Countervailing Duties, L/1141, adopted May 27, 1960, BISD 9S/194, 200, para. 34 (stating that “{i}t was agreed that the word ‘subsidies’ covered not only actual payments, but also measures having an equivalent effect.”).

⁶⁸ To the extent that the Chinese government entrusts or directs any private bodies to assist in effectuating the yuan's undervaluation, which assistance appears also to take place, the conclusion still holds under Article 1.1(a)(1)(iv) that the Chinese government is providing a financial contribution and service as defined by the SCM Agreement.

would dictate. Chinese exporters accordingly can sell for export increased volumes and earn additional returns in yuan that would not be the case if the yuan were not governmentally undervalued.

China's currency manipulation further contributes financially to Chinese exports to the United States and elsewhere by shielding Chinese exporters from expenses involved with hedging against foreign-exchange losses or purchasing guarantees to guard against exchange-rate fluctuations. These costs are avoided thanks to the Chinese government's guarantee of a substantially undervalued, pegged-exchange rate that prevents any currency fluctuations between the yuan and the U.S. dollar. This same established undervaluation generates other financial contributions indirectly by saving time and effort otherwise for Chinese exporters in conducting their exporting operations.

(b) Benefit

Under Article 1.1(b) of the SCM Agreement, a benefit is provided by these financial contributions because the Chinese government's policy and practice of devaluing the yuan make "the recipient 'better off' than it would otherwise have been, absent that contribution." See Appellate Body Report, Canada -- Measures Affecting the Export of Civilian Aircraft, adopted Aug. 20, 1999, WT/DS70/AB/R, para. 157 ("Canada – Aircraft") ; see also Panel Report, United States – Imposition of Countervailing Duties on Certain Hot-Rolled Lead and Bismuth Carbon Steel Products Originating in the United Kingdom, adopted June 7, 2000, WT/DS138/R, at paras. 6.66-6.69 (stating that "{t}he existence or non-existence of 'benefit' rests on whether the potential recipient or beneficiary . . . received a 'financial contribution' on terms more favourable than those available to the potential recipient or beneficiary in the market.").

Given that China does not permit its foreign-exchange rate to be set by market forces, the probable free-market value of the yuan is an acceptable benchmark for the purpose of evaluating

the benefit of China's currency manipulation. This methodology was endorsed in Canada -- Civil Aircraft, which states that “{i}n our view, the marketplace provides an appropriate basis for comparison in determining whether a ‘benefit’ has been ‘conferred’, because the trade-distorting potential of a ‘financial contribution’ can be identified by determining whether the recipient has received a ‘financial contribution’ on terms more favourable than those available to the recipient in the market.” Canada -- Aircraft, WT/DS70/AB/R, para. 157. The Appellate Body added that “Article 14, which we have said is relevant context in interpreting Article 1.1(b), supports our view that the marketplace is an appropriate basis for comparison.” Id.

Thus, there is no doubt that, under these terms, Chinese exporters and exports receive a primary benefit from China's pegged-exchange rate of the considerable difference between the governmentally-controlled exchange rate and the rate that would prevail under a market-exchange system for the yuan. In addition, Chinese exporters and exports receive secondary benefits by way of reduced transaction costs stemming from the absence of a fluctuating foreign-exchange market and foreign-exchange risks. Within the meaning of Article 1.1(b) of the SCM Agreement, therefore, these primary and secondary benefits certainly leave China's exporters and exports in a far better position than if the yuan were not so severely undervalued.

(c) **Specificity**

Under Article 1.2 of the SCM Agreement, a subsidy as defined in Article 1.1 is subject to the provisions of Part II of the SCM Agreement if that subsidy is “specific” in accordance with Article 2 of the SCM Agreement. In turn, Article 2.3 states that “{a}ny subsidy falling under the provisions of Article 3 shall be deemed to be specific,” while Part II in Article 3 of the SCM

Agreement, as relevant, prohibits subsidies that are contingent, in law or in fact, upon export performance.⁶⁹

China's undervalued exchange-rate regime is specific and properly classified as a prohibited export subsidy under the foregoing provisions of the SCM Agreement for a number of compelling reasons.⁷⁰ First and foremost, as just observed, Article 3 of the SCM Agreement prohibits subsidies that are contingent, in law or in fact, upon export performance. Petitioners do not contend that the Chinese government's subsidy program described here is explicitly contingent in law on export performance. Petitioners do contend and demonstrate below, however, that this program is "in fact tied to actual or anticipated exportation or export

⁶⁹ Article 3: Prohibition

3.1 Except as provided in the Agreement on Agriculture, the following subsidies, within the meaning of Article 1, shall be prohibited:

(a) subsidies contingent, in law or in fact⁴, whether solely or as one of several other conditions, upon export performance, including those illustrated in Annex I⁵;

⁴ This standard is met when the facts demonstrate that the granting of a subsidy, without having been made legally contingent upon export performance, is in fact tied to actual or anticipated exportation or export earnings. The mere fact that a subsidy is granted to enterprises which export shall not for that reason alone be considered to be an export subsidy within the meaning of this provision.

⁵ Measures referred to in Annex I as not constituting export subsidies shall not be prohibited under this or any other provision of this Agreement.

(b) subsidies contingent, whether solely or as one of several other conditions, upon the use of domestic over imported goods.

3.2 A Member shall neither grant nor maintain subsidies referred to in paragraph 1.

⁷⁰ As indicated earlier, the SCM Agreement's Illustrative List is not an exclusive listing of export subsidies, but merely provides examples of certain types of prohibited export subsidies. Simply because a particular subsidy program is not explicitly identified in Annex I does not mean the program is not an export subsidy. To argue otherwise would be to make Article 3 of the SCM Agreement redundant and meaningless, which it is not.

earnings.” See SCM Agreement, Article 3.1(a) n.4.⁷¹ In other words, while China has not expressly stated in its laws that its undervalued exchange-rate regime is designed to increase exports to the United States in an effort to bolster Chinese manufacturing capabilities and increase China’s employment levels and U.S.-dollar holdings, in fact the policy is designed to, and actually does, accomplish these goals.

To determine whether a subsidy is de facto contingent upon export performance requires an analysis of the facts of the subsidy and the nature of its tie to export promotion. The Appellate Body articulated the required inquiry in one case as follows:

. . . the existence of this relationship of contingency, between the subsidy and export performance, must be *inferred* from the total configuration of the facts constituting and surrounding the granting of the subsidy, none of which on its own is likely to be decisive in any given case.

Recognizing the difficulties inherent in demonstrating *de facto* export contingency, the Uruguay Round negotiators provided a standard, in footnote 4 of the *SCM Agreement*, for determining when a subsidy is "contingent . . . in fact . . . upon export performance.

Canada -- Aircraft, WT/DS70/AB/R, paras. 167-168 (emphasis in the original). As cited previously, footnote 4 to Article 3 of the SCM Agreement directs that the standard for ascertaining that a subsidy is contingent in fact upon export performance

. . . *is met* when the *facts demonstrate* that the *granting* of a subsidy, without having been made legally contingent upon export performance, is *in fact tied to actual or anticipated exportation or export earnings*. The mere fact that a subsidy is granted to enterprises which export shall not for that reason alone be considered to be an export subsidy within the meaning of this provision.

⁷¹ Petitioners do not allege that the mere fact that a subsidy is granted to enterprises that export for that reason alone classifies China’s currency manipulation as a prohibited export subsidy under Article 3.

Canada -- Aircraft, WT/DS70/AB/R, para. 168 (emphasis in the original). Toward this end, evaluation of whether a subsidy is contingent, in fact, upon export performance must examine three elements: (1) whether the granting authority has imposed a condition based on export performance in providing the subsidy; (2) whether the facts demonstrate that the granting of a subsidy is tied to or contingent upon actual or anticipated exports; and (3) whether, as one relevant fact among others analyzed, the subsidy recipient is export-oriented. See Canada -- Aircraft, WT/DS70/AB/R, paras. 170-173.

The application of these factors to China's foreign-exchange policy and practice confirms that China's undervalued exchange-rate regime constitutes a de facto export subsidy. First, the Chinese government, as the granting authority, imposes a condition based on export performance in providing the subsidy. The subsidy, derived from the undervalued yuan, is dependent upon the existence of export performance in order to take effect. The nexus between the subsidy of the yuan's exceptional undervaluation and the prerequisite of exportation for a company in China to enjoy that subsidy is so close and inextricably linked that conditionality is indisputable.

Second, the facts demonstrate that the granting of the subsidy is tied to or contingent upon actual or anticipated exports from China, because the subsidization would not occur if exports did not occur. In order for the foreign-exchange program to operate, products must be traded internationally. Without export performance, there would be no foreign currency to exchange. Moreover, the fact that the subsidy results in increased exports to the United States and elsewhere and in the accumulation by China of massive foreign-exchange reserves provides additional evidence of tying. Thus, the required tying/contingency element is satisfied.

Finally, while not a definitive factor, the primary recipients of the subsidy under this foreign-exchange program are undoubtedly manufacturing companies in China that export and

that are exporting in ever-increasing amounts so as to benefit from this program. These beneficiaries of China's undervalued exchange-rate regime accordingly are export-oriented.

