"Currency Manipulation and its Effects on American Businesses and Workers"

House Committee on Financial Services, Subcommittee on Domestic and International Monetary Policy, Trade and Technology; Committee on Ways and Means, Subcommittee on Trade; and Committee on Energy and Commerce, Subcommittee on Commerce, Trade and Consumer Protection

Testimony
By

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Thank you, Chairmen and members of the Subcommittees for this opportunity to explore the issue of "currency manipulation and its effects on American businesses and workers." Thank you for holding hearings to shed light on an issue that is critical to every American business and worker.

My name is Mustafa Mohatarem. I am the Chief Economist of General Motors Corporation. I am responsible for economics and trade policy.

I want to focus my remarks today on how the Government of Japan deliberately fosters a weak yen to promote its exports and offer a windfall to its manufacturers, much to the detriment of American businesses and workers and in dramatic contrast to the significant appreciation of the Euro, the Canadian and South Korean currencies over the past year.

By nearly every expert account, the Japanese yen is severely undervalued in comparison to the U.S. dollar and other world currencies. This misalignment provides billions of dollars in annual subsidies for Japanese auto exports and for the production of Japanese vehicles made in the United States with parts imported from Japan. It has contributed to the loss of hundreds of thousands of jobs in the auto and supplier industries in the United States; it is a major source of the nation's nearly $90 billion U.S. trade deficit with Japan; and has contributed to the severe economic decline in my home state of Michigan and in many communities in America. It is time for the U.S. government to demand that Japan allow the yen to appreciate. If freely traded, many experts believe the yen would approach 90 to the dollar instead of today's 120 to the dollar.

U.S. automakers are fully confident that our vehicles can compete successfully with other manufacturers in any market in the world, including the United States. We welcome competition from Japanese companies and other international competitors. We believe that competition in a free and undistorted environment is good for consumers, good for innovation, and good for creating ever safer and more energy efficient vehicles. We are also proud of the enormous strides we have made and continue to make with our UAW and IUE colleagues towards these ends.

Working with our unions, suppliers and distributors, General Motors has made substantial cuts in structural costs, including the costs associated with pensions and health care. We've made tremendous improvements in the productivity of our workforce and the quality of our products. We continue to work with the federal government on ways to improve the quality and efficiency of the nation's health care system and to promote increases in the energy efficiency of our vehicles and factories. But we are also affected by policies of foreign governments that are beyond the control or influence of what any particular company can do. It is those policies that I wish to address today.

GM, Ford and DaimlerChrysler have invested a combined $10 billion per year in the United States in each of the last four years, and purchase 80 percent of all U.S-produced automotive parts and components. U.S. auto manufacturers are at the heart of the U.S. manufacturing economy, directly employing some 340,000 U.S. workers and supporting nearly 6.5 million jobs throughout the U.S. economy. This compares to roughly 75,000 workers the Japanese producers directly employ in this country.

Over the past several years, the Government of Japan has engaged in at least four strategies to keep the yen weak and thus provide an enormous subsidy to Japan's vehicle and autoparts exporters. These approaches include: maintaining huge exchange reserves as a signal to the markets; implementing massive interventions in currency markets, especially from 2002-2004; signals of possible interventions to the currency markets through statements from Japan's officials (so-called "jawboning"); and purchases of dollar-denominated securities by quasi-public entities and private investors spurred on by Japan's yen policy.