In summary, when Articles 1, 2 and 3 of the SCM Agreement are scrutinized in light of their texts and pertinent dispute settlements, China's currency-manipulation scheme is shown to be a prohibited de facto export subsidy. Under Article 3.2 of the SCM Agreement and China's commitments made upon its accession to the WTO, therefore, China is bound to terminate and cease granting all benefits under this export subsidy.

v. **The Conclusion That China's Maintenance of An Undervalued Exchange-Rate Regime Is a Prohibited Export Subsidy Is Reinforced By Items (b) and (j) of the Illustrative List of Prohibited Export Subsidies in Annex I of the SCM Agreement**

The unlawful nature of China's maintenance of an undervalued exchange-rate regime as a prohibited export subsidy is punctuated by several aspects of that scheme that are covered by item (b) and item (j) of the SCM Agreement's Illustrative List at Annex I of prohibited export subsidies. The conclusion that China's exchange-rate manipulation is a prohibited export subsidy and a prohibited import-substitution subsidy is not dependent upon a finding that certain aspects of the programs used to implement the scheme are separately identified on the SCM's Illustrative List of export subsidies. But the inclusion of certain Illustrative List practices within the overall scheme of China's currency manipulation contributes to a finding that the entire program is a prohibited export subsidy and undermines arguments that the Chinese government's currency peg is WTO-compliant.

(a) **Item (b)**

Item (b) identifies as prohibited export subsidies "{c}urrency retention schemes or any similar practices which involve a bonus on exports." Currency-retention schemes have been defined as arrangements that usually involve dispensation for certain exporters to retain a portion

of their foreign-exchange earnings despite a general rule under which residents must surrender receipts of foreign exchange to local banks, or the central bank, in exchange for local currency.⁷²

The Chinese government administers a currency-retention scheme under its currency-exchange regime.⁷³ As such, China's currency-retention program comes under item (b) of the SCM Agreement's Illustrative List of prohibited export subsidies. By providing certain Chinese exporters with preferential access to foreign exchange that China's laws would otherwise require be converted into yuan, China's currency-retention program provides extra financial encouragement to those favored exporters to export. It also appears that China's currency-retention scheme goes even further and additionally extends bonuses to certain high-performing exporters.⁷⁴ In each and both of these respects, therefore, the Chinese government's currency-retention program is a prohibited export subsidy within the meaning of item (b) and the SCM Agreement's articles.

(b) Item (j)

Item (j) identifies the following programs as export subsidies:

{t}he provision by governments (or special institutions controlled by governments) of export credit guarantee or insurance programmes, of insurance or guarantee programmes against increases in the cost of exported products or of exchange risk

⁷² Deborah E. Siegel, *Legal Aspects of the IMF/WTO Relationship: The Fund's Articles of Agreement and the WTO Agreements*, 96 A.J.I.L. 561, 596 (July 2002).

⁷³ See, e.g., Exhibit 5, Detailed Rule for Implementation of Regulation on Management Over the Verification of Export Collection of Foreign Exchange, Chinalawinfo Laws and Regulations, PRCLEG 1131 (promulgated June 22, 1998) (effective Aug. 1, 1998); Circular on Relevant Issues Concerning Submitting Tax Certificates for Sales of and Payment in Foreign Exchange Related to Non-Trade and Certain Capital Accounts Transactions, Chinalawinfo Laws and Regulations, PRCLEG 2329 (promulgated May 19, 2000) (effective May 19, 2000); and Regulations on the Sale and Purchase of and Payment in Foreign Exchange, Chinalawinfo Laws and Regulations, PRCLEG 526 (promulgated June 20, 1996) (effective July 1, 1996).

⁷⁴ Id.

programmes, at premium rates which are inadequate to cover the long-term operating costs and losses of the programmes.

As indicated above, China's currency-manipulation scheme relies heavily upon the Chinese government's direction of the state-owned banks' currency actions. While not explicitly identified as an exchange-risk program, this system controlled by the Chinese government clearly functions as one given the extreme nature of the exchange rate peg. As alluded to earlier, the financial contribution provided by China to its exporters is a total elimination of the need for, and the cost of, private exchange-risk programs. The indirect financial contribution created and supported by the foreign-exchange program clearly benefits Chinese exporters. The peg is so absolute and extreme in nature that Chinese exporters are completely relieved of costs they would otherwise be obligated to pay under any normal currency exchange regime. Exporters are relieved of all exchange risk by the Chinese government's rigid pegging and substantial undervaluation of the yuan vis-à-vis the U.S. dollar. This arrangement stands in stark contrast to the situation of exporters in other countries who either must pay for foreign-currency hedges and guarantees or run the risk of unprotected exchange losses. As explained above, other countries that maintain, or have maintained, pegged currencies have adjusted them when they have become unreasonable, untenable, or have caused severe adverse trade effects and so have imposed at least some level of currency risk on their exporters. This is untrue in China.

In assessing the benefit associated with this export subsidy, the proper focus is not on the label the Chinese government ascribes to its actions, but on the substance and nature of the benefit provided to Chinese exporters and their exports (which may be measured by the cost of this program to the Chinese government under item (j), in an unusual departure from the standard benefit-to-the-recipient approach). Chinese exporters who are not required to incur these costs receive a specific and an unfair prohibited export subsidy within the meaning of item (j) and the

SCM Agreement's articles as the result of China's undervalued exchange-rate regime that advantages China's export trade.

c. **China's Maintenance of An Undervalued Exchange-Rate Regime Also Violates China's WTO Obligations Concerning Agricultural Products**

In the course of the negotiations leading to China's becoming a Member of the World Trade Organization on December 11, 2001, China committed that, ". . .by the date of accession, China would not maintain or introduce any export subsidies on agricultural products."⁷⁵ With respect to its covered agricultural products,⁷⁶ therefore, China's undervalued exchange-rate regime is directly at odds with this unequivocal commitment by China not to maintain or introduce any export subsidies as of the entry into force of its accession agreement on December 11, 2001. This categorical commitment by China informs and governs China's obligations concerning export subsidies on agricultural products under Articles 3, 9 and 10 of the WTO Agreement on Agriculture. These provisions indicate that a Member State shall not provide subsidies in excess of those specified in that Member State's schedule of commitments.

The WTO Agriculture Agreement does not itself define what constitutes a "subsidy." It is well-established, however, that the definition of a "subsidy" in Article 1.1 of the SCM Agreement is applicable as well in the context of the Agriculture Agreement, so that in both settings a "subsidy" exists if there is a "financial contribution" that confers a "benefit" on the

⁷⁵ Report of the Working Party on the Accession of China, WT/ACC/CHN49 at 44 (para. 234) (Oct. 1, 2001).

⁷⁶ See China's Schedule of Concessions and Commitments on Goods (Schedule CLII), Annexed to China's WTO Protocol of Accession, WT/MIN(01)/3 (Nov. 10, 2001, WT/MIN(01)/3/Add.1 (Nov. 10, 2001).

recipient beyond what otherwise would have been available to the recipient in the marketplace.⁷⁷ It is also well-established that the requirement in Article 1(e) of the Agriculture Agreement that “export subsidies” be “contingent upon export performance” is to be understood identically to that same requirement in the SCM Agreement.⁷⁸

Thus, for the reasons set forth in Section III.A.2.b.iv above, China’s undervalued exchange-rate regime constitutes a prohibited export subsidy on its agricultural products sold to the United States. No less than non-agricultural products exported from China to the United States, Chinese agricultural products sent to the United States benefit from the financial contribution conferred by the Chinese government’s rigid undervaluation of the yuan, and that subsidy is contingent in fact upon export performance and so is specific. Taken together, China’s pegging of 8.28 yuan to the U.S. dollar and all of the various underlying activities by the Chinese government that affect that pegging are governmental action that play a critical part in encouraging and enabling Chinese exporters to sell their products abroad at heavily subsidized prices.⁷⁹ As such, China’s currency-manipulation program is an export subsidy that is contrary to China’s commitment to end export subsidies upon its accession to the WTO and prohibited by the Agriculture Agreement on exports from China to the United States of agricultural products.

⁷⁷ See, e.g., Appellate Body Report, Canada – Measures Affecting the Importation of Milk and the Exportation of Dairy Products, adopted Oct. 27, 1999, WT/DS103/AB/R, WT/DS113/AB/R, para. 87.

⁷⁸ See Appellate Body Report, United States – Tax Treatment of “Foreign Sales Corporations,” adopted Mar. 20, 2000, WT/DS108/AB/R, para. 141.

⁷⁹ See also Appellate Body Report, Canada – Measures Affecting the Importation of Milk and the Exportation of Dairy Products – Second Recourse to Article 21.5 of the DSU by New Zealand and the United States, adopted Jan. 17, 2003, WT/DS103/AB/RW2, WT/DS113/AB/RW2, paras. 145-146 (Canadian governmental action allowing the profitable export from Canada of milk at prices below the cost of production found to be an export subsidy under Article 9 of the Agriculture Agreement).

3. **China's Maintenance of An Undervalued Exchange-Rate Regime Violates Article XV:4 of the GATT**

a. **Background**

Article XV:4 of the GATT and its accompanying addendum state,

Contracting parties shall not, by exchange action, frustrate* the intent of the provisions of this Agreement, nor, by trade action, the intent of the provisions of the Articles of Agreement of the International Monetary Fund.

The word “frustrate” is intended to indicate, for example, that infringements of the letter of any Article of this Agreement by exchange action shall not be regarded as a violation of that Article if, in practice, there is no appreciable departure from the intent of the Article. Thus, a contracting party which, as part of its exchange control operated in accordance with the Articles of Agreement of the International Monetary Fund, requires payment to be received for its exports in its own currency or in the currency of one or more members of the International Monetary Fund will not thereby be deemed to contravene Article XI or Article XIII. Another example would be that of a contracting party which specifies on an import license the country from which the goods may be imported, for the purpose not of introducing any additional element of discrimination in its import licensing system but of enforcing permissible exchange controls.

While undervalued exchange-rate regimes like that of China have not been the subject of GATT/WTO challenges, previous deliberations on Article XV:4 give rise to relevant conclusions.

First, measures that are monetary in form but that have some effect on trade can be considered under the GATT's rules as far as the trade effect is concerned.⁸⁰

Second, even when a monetary measure such as a temporary import surcharge is regarded by the IMF as being necessary to stop a serious deterioration in a country's balance-of-payments

⁸⁰ See 1981 Report of the Committee on Balance-of-Payments Restrictions, Italian Deposit Requirement for Purchases of Foreign Currency, BOP/R/119, adopted Nov. 3, 1981, C/M/152.

position, that measure can be considered and treated under the GATT as an inappropriate, trade-restrictive measure and an undue burden upon the import account of the country imposing the surcharge with consequent serious effects on the trade of other Member States of the WTO.⁸¹

Third, as between Article XV:4 and Article XV:9 of the GATT, the question of their relationship has been left for empirical consideration if and when particular points arise that have a bearing on that relationship, and general principles about that relationship have not been laid down by the Member States. Issues in this regard can be pursued by means of dispute settlement under Article XXIII of the GATT, and Article XV:9(a) of the GATT does not preclude the Member States from discussing with a Member State the effects on other Member States' trade caused by exchange controls or restrictions maintained by that Member State.⁸²

Fourth, it is often quite difficult or impossible to define clearly whether a governmental measure is financial or trade in nature, and a given measure can be both.⁸³

Fifth, and lastly, analysis of a measure that is arguably both financial and trade in character entails a number of steps designed to ensure that the measure is not inconsistent with either the GATT or with the IMF's Articles of Agreement.⁸⁴ Thus, in the early 1950s, Greece instituted the levy of a special "contribution" on certain imported goods. Greece described this payment as "a charge imposed on foreign exchange allocated for the importation of goods from

⁸¹ See Report of the Working Party, United States Temporary Surcharge, adopted Sept. 16, 1971, BISD 18S/212, 222, para. 39.

⁸² Id. at para. 8. Article XV:9(a) of the GATT states that "{n}othing in this Agreement shall preclude: (a) the use by a contracting party of exchange controls or exchange restrictions in accordance with the Articles of Agreement of the International Monetary Fund or with that contracting party's special exchange agreement with the CONTRACTING PARTIES. . . ."

⁸³ See Report of the Special Sub-Group, Relations Between the GATT and the International Monetary Fund, adopted Mar. 2, 4, and 5, 1955, BISD 3S/170, 196, para. 2.

⁸⁴ See Panel Report, Special Import Taxes Instituted by Greece, adopted Nov. 3, 1952, BISD 1S/48 ("Greek Taxes").

abroad equivalent to a multiple currency practice” and designed to cover a widening gap between Greece’s official exchange rate and the effective purchasing power of the drachma.

The panel ultimately concluded that more information was needed to render a ruling on the merits, and the matter was resolved without further dispute settlement when Greece thereafter terminated the measure following devaluation of the drachma in April 1953. Prior to that point and in deferring further consideration, however, the panel outlined its train of thought as to how the matter subsequently should be evaluated. In particular, the panel remarked that (1) the principal question was whether the Greek tax was an internal tax or a charge on imported products under Article III:2 of the GATT, in which event the panel would decide if the tax was consistent with that provision; (2) on the other hand, if the charge were, as Greece contended, a tax on foreign exchange allocated for the payment of imports, the question for the IMF would be whether the measure constituted a multiple currency practice and was in conformity with the IMF’s Articles of Agreement, in which case the Greek charge would fall outside the scope of Article III of the GATT; and (3) even if the Greek measure was outside the ambit of Article III of the GATT, “. . . the further question might arise under Article XV:4 whether the action of the Greek Government constituted frustration by exchange action of the intent of the provisions of Article III of the General Agreement.”⁸⁵

In short, under the panel’s sound thinking in Greek Taxes, even if no other provision of the GATT is deemed to have been violated by a measure, and even if no provision of the IMF’s Articles of Agreement has been violated by that measure, that measure can still run afoul of Article XV:4 of the GATT if that measure is exchange action that “frustrates” the intent of the GATT’s provisions.

⁸⁵ See id. at paras. 5, 7, and 8.

b. **By Maintaining An Undervalued Exchange-Rate Regime, China Is Wrongly Frustrating the Intent of a Series of the GATT's Provisions**

To “frustrate” something is to prevent or thwart the attainment of a purpose or to nullify, defeat, or bring a goal to nothing. Within the legal framework described immediately above, China’s undervaluation of its yuan is “exchange action” under Article XV:4 that insidiously has been acting to frustrate the linchpins of the international trading system.⁸⁶

While the purpose of the GATT as a whole can be articulated in a variety of ways, perhaps the most powerful expression of its far-reaching aims is found in the Preamble to the Agreement Establishing the World Trade Organization. In pertinent part, that Preamble speaks of “. . . raising standards of living, ensuring full employment and a large and steadily growing volume of real and effective demand, and expanding the production of and trade in goods” The Preamble goes on to indicate that the Parties to the WTO’s Agreement are to contribute to these objectives “. . . by entering into reciprocal and mutually advantageous arrangements

⁸⁶ China’s undervaluation of the yuan can also be seen as “trade action” under Article XV:4 that frustrates the intent of the IMF’s Articles of Agreement. Under Article IV, Section 1(iii) of those Articles, for example, each member of the IMF shall “. . . avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members.” This general obligation is based upon the recognition that “. . . the essential purpose of the international monetary system is to provide a framework that facilitates the exchange of goods, services, and capital among countries, and that sustains sound economic growth, and that a principal objective is the continuing development of the orderly underlying conditions that are necessary for financial and economic stability” Even if the yuan’s undervaluation is not viewed in this light, however, this measure by China is one that is monetary in form and trade-restrictive in effect and consequently violative of Article XV:4 as “exchange action” that frustrates the intent of various provisions of the GATT. See 1981 Report of the Committee on Balance-of-Payments Restrictions, Italian Deposit Requirement for Purchases of Foreign Currency, BOP/R/119, adopted Nov. 3, 1981, C/M/152; and Report of the Working Party, United States Temporary Surcharge, adopted Sept. 16, 1971, BISD 18S/212, 222, para. 39.

directed to the substantial reduction of tariffs and other barriers to trade and to the elimination of discriminatory treatment in international trade relations”

China’s maintenance of an undervalued exchange-rate regime is “exchange action” that violates Article XV:4 by frustrating the intent of the GATT’s fundamental Articles that are meant to serve as the means to achieve the ends incorporated in the Preamble of the WTO’s Agreement. This frustration of the intent underlying the GATT’s provisions is apparent from different vantages, any one of which suffices to establish a violation of Article XV:4.

Under Article I of the GATT and the principle of most-favored-nation (“MFN”) status, imports by China from the United States are to be treated no less favorably than imports into China from any other Member State of the WTO. This principle of non-discrimination, however, is undercut by China’s undervalued exchange-rate regime. Whenever the U.S. dollar appreciates against the currency of a third country, the yuan automatically and comparably appreciates against that third currency, but not against the U.S. dollar, due to the strict pegging of the yuan to the U.S. dollar. As a result, the third country’s products become more attractively priced and competitive for export to China while U.S. products do not. Imports into China from the United States consequently are disadvantaged vis-à-vis imports from other countries and denied MFN treatment.

Under Article II of the GATT, China’s tariff bindings are not to be exceeded. China’s ad valorem customs duties, however, when applied to the inflated, yuan-denominated prices that result from China’s undervaluation of the yuan, yield similarly inflated amounts of yuan-denominated customs duties. In a perverse fashion, the weakening of the U.S. dollar means a commensurate weakening of the yuan and a corresponding increase in the amount of yuan-

denominated customs duties that the Chinese importer must pay. China's tariff bindings become unacceptably elastic and uncertain and effectively exceeded as a result.

Under Article III of the GATT, China is obligated not to apply to domestic or imported products any laws, regulations, and requirements that affect the internal sale, offering for sale, purchase, transportation, distribution or use of products so as to afford protection to domestic production. China's inflexible and extreme pegging of the yuan to the U.S. dollar and currency controls, however, negate or erode this non-discriminatory principle of national treatment by so inflating the yuan-denominated price of imports into China from the United States that U.S. products are either excessively or prohibitively expensive and Chinese-origin products are favored and protected.

Under Articles VI and XVI of the GATT, China has committed to abide by the principle that export subsidies are prohibited. The Chinese government's persistent undervaluation of the yuan as compared to the U.S. dollar, however, acts in fact to subsidize all products exported from China to the United States.

Under Article XI of the GATT, China is barred generally from imposing measures other than duties, taxes or other charges that prohibit or restrict imports into China of any product from the United States. China's undervaluation of the yuan, however, variously serves to prohibit and restrict imports into China of products from the United States by so increasing the yuan-denominated prices of U.S. products that Chinese importers either cannot afford to import the U.S. products at all or can only import lesser quantities of the U.S. products than would be the case were the yuan commercially valued realistically against the U.S. dollar.⁸⁷

⁸⁷ In connection with an early draft of Article XV, the link between Article XI's general prohibition against quantitative restrictions and Article XV's purpose of preventing exchange (...continued)

By way of recapitulating, therefore, by means of the expedient of manipulating its currency as it has, China dramatically has frustrated the intent of the GATT. This exchange action by China at once is undercutting all of the GATT's principal concepts that together have formed the backbone of the international trading system since the end of World War II. With reference to the addendum to Article XV:4, China's undervaluation of the yuan appreciably departs from the intent of the foregoing provisions of the GATT. In actuality, China's refusal to set a realistic rate based on market conditions or allow the yuan to seek its own market-driven balance against the U.S. dollar is a direct challenge to the GATT's principles with debilitating effects both for the United States and the global economy as a whole. China's undervaluation of the yuan violates Article XV:4 of the GATT.