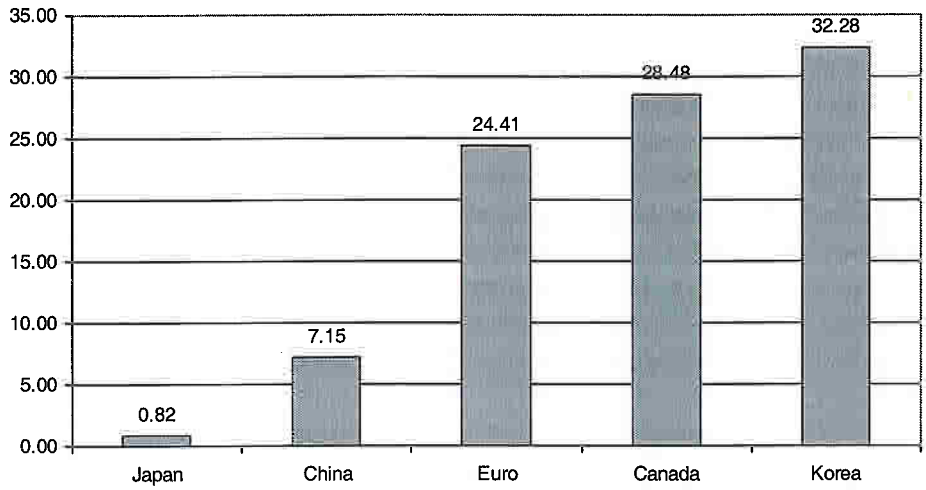
Since 2001 the Bank of Japan has accumulated an additional $500 billion in foreign exchange reserves through currency interventions in order to keep the yen weak against the dollar and other major world currencies. While Japan stopped its massive direct interventions in 2004, Japan's Finance Ministry officials subsequently engaged in official jaw-boning to keep the yen down. In addition, there have been significant additional purchases of dollar-denominated securities by quasi-public Japanese entities and by private investors, both of which are encouraged by Japanese government policies. The Bank of Japan continues to maintain a level of foreign currency reserves -- $875 billion in total of which 80% is in U.S. dollars -- that is well above any level needed to insure against precautionary risks or other concerns. These reserves and the threat of further dollar purchases have helped to support the so-called carry trade in which investors borrow funds in low-interest yen in order to invest in higher interest-bearing U.S. securities.

Prior to these massive interventions, the yen was valued at close to parity with the dollar at a level of approximately 95-100 yen to the dollar. We agree with the assessment of most economists today that the yen is undervalued by at least 25 – 30 percent against the dollar. To quote Johns Hopkins Professor Steven Hanke,

> Amid the credit-boom phase of the present business cycle, the Japanese yen has been weak across the board, and is 25% undervalued against the dollar. One reason for this is that the Japanese government engaged in massive intervention to push down the value of the yen in late 2003 and early 2004. Investors thought that the government was committed to a weak yen policy. That, and the fact that interest rates in Japan are some of the lowest in the world, meant that investors thought they had a free lunch in the form of the carry trade – borrowing in low-rate yen, investing the proceeds at higher rates in other currencies. The yen carry trade has become wildly popular, accounting for perhaps $1 trillion of yen-denominated borrowings . . . ["Prepare for a Storm," *Forbes Asia*, April 23, 2007]

As the U.S. trade deficit has grown, most of the world's currencies have adjusted in the expected way: they have strengthened against the dollar. However, the world's freely traded currencies have been disproportionately carrying the burden of these adjustments. The currencies of many of our major trading partners have appreciated sharply against the dollar. Over the past four years and as shown in the chart below, the Euro has risen by 24%, the Canadian dollar by 28%, and the Korean Won by 32%. But, because of persistent Japanese government direct and indirect interventions, the yen has increased by less than one percent. Over that same period, even the Chinese Renminbi has risen by 7% or nearly nine times the increase for the yen.