B. China's Maintenance of An Undervalued Exchange-Rate Regime Is Unjustifiable and Burdens and Restricts U.S. Commerce By Violating China's Obligations Under the International Monetary Fund's Articles of Agreement

Section 301(a)(1) of the Trade Act requires the USTR to take mandatory action if "an act, policy, or practice of a foreign country -- . . . (ii) is unjustifiable and burdens or restricts United States commerce." Furthermore, under section 301(d)(4)(A), "An act, policy, or practice is unjustifiable if the act, policy, or practice is in violation of, or inconsistent with, the international legal rights of the United States."

(...continued)

arrangements or exchange action from frustrating the intent of the GATT's provisions was underscored. As explained by the U.S. delegate at a drafting session in 1946, Article XV's focus is that ". . . exchange restrictions will not be imposed on imports from other members. That corresponds to the basic provision that quantitative restrictions will not be used, the one being regarded as an alternative to the other." U.N. DOC. EPCT/C.II/PV.8, at 5 (1946). See also Art. XV:5, which states that the Member States shall report to the IMF if, at any time, they consider that exchange restrictions on payments and transfers as to imports are being applied by any Member State in a manner inconsistent with the GATT's exceptions for quantitative restrictions.

China's policy of maintaining an undervalued exchange-rate regime is a violation of its obligations under the IMF's Articles of Agreement. In 1980, China assumed Taiwan's seat in the IMF and received one seat on the Board of Executive Directors. In 1996, two years after China had unified and realigned its exchange rate, China removed exchange restrictions on its current-account transactions by accepting Article VIII of the IMF's Articles of Agreement. Since 1996, China has maintained its exchange rate at 8.28 yuan per dollar which, as explained in Section II above, constitutes a severely and persistently undervalued exchange rate and an extreme case of currency manipulation. China's policy of maintaining an undervalued exchange-rate regime violates its obligations under Articles IV and VIII of the IMF's Articles of Agreement.

Article IV requires that each IMF member shall: "(iii) avoid manipulating exchange rates or the international monetary system in order to . . . gain an unfair competitive advantage over other members." First, China's fixed exchange-rate system requires that it intervene in every export transaction in order to maintain the fixed exchange rate, constituting manipulation. In addition, China has instituted capital controls further to enforce the fixed-exchange mechanism. Evidence of the magnitude of the practice is the accumulation of foreign-exchange reserves, which have grown to \$483 billion (as of end-July 2004), about a third of China's gross domestic product. Second, China's policy of maintaining an undervalued exchange rate has given China and particularly China's exports an unfair competitive advantage in trade with the United States and other members of the IMF. China's undervalued exchange-rate policy subsidizes China's exports to the United States and other countries and denies the United States and other countries equal treatment as provided for under Articles I and III of the GATT. China's undervalued exchange rate system causes prices of U.S. products in the Chinese market to be higher than

what would prevail under market conditions and causes prices of China's products to be lower in the U.S. market than what would prevail under market-determined exchange rates. This subsidized practice gives China's products a competitive advantage when competing with U.S. products in the Chinese marketplace, in the United States and in third-country markets, contrary to the obligations under the IMF's Article IV, section 1 (iii).

China's policy of maintaining an undervalued exchange-rate system also violates the IMF's Article IV, section 1(ii), which states that each member of the IMF shall "(ii) seek to promote stability by fostering orderly underlying economic and financial conditions and a monetary system that does not tend to produce erratic disruptions."

China's policy of maintaining an undervalued exchange-rate system is creating financial instability that will eventually disrupt global financial markets unless China appreciates its currency in line with underlying economic fundamentals. The threat to the international financial system is exacerbated by the size of China's economy, China's volume of global trade and foreign direct investment in China. China's accelerating accumulation of foreign-exchange reserves is generating disequilibrium in the international financial system, will tend to create inflation and over-investment in China, and will lead to the conditions for another international financial crisis.

As described in detail in Exhibit 1, under its fixed-exchange-rate system with tight capital controls, China has sacrificed its fuller integration into the world economy in favor of exchange-rate stability and monetary independence. The inappropriateness of this exchange-rate regime is perhaps best illustrated by the enormous lengths to which the Chinese government must extend its interference in the market in order to achieve these monetary policy goals. Moreover, China's

adherence to these goals -- no matter what their cost or how superficially they are achieved -- is even more revealing.

The type of closely controlled exchange regime employed by China ordinarily is confined to countries with relatively minor and/or balanced trade and investment flows with the rest of the world. This situation is due to the fact that large and imbalanced flows can quickly overwhelm such a closely-controlled system, although this danger has yet to prove a deterrent to China. In its dogged pursuit of exchange-rate undervaluation and stability, the Chinese government has had to intervene to purchase ever-greater volumes of foreign exchange (especially U.S. dollars) each year. Nevertheless, while these purchases have succeeded in keeping the yuan's value stable against the U.S. dollar, they completely run counter to the trend in the rest of the world, where the U.S. dollar generally has fallen significantly in value. Thus, when the U.S. dollar fluctuates against other foreign currencies, China's achievement of exchange-rate stability with the U.S. dollar directly undermines achievement of exchange-rate stability with respect to all other currencies which float against the U.S. dollar. In other words, the actual exchange-rate stability achieved is limited to the U.S. dollar. By virtue of achieving stability with the U.S. dollar, China faces potentially less stability with respect to other currencies.

The other policy goal of monetary independence likewise is undermined by China's maintaining a fixed exchange rate in the face of such large imbalances in its trade and investment flows. As discussed generally in Section II and Exhibit 1, rather than permit the yuan to increase in value, the Chinese government has chosen instead to offer any amount of yuan needed to absorb any supply of foreign currency. Consequently, as shown in the table below, as larger and larger foreign-currency surpluses have flowed into the Chinese market, the Chinese government has had to flood the market with more and more yuan. Thus, if China wishes to maintain

exchange-rate stability in the face of such foreign-currency inflows, it does so at the cost of its control over its domestic money supply. Along with this rapid growth in the money supply, however, there is increasing evidence that the Chinese government has fostered a speculative over-investment boom and the foundation for much higher inflation in the future. If not corrected, these trends will coalesce in an unstable bubble that, due to the size of China’s economy and volume of trade, will adversely affect international trade and financial markets, contrary to the obligations in the IMF’s Article IV, section 1 (ii).

**Money Supply
(Billion Yuan)**

	2000	2001	2002	2003
Money	5,454	6,168	7,266	8,645
% increase	--	13.1%	17.8%	19.0%
Quasi Money	8,142	9,472	11,412	13,710
% increase	--	16.3%	20.5%	20.1%

Source: IMF: International Financial Statistics

China’s policy of maintaining an undervalued exchange-rate regime also violates the IMF’s Article VIII, section 3, which states:

No member shall engage in, or permit any of its fiscal agencies referred to in Article V, Section 1 to engage in any discriminatory currency arrangements or multiple currency practices, whether within or outside margins under Article IV or prescribed by or under Schedule C, except as authorized under this Agreement or approved by the Fund.

As previously discussed, China’s undervalued exchange-rate policy discriminates against U.S. exports of goods and services. By maintaining an undervalued exchange rate for the yuan against the U.S. dollar, China discriminates against U.S. products to China’s benefit. Prices of Chinese goods and services in the U.S. market are lower than what would prevail under an exchange rate that reflected underlying economic fundamentals. Conversely, the prices for U.S.

products in China are higher than what would prevail with an exchange rate that reflected underlying economic fundamentals. In addition, the fixed undervalued exchange rate discriminates against other IMF countries. As the U.S. dollar depreciates against other currencies, the exchange rate with China does not change, and the advantage that China has through its undervalued exchange rate remains the same. Other currencies adjust simultaneously to the yuan and the U.S. dollar because the exchange rate is fixed, but those currency adjustments must be greater than what would be required under market conditions because the yuan is undervalued and unable to appreciate against the dollar.

While China's undervalued exchange rate clearly discriminates against the United States and other IMF members, as the results of the recent Article IV consultations attest, this discriminatory currency practice has not been authorized by the Fund. The Article IV consultations that were made public in 2000 concluded, "... Directors suggested that the authorities move ahead gradually with a more flexible implementation of the current arrangements, involving the widening of the trading band around a reference rate based on a basket of currencies."

Since that review, China has not implemented either expanded flexibility through increases in the trading band or adopted a basket of currencies as a reference rate. In short, the yuan has shown no flexibility since that review, and China's foreign-exchange reserves have continued to accelerate to about \$483 billion (as of end-July 2004), or a third of China's GDP.

Once again, in the IMF Article IV consultations made public in 2003, Executive Directors have urged China to adopt greater flexibility in its exchange-rate regime.⁸⁸

Directors considered that the rapid build-up of foreign exchange reserves indicates some pressure on the exchange rate and imposes costs on the Chinese economy, especially difficulties in preventing excessive monetary expansion. In this context, Directors observed that increased flexibility of the exchange rate over time would be in the best interest of China. In particular, it would allow more room to pursue an independent monetary policy, help cushion China's economy against adverse shocks, and facilitate adjustment to the major structural reforms that are underway. Directors considered that China could, in a phased manner, introduce more flexibility to its exchange rate without causing major disruptions to its economy. Most Directors stressed that a move toward flexibility should be carefully planned and sequenced with ongoing structural reforms that are crucial to its success, and emphasized the need to move speedily with these reforms.

In short, Executive Directors have recommended in the last two reviews that China introduce greater flexibility into its exchange-rate regime. All Directors have believed that China's undervalued fixed-exchange-rate regime imposes significant costs on China's economy,

⁸⁸ In the 2003 Article IV consultations, there apparently was some confusion over the extent of the undervaluation of China's yuan. According to the report:

Most Directors noted that there is no clear evidence that the renminbi is substantially undervalued at this juncture. Directors also felt that a currency revaluation would not by itself have a major impact on global current account imbalances -- particularly given China's relatively small share in world trade.

The confusion over the degree of undervaluation is related to the underlying data. The fundamental conclusion of the Executive Directors was based on China's own foreign trade data, which substantially underestimate China's bilateral and global trade surplus. As set forth in Section II.D, when China's imports and exports are calculated on the basis of data from China's trading partners, China shows a global trade surplus over \$100 billion more annually than what China calculates. Had the Executive Directors considered China's actual trade surplus, a conclusion of substantial undervaluation would have been evident. Given that China has not been more forthcoming in introducing flexibility into its exchange-rate regime, Executive Directors apparently have begun to become more vocal in their opposition to China's undervalued fixed-exchange-rate regime and its impact on global trade and finance.

particularly greater risks associated with monetary expansion, thus urging greater flexibility. That China has shown no flexibility indicates that China has continued to be in violation of its obligations to the IMF under Article VIII of the IMF's Articles of Agreement.

C. Summary

China's undervaluation of the yuan vis-à-vis the U.S. dollar violates basic and essential principles and provisions of the World Trade Organization and its agreements as well as vital obligations of China under the IMF's Articles of Agreement. China's manipulation of its currency and the magnitude of the adverse consequences flowing from China's behavior for the United States and the global economy are unprecedented and should not be tolerated.

By the expedient of the yuan's severe undervaluation, the Chinese government is doing great harm to the WTO's rules-based system and also to the international monetary system. On the one hand, as this section emphasizes, the yuan's undervaluation comprehensively subsidizes all of China's exports. On the other hand, the yuan's undervaluation – as a practical matter – variously acts as a tax, added import duty, and effectively as a quantitative restriction on imports into China. These far-reaching effects of the yuan's undervaluation at a minimum frustrate the GATT's basic intention of opening markets. Indeed, China's utter refusal to eliminate this undervaluation immediately and the large-scale and harmful consequences of this intransigence for the global economy present issues of first impression that Articles I, II, III, and XI of the GATT are being violated. These problems are addressed in the Attachment to this petition.

If China's accession to the WTO in December 2001 is to be a constructive step, it is imperative that China – as the major trading country that it is – honor its obligations. Under 19 U.S.C. § 2411(a), therefore, the China Currency Coalition urges that mandatory action be taken to enforce the international legal rights owed by China to the United States.

IV. CHINA'S POLICY OF AN UNDERVALUED YUAN IS HAVING A DEVASTATING EFFECT ON U.S. PRODUCTION

A. Overview

China's exchange-rate policy effectively pegs its currency solely to the U.S. dollar regardless of the underlying economic fundamentals or relative competitive conditions between the two countries. As explained in detail in Exhibit 1, the other countries joining China in employing such an exchange-rate regime are predominantly very minor economies in the Caribbean, Middle East and Africa, none of which is a major exporter to the United States or to the rest of the world. By virtue of their small size, these economies simply are not capable of materially distorting global trading patterns, regardless of the exchange-rate fluctuations that might occur absent such regimes.

The same cannot be said of China, as recognized directly by the Administration, which has already called on China to allow at least some fluctuation in its exchange rate or, better yet, to move to a floating regime along with the other major trading nations whose ranks China now has joined.

Instead, China has held steadfastly to its fixed-rate regime in the face of soaring trade surpluses and foreign-direct-investment inflows. Moreover, it is no accident that the United States – the country to whose currency China has pegged the yuan – has been the primary source of these trade surpluses and foreign-direct-investment inflows. As discussed above, the end result of the trade between the United States and China is a massive oversupply of U.S. dollars and undersupply of yuan that normally would cause the yuan to rise in value vis-à-vis the U.S. dollar. In order to prevent an appreciation of its currency, the Chinese government must squelch market forces on each side of the trading relationship by absorbing the excess U.S. dollars (which are increasingly recycled into U.S. governmental debt for lack of other uses given the

magnitude of the surfeit), while simultaneously flooding the Chinese market with undersupplied yuan.

Two obvious questions beg to be asked regarding the consequences of China's strategy. Why is the Chinese government so willing to accumulate huge surpluses of U.S. dollars when interest rates on U.S. dollar-denominated assets are at generational lows and far below comparable interest rates in China? And, similarly, why is the Chinese government willing to risk inflation and overheating its economy (by expanding its money supply in order to absorb the excess foreign currency), as well as increasingly to orchestrate banking activity in the country, rather than simply let the value of the yuan mediate these forces and imbalances? While the answers to these questions are complex and multi-dimensional, they all clearly revolve around the exchange rate of the yuan. Clearly, if permitting the exchange rate to fluctuate would resolve many of these issues for China, then its steadfast refusal to permit any meaningful change in the exchange rate must confer some benefit. Given the trade imbalances that have resulted under the fixed exchange rate, it is likewise clear that one of the primary benefits to China is a compelling competitive advantage in trade with the United States.

China's artificially-maintained competitive advantage in trade with the United States translates into a de facto competitive disadvantage for the United States and its businesses competing with China, whether in the United States, in China, or in third-country markets. This competitive disadvantage has grown steadily more oppressive for U.S. businesses in recent years as relative economic conditions have changed not only in the United States and China, but also in the rest of the world. The widespread and significant decline in the value of the U.S. dollar against the major foreign currencies since the end of 2001 is perhaps the best single indicator of these changes. Since that time, the U.S. dollar has declined by 20 percent (as of August 2004)

against the currencies of its major trading partners (excluding China).⁸⁹ Although China is a major trading partner of the United States, its currency has remained virtually unchanged in value versus the U.S. dollar over that same period of time. Thus, under current economic conditions, the longstanding undervaluation of the yuan has become indisputable and injurious, as manifest so clearly in the United States' trade deficit with China, which has not only reached historic proportions, but continues to grow rapidly.

The Chinese government's ever-expanding exertions to foster and maintain its significantly undervalued exchange rate effectively preclude any competitive advantage that would otherwise be gained by U.S. commercial interests from such a sustained and substantial decline in the value of the U.S. dollar elsewhere in the world, as economic conditions and the sheer size of the trade deficit with China also warrant. The result for U.S. commerce vis-à-vis any individual Chinese good in any market in the world is the inability to gain competitive cost or price traction against Chinese products. In effect, the undervalued yuan prevents U.S. producers from regaining levels of output and sales appropriate to current global economic conditions, as well as the unit-cost declines that typically accompany expanded output.

Moreover, U.S. producers consequently do not benefit from the restoration of profits that greater cost-competitiveness should bring. Those U.S. producers whose market is primarily or exclusively domestic have seen imports from China more than triple since the introduction of the pegged-exchange rate. Nor can U.S. companies rely on growth in export markets, in particular to fast-growing China, as any exchange-rate declines in U.S. export prices are instantaneously matched by corresponding declines in Chinese export prices. With U.S. businesses facing

⁸⁹ Federal Reserve Statistical Release H.10, Foreign Exchange Rates – Broad Index. The broad index is a weighted average of the foreign exchange values of the U.S. dollar against the currencies of a large group of major U.S. trading partners.

greater Chinese competition at home and abroad across a widening spectrum of goods, U.S. commerce increasingly will be burdened and restricted by the Chinese government's currency policy if left unaddressed by the U.S. government.

The dangers to the international trading and financial system cannot be underestimated. History provides a recent, valuable lesson on the dangers of China's currency practices and calls for immediate action. According to economists,⁹⁰ China's devaluation of the yuan in the early 1990s had a significantly adverse economic effect on the economies of Southeast Asia and, by extension, the rest of the world. The Asian Financial Crisis, according to Surjit S. Bhalla,⁹¹

. . . occurred because of over-investment and over production; such over production was caused by planning for a future which had not correctly anticipated the important role that Chinese production, and low Chinese cost, would play; comparative costs became important because of the 50 percent Chinese devaluation (in the guise of exchange rate reform) that was allowed to occur between 1990 and 1993; capital continued to flow to East Asia because of the promise of high returns (bad anticipation of China's role) and because of the promise of stable returns (quasi-fixed exchange rate). Once the trade shares of the East Asian economies were affected, investments became relatively unprofitable; and once Thailand showed the way, the other East Asian competitors of China followed.

China's maintenance of an undervalued exchange-rate regime is creating the same imbalances in trade and over-investment that occurred in the early- to mid-1990s, which culminated in the Asian Financial Crisis. China's unwillingness to address these imbalances meaningfully threatens the international trading and financial system with a similar crisis. Unlike the last Asian Financial Crisis, a new, China-led crisis is likely to have a far greater

⁹⁰ C. Fred Bergsten, "The Asian Monetary Crisis: Proposed Remedies," prepared remarks to the U.S. House of Representatives, Committee on Banking and Financial Services, November 13, 1997; John H. Makin, "The New Paradigms," American Enterprise Institute (October 1997).