Appreciation vs. Dollar
April 2003 - April 2007



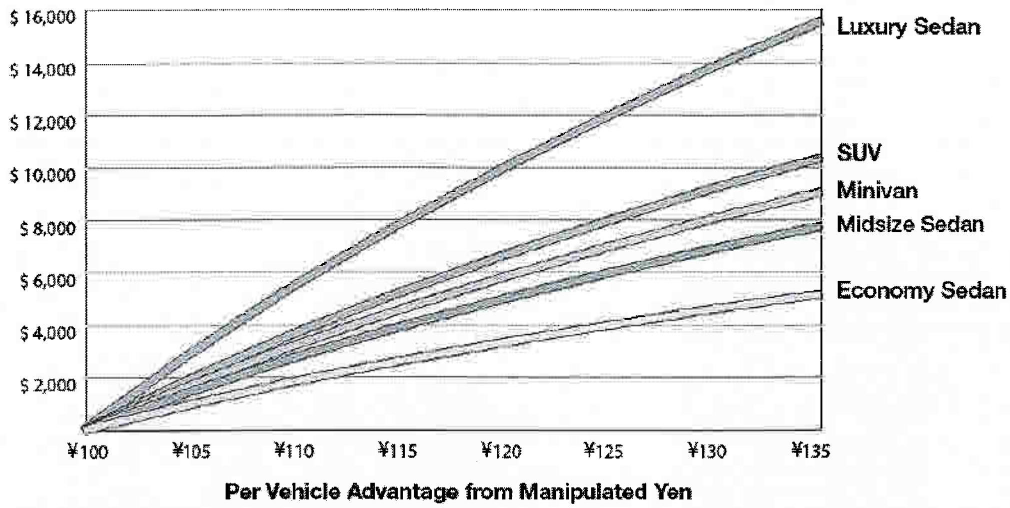
Source: General Motors Economics Staff

What is particularly disturbing in this story is that to achieve a weak and undervalued yen the U.S. government quietly endorsed Japan's efforts to keep the yen weak. In a recent book entitled "Global Financial Warriors: The Untold Story of International Finance in the Post-9/11 World," John B. Taylor, former Treasury Under Secretary for International Affairs, documents the U.S. Treasury Department's support for and acquiescence in the Japanese government's massive and historic manipulation of the Japanese yen from 2002 to March 2004. Mr. Taylor recognizes that this policy, which included frequent verbal interventions, or jawboning, as well as massive quantitative interventions in order to keep the dollar from falling to its equilibrium value, succeeded at the expense of the U.S. manufacturing sector and its employees.

Excerpts from John Taylor's book:

- "An increase in the price of the dollar makes U.S. exports less attractive, and thereby makes U.S. exporting firms and their employees very unhappy." (page 282)
- "Our policy toward exchange rate intervention in Japan was part of our effort to be supportive of quantitative easing. By not registering our strong objections to the intervention, effectively allowing it to happen, we made it easier for the Japanese to pump up their money supply." (page 286)
- "I did not object, as Treasury might have in the past [when told by the Japanese government that its currency intervention was going to increase], but I repeated our own views about keeping intervention to a minimum. True to their word intervention did increase; eventually it increased to unprecedented magnitudes, to $320 billion!" (page 286)
- "After a few months into 2003, the unprecedented nature of the intervention was becoming clear to everyone." (page 286)
- Quoting BusinessWeek: "...[Japanese Finance Minister Zembei Mizoguchi] enjoys celebrity status. And with good reason: This financial diplomat – call him Mr. Dollar – is the architect of perhaps the biggest single-handed currency intervention since World War II." (page 294)
- "If the United States thinks that Japan or China should stop intervening, then it must develop a diplomatic strategy to bring this change about." (page 281)

With the yen valued at 120 to the dollar as compared to the 90 yen per dollar that many economists estimate as its "fair market value," the Bank of Japan has provided Japan's automakers with an average subsidy of more than $4,000 on each midsize sedan exported to the United States, as shown in the graph below. This amounts to a subsidy of more than $9 billion on the 2.1 million vehicles exported to the United States in 2006. There's an additional subsidy of roughly $4.5 billion for imported parts used in American-assembled Japanese cars. This amounts to a total of more than $13.5 billion in subsidies to our Japanese competitors. This is above and beyond the normal profit these companies make, and therefore a Japanese government-subsidized windfall.



Source: Automotive Trade Policy Council

Japanese auto producers use these windfall subsidies to support their marketing and incentive campaigns, for their investments in research and development of new products, and for expansion of their operations around the world. The leading Japanese auto companies make almost three quarters of their global profits in the U.S. market. Their own public financial reports credit the weak yen for boosting profit margins. Over the last eighteen- month period the Japanese companies reported that the weakening of the yen contributed $7 billion in additional profits.

Opening Japanese auto manufacturing facilities in the United States has not slowed down the imports of automobiles from Japan. The reverse has happened: Japan exported more than 2.1 million vehicles to the U.S. in 2006, the most since the mid-1980s before they built facilities in the U.S. Last year alone, almost half of all Toyotas sold in the U.S. market were built, not in America, but in Japan.