⁹¹ Surjit S. Bhalla, Chinese Mercantilism: Currency Wars and How the East Was Lost, Indian Council for Research on International Economic Relations (July 1998).

impact on the United States given the extent of the greatly-expanded trading and investment relationships between the two countries, the pegging of the undervalued yuan to the U.S. dollar, and the already strained economic and fiscal conditions now prevailing in the United States. It is even less certain to what extent many U.S. businesses could withstand such an exogenous shock on top of the burdens they already face.

B. Both U.S. Imports From China and the U.S. Trade Deficit With China Are Soaring

Since 2001, U.S. consumption of manufactured goods grew by only three percent, while U.S. imports of manufactured goods from the entire world except for China rose proportionally, increasing by a moderate 4 percent. In marked contrast, U.S. imports of manufactured goods from China skyrocketed by 49 percent in the same time period – a remarkable performance considering that China was already the fourth leading foreign supplier to the United States of manufactured goods at the start of the period, behind only Canada, Japan and Mexico. By the end of 2003, China trailed only Canada among the leading suppliers of imported manufactured goods to the United States.

In fact, the growth in U.S. imports from China was so rapid in relation to the rest of the world that it accounted for 56 percent of the total growth in U.S. imports of manufactured goods between 2001 and 2003. In other words, the increased volumes from China alone exceeded the increase in volumes from every other country in the world combined. The impact of the increased U.S. imports from China on U.S. businesses has been the subject of much debate in the course of discussing recent trends in trade between the two countries. As this debate has unfolded it has tended to become more polarized, with some observers asserting that China's gains have come predominantly at the expense of U.S. manufacturers, while others assert that China's gains have come predominantly at the expense of other foreign suppliers. As the

analysis in this section demonstrates, however, U.S. manufacturers have borne the brunt of China's gains in the U.S. market, not only because it is the most important market for U.S. manufacturers (who therefore have the most to lose here), but also because, unlike foreign producers, U.S. manufacturers are denied any competitive exchange-rate adjustments vis-à-vis China in the U.S. market.

As noted above, the overall U.S. trade deficit with China is the largest bilateral imbalance ever seen in the history of world trade. China alone has accounted for fully 40 percent of the increase in the overall U.S. trade deficit in manufactured goods since 2001. More specifically, the overall U.S. merchandise trade deficit with China was \$125 billion in 2003, up from \$103 billion in 2002. The trade deficit with China in manufactured goods was even larger, at \$128 billion. In short, despite strong growth in U.S. exports of manufactured products and all merchandise to China (up 49 percent between 2001 and 2003), the much larger volumes and similar growth rate in corresponding U.S. imports from China have caused the trade deficit to soar. By the end of 2003, both import volumes from China and the trade deficit with China were so large that even a significant slowing in the future growth in imports from China will be insufficient to cause a material change in the U.S. trade deficit with China, as explained further below.⁹²

⁹² To illustrate this point more clearly, the total value of U.S. merchandise imports from China was 5.7 times higher than corresponding U.S. merchandise exports to China in 2003. For manufactured goods only, U.S. imports from China were a stunning 9.5 times higher than corresponding U.S. exports to China. Stated differently, this means that the United States imports more manufactured goods from China in 6 weeks than it ships to China in an entire year.

C. **If Recent Trends Continue, the U.S. Trade Deficit With China Will More Than Double in Five Years**

Since China pegged its currency to the U.S. dollar in 1994, U.S. imports from China have increased at an average annual rate of 17 percent, while corresponding U.S. exports to China have increased at an annual average rate of 13 percent. Like all compounded values, even small differences in growth rates over time will produce large differences in final values, particularly if, as in the case of trade between the United States and China, there are large differences in the starting values. Consequently, a seemingly modest difference in relative growth rates has nonetheless produced a yawning gap between total U.S. imports from China, which reached \$152 billion in 2003, and total U.S. exports to China, which reached only \$28 billion in 2003. If historical growth rates continue for just five more years, the U.S. trade deficit with China will more than double to \$283 billion by the end of 2008.⁹³

⁹³ By 2008, U.S. imports from China will increase to \$332 billion, while U.S. exports to China will increase to \$49 billion, if they both respectively maintain their historical annual average growth rates shown. As a result, the U.S. trade deficit to China will increase to \$283 billion, or more than twice its current level.

Possible Trends in the U.S.-China Trade Deficit in the Next 5 Years (\$ billions)
Have We Reached the Point of No Return?

Alternative Growth Scenarios for U.S. Imports	Alternative Growth Scenarios for U.S. Exports			
	8% <i>(Slower growth)</i>	13% <i>(Historical average growth)</i>	18% <i>(Faster growth)</i>	30% <i>(2003 actual growth)</i>
22% <i>(2003 actual growth)</i>	(\$371)	(\$361)	(\$349)	(\$311)
17% <i>(Historical average growth)</i>	(\$293)	(\$283)	(\$271)	(\$233)
12% <i>(Slower growth)</i>	(\$228)	(\$218)	(\$206)	(\$168)
3% <i>(Slower growth)</i>	(\$137)	(\$127)	(\$115)	(\$77)

As the volumes of both U.S. imports from China and U.S. exports to China increase, and as the trading relationship between the countries matures further, it is possible that future growth rates will diverge from their respective 10-year historical averages. For example, in 2003, both U.S. imports and U.S. exports with China grew significantly more quickly than their respective 10-year averages. Due to the differences in the sheer volume of the trade flows, however, even if U.S. exports continue growing at the accelerated pace evident in 2003, while U.S. imports merely maintain their historical growth rate, the U.S. trade deficit will continue to expand. As shown in the table above, this relatively optimistic scenario results in an increase of more than \$100 billion in the trade deficit to \$233 billion in five years.⁹⁴

⁹⁴ Notably, this is exactly the scenario that has unfolded to date in 2004 (through June) according to official U.S. trade statistics recently reported by the U.S. International Trade Commission. (...continued)

Moreover, should U.S. export growth return to its still robust historical average of 13 percent over the next five years, U.S. import growth from China will have to plummet to just 3 percent in order to keep the annual deficit where it currently stands at around \$125 billion. As clearly depicted in the table, any expectations that continued strong U.S. export growth will halt or even reverse the growing trade deficit with China likely will prove to be badly mistaken absent a significant slowing in import growth due to the sheer magnitude in the volume of imports from China. As noted above in Section IV.C, although U.S. export growth to China continued to accelerate through the first half of 2004, the U.S. trade deficit with China is on track to deteriorate further to nearly \$160 billion by year-end 2004.

The central question is how to slow imports from China without resorting to measures that would violate global trade rules and without potentially endangering the comparatively small but still important inroads the United States has made in the Chinese market. While U.S. businesses expect China's market to become even more important, current trends are leading to a tipping point where the much-awaited potential of the Chinese market will be dwarfed, perhaps permanently, by the heavy losses already sustained by U.S. companies and workers in the U.S. domestic market. The longer the Chinese government is permitted to continue to manipulate its trade relationship with the United States, these data make clear that the costs and risks for the United States will increase commensurately.

(...continued)

Both U.S. exports to China (up 37 percent) and U.S. imports from China (up 29 percent) increased faster than their respective historical rates of growth. Despite the significantly faster growth in U.S. exports, however, the U.S. trade deficit with China *increased* by 27 percent to \$69 billion for the first six months of 2004.

D. U.S. Production Is Being Displaced By U.S. Imports From China

While the above figures are indisputable, some observers discount the effect of U.S. imports from China on the U.S. domestic manufacturing base despite their sustained and meteoric rise. This alternative view centers on allegations that increased imports from China merely displace imports from other low-wage countries rather than U.S. domestic production, essentially leaving U.S. domestic output and employment unaffected. Fundamentally, increased U.S. imports from China can only come at the expense of three potential sources, as follows:

- (1) directly from U.S. production, if the overall market is flat or declining;
- (2) directly from other foreign production, if the overall market is flat or declining;
and,
- (3) indirectly from U.S. and/or foreign production, if the overall market is growing.

At the outset, the salient point is that, regardless of whether China's gains come at the expense of existing domestic or foreign production, or due to an expansion in the overall market, all such gains represent some mix of actual and potential losses to U.S. domestic production. While the direct losses to U.S. domestic production illustrate this most emphatically, the fact is that increased imports from China could also displace domestic production that otherwise would have gained share from other foreign production (particularly from countries whose currencies have appreciated significantly vis-à-vis the U.S. dollar), or from an expansion in the market.

Nevertheless, despite compelling and wide-ranging evidence to the contrary, some observers highlight the fact that China's share of total U.S. imports has increased, while other countries' shares of total U.S. imports have fallen. These observers take these trends as evidence that China's gains in the U.S. market have come significantly, or even largely, at the expense of

other foreign production rather than from U.S. domestic production.⁹⁵ Mere comparisons of relative import market shares, however, are not meaningful, because all countries' shares must, by definition, total 100 percent. As U.S. imports from China rise more rapidly than U.S. imports from other countries, mathematically China's share of total imports must rise, while other countries' collective share must fall because the total import market, regardless of its absolute size, will always equal 100 percent.

Additionally, some observers conclude that exports to the United States from China must have displaced exports from other Asian countries, rather than U.S. production, based on evidence that U.S. imports from China have risen while overall imports from Asia have remained largely stagnant. As an initial matter, the difficulty with this view is that there is no à priori reason why imports should be increasing more quickly than U.S. production, particularly during a period when U.S. economic growth slowed and the U.S. dollar declined significantly in value. Indeed, as noted above, total U.S. imports of manufactured goods rose by only 4 percent over the past two years – a rate closely comparable to the 3 percent increase in overall U.S. consumption of manufactured goods during that period. Why did U.S. imports from China grow so much more quickly than those from other countries, including countries whose wages are as low as, or even lower than, China's? Unfair trading conditions driven by China's undervalued currency

⁹⁵ Coincident with the very rapid and massive increase in U.S. imports from China that is entirely concentrated in manufacturing goods, U.S. manufacturing employment suffered unprecedented erosion. From August 2000 through February 2004, manufacturing employment declined for 43 consecutive months before the streak finally was broken in March 2004, according to the U.S. Bureau of Labor Statistics. Over the course of the uninterrupted decline, more than three million U.S. manufacturing jobs were lost (most by production workers), leaving U.S. manufacturing employment at its lowest levels since 1950. While there were multiple causes for this decline in employment, it is difficult to see how an unprecedented rise in manufactured imports and an unprecedented decline in domestic manufacturing employment can be argued to be only loosely related or even unrelated.

must be a primary factor, particularly given that China's export prices in yuan have fallen by nearly 30 percent since 1995, aided by an exchange-rate regime that was not permitted to function and balance the shift in relative prices between the U.S. and Chinese markets.

The table below summarizes China's actual trade performance in the United States compared with China's primary lower-wage Asian competitors (i.e., India, Malaysia, Thailand, Singapore, Korea and Taiwan) in the 2001-2003 period. As an initial matter, the data show that total U.S. imports from these other Asian countries collectively increased by 5 percent or by more than \$6 billion, while those from China surged by 49 percent or by nearly \$50 billion in the period. Thus, there is no factual basis for claims or arguments that U.S. imports from other Asian countries competing with China have declined or remained stagnant. As shown, U.S. imports from these countries have not only increased, but also have done so despite generally appreciating currencies in the region versus the U.S. dollar over the period.

Moreover, when the increase in U.S. imports from China is viewed in the context of the typical U.S. import volume from these other countries, it becomes even clearer that any purported reduction in U.S. imports from these countries at the hand of Chinese suppliers during this period was modest at best. As shown, total U.S. imports from these other countries were \$130 billion in annual 2001. In comparison to the \$50-billion increase in U.S. imports from China, therefore, the existing import volume from these other countries simply is not large enough to have possibly explained a significant part of China's increase.

The only way a displacement argument can be defended in light of these data is if it is further assumed that imports from these other countries would have increased substantially more than they actually did. Such an assumption runs counter to prevailing economic conditions during the period, which included a sharp contraction in technology-related production and a

sustained depreciation in the U.S. dollar, despite which imports from these countries still managed to increase significantly. Without the benefit of such a strained assumption, therefore, the data more strongly support the line of reasoning that U.S. domestic production has suffered much greater displacement from the increase in imports from China than is the case for China's other Asian competitors.

Comparison of China's U.S. Trade Performance with Other Asian Countries

Country	Exchange Rates <i>(foreign currency per U.S. dollar)</i>			U.S. Imports <i>(millions of U.S. dollars)</i>		
	Dec 2001	Dec 2003	Chg vs USD	Annual 2001	Annual 2003	Pct Chg
China	8.2766	8.2767	0.00%	\$ 102,069	\$ 151,620	49%
India	48.27	45.55	5.63%	\$ 9,708	\$ 13,034	34%
Malaysia	3.80	3.80	0.00%	\$ 22,228	\$ 25,321	14%
Taiwan	35.00	33.99	2.89%	\$ 33,262	\$ 31,490	-5%
Singapore	1.85	1.70	8.01%	\$ 14,899	\$ 14,291	-4%
Korea	1,313.50	1,192.00	9.25%	\$ 34,917	\$ 36,930	6%
Thailand	44.24	39.63	10.42%	\$ 14,672	\$ 15,075	3%
Subtotal	NA	NA	NA	\$ 129,686	\$ 136,141	5%

While examining relative import market shares or comparing absolute levels of U.S. imports from among different countries provides a rough estimation of the extent to which increased imports from China have displaced U.S. production or imports from other countries, the true displacement effect of imports from China can be determined more precisely by examining import volumes in relation to corresponding domestic production and apparent consumption and identifying changes in import penetration as a proxy for the displacement effect. Sectoral data on U.S. shipments, imports and exports of manufactured goods published

by the U.S. Census Bureau permit a comprehensive analysis of import penetration using the maximum level of industry detail available. The analysis examines U.S. imports of manufactured goods from China and from the rest of the world and relates them to domestic U.S. manufactured goods production and apparent consumption⁹⁶ on a sector-by-sector basis from annual 2000 to annual 2003.

This analysis provides further confirmation that while a significant amount of China's rising sales to the U.S. market appears to have displaced other imports, a much greater portion of the increase appears to have displaced domestic U.S. producer share of the U.S. market. In order to distinguish between China's displacement of domestic U.S. producer share and China's displacement of imports from other countries, the analysis focuses first on the overall import penetration in the U.S. market. For each of the 58 discrete durable and non-durable goods sectors analyzed, if China's import penetration increased while overall import penetration remained flat over the period, then the increased imports from China were assumed to displace only imports from other countries, leaving no net displacement of domestic U.S. producer share. Conversely, if overall import penetration increased as much as or by more than China's import penetration, then the increased imports from China were assumed to displace only domestic U.S. producer share, leaving no net displacement of imports from other countries.

The analysis concludes that 60 percent of the total increase in U.S. imports from China over the period led to increases in China's share of the U.S. market that came at the expense of the market shares of domestic producers. The remaining 40 percent of the increase in U.S. imports from China, while likewise increasing China's share of the U.S. market, was not

⁹⁶ Apparent consumption is derived by adding domestic production and U.S. imports, then deducting U.S. exports, because exports are included in domestic production but not consumed in the United States.

accompanied by an overall increase in import penetration and, therefore, was assumed to have come at the expense of the market shares of other foreign producers rather than the market shares of U.S. domestic producers.⁹⁷

As explained in the preceding footnote, the 60-percent share of total U.S. imports from China that was found to displace U.S. domestic producers' market share in the United States translated into a \$31 billion gain for China's producers. To put the value of this displacement in perspective, it should be considered that total U.S. manufacturers' shipments fell by \$209 billion between 2000 and 2003. China's displacement of U.S. domestic producers' share thus is equivalent to almost 15 percent of the overall decline in U.S. manufacturers' shipments over this period.

E. Cost Pressure on U.S. Manufacturers Due to Imports Into the United States From China

China's extremely low prices, aided in significant part by the undervalued yuan, are putting tremendous pressure on domestic firms by undercutting their pricing power. As U.S. production and especially non-production costs (such as medical-care costs, litigation costs, etc.)

⁹⁷ U.S. government data disaggregate current manufacturing production into 58 categories or sectors. The analysis examines each category to determine that China's overall market share of U.S. manufactured goods consumption increased by 1.1 percentage points over the period analyzed. Given that the total U.S. market for manufactured goods was \$4.5 trillion in 2003 (based on U.S. manufacturers' shipment data, rather than value-added), the increase in China's overall market share translates into a \$50 billion increase in China's sales to the U.S. market.

This 1.1-percent increase in market share pertains to all sales of Chinese goods in the U.S. market, whether they displaced domestic production or imports from other countries. The portion of this market-share increase that appears to have displaced domestic production (*i.e.*, not offset by declines in market share from other countries) equals 0.7 percent of U.S. consumption of manufactured goods, or about \$31 billion. The balance of China's overall market-share gains, or 0.4 percent of U.S. consumption of manufactured goods, appears to have displaced other foreign production rather than U.S. production (*i.e.*, was offset by declines in market share from other countries). Thus, between 2000 and 2003, approximately 60 percent of China's increased import penetration appears to have displaced U.S. production, while the balance appears to have displaced imports from other countries.

rise, U.S. companies find they are unable to pass these costs on to their customers, in large part because of intense price suppression in the U.S. market by China's exporters. Consequently, many U.S. firms are unable even to cover their costs, let alone make a sufficient profit to sustain investments needed to improve competitiveness and remain in business. As a result, increasing numbers of companies are considering temporary or permanent closures, or shifting production abroad – perhaps to China – as the only way to survive under these hyper-competitive conditions caused in significant part by China's artificial currency advantages. This loss of flexibility is another cost that the U.S. industry suffers due to China's currency regime and one that is often overlooked because it is either difficult or controversial to quantify.

F. U.S. Exports to China Are Falling Behind

China's currency policies are also affecting U.S. exports, because the yuan's undervaluation affects the prices of U.S. goods in yuan in China's market. This point is often lost in observations that U.S. exports to China rose by a seemingly strong 28 percent in 2003, which was considerably faster than overall U.S. export growth, which rose by only 4 percent in 2003.

A different picture emerges, however, when U.S. export growth to China is viewed in the context of the overall growth in China's imports, which reached 40 percent last year. Imports from the United States were the slowest-growing compared with imports from China's largest foreign suppliers. According to China's data, the U.S. share of China's total imports actually declined to a new low at only 8.2 percent of total imports, compared to a share of 12.1 percent as recently as 1998. In fact, if its share had not fallen, U.S. exports to China would have been \$16 billion higher in 2003 than they actually were – a significant difference of about 50 percent.

This general pattern is evident in each of China's major import categories. For example, in electrical machinery, the largest import category, China's total imports increased by 42

percent in 2003, while those from the United States fell by 4 percent. Since 2001, the U.S. share of this key import category has dropped by half, indicating that the United States' poor relative performance in this category was not confined just to last year.

In China's second-largest import category, non-electric machinery, imports from the United States rose by 9 percent in 2003, but again trailed China's total imports in this category, which rose by 37 percent. And, once again, this relative decline was not a temporary setback, as the U.S. share has fallen by half from 16 percent in 1999 to 8 percent last year.

Finally, a similar trend is evident in China's third largest category of manufactures imports -- optical and medical equipment -- in which imports from the United States rose by 32 percent in 2003, while China's total imports surged by 86 percent. Once again, between 2001 and 2003, the U.S. share of this important category plunged from 25 percent to 11 percent.

Clearly the United States is not sharing proportionately in China's otherwise robust import growth, and China's currency peg against the U.S. dollar is a prime factor in the United States' under-performance in the Chinese market. The fact that China imports about 50 percent more from the EU than from the United States confirms this detrimental impact to be the case.

G. U.S. Affiliates Are Not Causing the Import Surge From China

Foreign direct investment plays a large role in China's exports. According to the Congressional Research Service's report on China's pegged exchange rate, slightly over 50 percent of China's total exports are produced by foreign-owned enterprises. These foreign-owned firms appear to have accounted for about two-thirds of China's overall export growth since 1994. Some observers mistakenly extrapolate these data to conclude that the bulk of U.S. import growth from China originates from U.S.-owned production in China. In actuality, data from the U.S. Department of Commerce show that imports from U.S. affiliates in China actually account for only a small amount of total U.S. imports from China.

The latest annual report by the Commerce Department's Bureau of Economic Analysis on U.S. Foreign Direct Investment Abroad⁹⁸ indicates that U.S. manufacturing affiliates in China shipped \$2.9 billion of goods to the United States in 2001. This was only 3 percent of the \$99.7 billion of manufactured goods imported by the United States from China in that year. While this number is viewed with skepticism by many, it remains the only official data published by the U.S. government that are directly relevant to this issue. As such, there is no official basis for claims that the vast bulk of U.S. affiliates' production in China is exported back to the United States and is, therefore, a primary driver of surging U.S. imports from China.

The only other source of U.S. government data on this subject is the Census Bureau's annual report on "Related Party Trade." This report reveals the extent of U.S. export and import trade conducted by related parties -- *i.e.*, by parents and their related affiliates. This report indicates that only 20 percent of total U.S. imports from China reflect shipments to all multinationals located in the United States from their affiliates in China. This percentage, however, covers all related-party trade, rather than that solely from U.S.-owned multinationals. Thus, this percentage includes, for example, all imports into the United States by Japanese multinational firms from their affiliates in China. Moreover, because the bulk of foreign investment in China is sourced from Hong Kong, Taiwan, and Japan, it is only logical to infer that the bulk of such related-party imports into the United States is from foreign-owned multinationals rather than U.S.-owned multinationals.

In conclusion, therefore, the available data suggest that 20 percent of total U.S. imports from China is the absolute ceiling for the portion that can be attributed to U.S.-owned multinationals, while 3 percent of total imports is the most accurate direct measure available.

⁹⁸ See Table II.I.19, Operation of U.S. Parent Companies and Their Foreign Affiliates, 2001.

H. Country of Production Is Important

The analysis above confirms that a portion of total U.S. imports from China indeed is displacing imports from other countries and that an increase in the value of China's currency might shift some of China's production back to other countries rather than to the United States. The fact that production might not shift directly back to the United States, however, does not mean that the United States would fail to accrue any benefit. Moreover, this conception ignores the broader fact that if the production does not belong in China based on unfettered economic merit, speculation on where the production might then shift is irrelevant.

There are several reasons why the U.S. economy and U.S. production would benefit even if China-based production activities do not return directly to the United States. For example, Mexico also has been a significant casualty in the shifting of production to China, some of which served the U.S. market and now is shipped back to the United States from China instead. If some of that production returned to Mexico, it would cause an automatic gain in the U.S. trade account, because Mexico imports proportionately more from the United States than China does. For every additional U.S. dollar China earns from the United States and spends somewhere in the world, it is likely to spend only 8 cents in purchasing U.S.-made products (the United States has an 8-percent share of China's imports). In contrast, the United States has more than a 70-percent share of Mexico's imports of goods and services, such that for each additional U.S. dollar Mexico earns in the United States, it is likely to spend 70 cents in purchasing U.S.-made products.

Moreover, the United States' relative competitiveness against Mexico, in this example, would be improved under the presumption that the production originally shifted from Mexico to China for cost reasons (of which China's currency undervaluation might be a significant reason). If production returned to Mexico without the benefit of a grossly undervalued yuan, the

competitiveness of U.S.-based production would improve. Thus, even if the actual production does not return to the United States, U.S. producers stand a much better chance of success than if they have to compete with Chinese producers that can lever their undervalued currency into pricing power in export markets.

Finally, the controlled Chinese currency is a major factor behind other Asian countries' interventions to prevent their currencies from reflecting fair market values so as not to be competitively disadvantaged by China in the U.S. and other export markets. For example, an April 4, 2004, Reuters report states that "[a]ny move by China to revalue the yuan -- currently effectively fixed around 8.28 yuan per dollar -- would enable Malaysia to revalue the ringgit without sacrificing trade competitiveness." While China is hardly the only country in the region amassing U.S. dollar-based reserves in order artificially to improve export competitiveness, the extent of the Chinese government's intervention coupled with the aggressiveness of its export sector undoubtedly has fueled the practice among China's chief export competitors in the region such as Korea and Taiwan.

I. China's Currency Is Affecting Global Trade Negotiations

The goals of the United States in terms of achieving greater access to markets around the world are also being affected by China's currency policy. Other developing nations, which tend to have the highest tariffs, are reluctant to cut their tariffs for fear of Chinese competition. The European Union's Trade Commissioner, Pascal Lamy, drove this point home in a December 3, 2003, speech to the European Institute, when, in explaining the failure of the WTO's Ministerial meeting in Cancun, Mexico, during September 2003 he said:

Then there was China. Sometimes it seems as if the U.S., with the tough rhetoric about the need to reduce the trade deficit over the last weeks, is the only country concerned about China. But I don't think that is right. Clearly, no one likes to say it, but many developing countries in particular are concerned about

China's seemingly limitless capacity to produce and seemingly bottomless comparative advantage. In other words, if you are already worried about China's ability to scoop the pool, indeed perhaps the phrase is to dredge the pool, the last thing you want is trade liberalisation.

J. Relative Wages Are Not a Principal Factor

A common justification for China's rapid export growth is its significant advantage in labor-cost competitiveness. While low labor costs are certainly a key factor in some manufacturing operations, China is hardly the only country with low wages, and low wages per se are not sufficient to explain China's phenomenal export growth, particularly if productivity differences are taken into account.

In the United States, the cost of labor is a relatively small fraction of the total cost of manufacturing. Direct labor costs – production workers' wages and benefits – constitute only 11 percent of the total cost of manufacturing. While this ratio varies among industries, average labor costs in the United States simply are not significant enough by themselves to explain China's explosive export growth. Moreover, a significant portion of China's nominal labor-cost advantages is offset by significantly higher transportation costs, which typically constitute 10 percent of the product price.

In marked contrast, a 20- to 40-percent undervaluation of the yuan provides a comparatively huge benefit to Chinese exporters, because it affects the entirety of the final Chinese export prices, rather than merely a given cost component, and similarly reduces any ad valorem taxes, tariffs and other charges that are applied to such exports en route to U.S. customers.

K. The Undervalued Yuan Also Adversely Affects U.S. Service Suppliers

The undervaluation of the yuan not only has a negative impact on trade in manufactured products, but also on services. First, a multiplier effect exists between manufacturing and

intermediate activities such as services. Every dollar of a manufacturing product sold to a final user generates an additional \$1.43 of intermediate economic output, more than half in sectors outside manufacturing, which support several million more U.S. jobs. Second, the undervaluation of the yuan adversely affects service providers and exporters in the same way it adversely affects manufacturers -- by valuing those services at higher prices than would prevail under unfettered market conditions and by artificially boosting investment by service suppliers in China.

L. Summary

The evidence and analysis presented in this section provide objective and compelling support that China's currency policy is seriously undermining U.S. commerce, jobs, and production. China's undervalued yuan is playing a central role in generating a huge trade deficit by the United States with China, the largest bilateral trade deficit in history. This trade deficit is growing at an alarming rate and can reasonably be expected only to increase at the expense of the United States as long as China does not correct the yuan's undervaluation. A deficit of this magnitude is certainly not sustainable for the United States and is having an extremely debilitating effect on the strength and resilience of the U.S. economy.

V. CONCLUSION

As this petition demonstrates, China's undervalued exchange-rate regime violates fundamental international legal obligations undertaken by the Chinese government in its capacity as a Member of the World Trade Organization and of the International Monetary Fund. As this petition also demonstrates, China's policy of substantially undervaluing and manipulating the yuan is unjustifiably severely burdening and restricting U.S. commerce. This petition accordingly seeks the immediate elimination of the undervaluation of the yuan. The China Currency Coalition believes that China should promptly revalue the yuan by up to 40 percent.

Should China not act to eliminate the undervaluation of the yuan, the United States should seek authorization in the WTO through expedited dispute settlement (a) to offset the subsidy inherent in the undervalued currency by the application of across-the-board, equivalent tariffs on all Chinese imports into the United States and (b) to take measures to offset the disadvantage for U.S. exports to China.

Respectfully submitted,

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Attachment
Exhibits

September 9, 2004

**BEFORE THE OFFICE OF THE
UNITED STATES TRADE REPRESENTATIVE**

**PETITION FOR RELIEF UNDER SECTION 301(a)
OF THE TRADE ACT OF 1974, AS AMENDED**

**ON BEHALF OF THE
CHINA CURRENCY COALITION**

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September 9, 2004

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