Japan is facing a major and continuous decline in its own market for vehicles. Yet, even as demand within Japan for new autos is declining, Japanese companies are adding production capacity to Japan-based facilities, reactivating assembly lines, adding workers and postponing planned Japan factory closures as they move to export ever greater numbers of vehicles. All this is the result of a Japanese government policy to subsidize exports as the Japanese auto market shrinks.

Nowhere are the effects of the undervalued yen greater and more devastating than in my industry, which, according to the United States Bureau of Labor Statistics, has lost 300,000 highly productive, good-paying jobs since 2000. Nearly two-thirds of the 2006 U.S. trade deficit with Japan, or $56 billion out of a total of $88 billion, was the result of Japanese auto imports.

The impacts have been especially harmful to states in the industrial heartland. Michigan has lost nearly 120,000 of those auto industry jobs since 2000 and nearly 280,000 jobs in its manufacturing sector. Autos are vital to Michigan and to the industrial heartland because of substantial job multiplier effects: for every job created or destroyed in auto assembly there are anywhere from 3 to 5 jobs created or destroyed upstream in supply all the way up to the mine mouth and downstream through auto and parts distribution.

Some would suggest that these job declines have nothing to do with the yen. That is an incorrect assertion. We have made giant strides in recent years to enhance our competitiveness by working with our suppliers, workers, and distributors and many more improvements are in the works. While we are putting our own house in order, it should also be noted that there are external factors impacting competitiveness that are beyond our control and one of them is the exchange value of the U.S. dollar. To quote the former head of President Clinton's Council of Economic Advisers, Martin Baily, and his Peterson Institute of International Economics colleague, Robert Lawrence,

> The exchange rate of the dollar is the major factor leading to the trade deficit <u>rather than any structural inability of US manufacturing or services to compete in the new global environment.</u> . . . By far the most important reason the trade deficit is so large today is that the dollar is much higher than it was in 1981 or 1991. . . . [Martin Baily and Robert Z. Lawrence, "Can America Still Compete or Does it Need a New Trade Paradigm?" Institute for International Economics, December 2006 at http://www.iie.com/publications/pb/pb06-9.pdf, pages 8 and 9; emphasis added]

There is also a consensus among economists that while there are benefits to our economy from a strong dollar, such as lower overall inflation and reduced interest rates, the overvalued dollar has caused severe economic distortions that have artificially inflated certain goods producing and service sectors and there will be a day of reckoning when interest rates go back up as they must. Recent reports on the decline of housing construction and the concomitant slowing of GDP growth would suggest that this day may have already arrived.

The current Federal Reserve Board Chairman and then-Governor Ben Bernanke cautioned as early as March of 2005 that the trade deficit would be a concern precisely for these reasons. He said and I quote:

> In the United States, for example, the growth in export-oriented sectors such as manufacturing has been restrained by the U.S. trade imbalance . . . while sectors producing nontraded goods and services, such as home construction, have grown rapidly. To repay foreign creditors, as it must someday, the United States will need large and healthy export industries. The relative shrinkage in those industries in the presence of current account deficits--a shrinkage that may well have to be reversed in the future--imposes real costs of adjustment on firms and workers in those industries. ["The Global Savings Glut and the U.S. Current Account Deficit," Remarks of Governor Ben S. Bernanke, Homer Jones Lecture, March April 14, 2005, St. Louis, Missouri, updating a March address on the same topic]

Put another way, those jobs that the undervalued yen has destroyed in Michigan and in the nation's industrial heartland have been the result not of any lack of efficiency or competitiveness. Rather, they are the result of the decision by the government of Japan to push the yen down by twenty percent or more and keep it there. The loss of these jobs is the result of a weak yen and other Asian currencies that cheapen foreign imports at the expense of equally efficient domestic, U.S. producers, their suppliers and employees. When the dollar someday falls to its competitive, undistorted level against the yen many of the jobs that Chairman Bernanke said will be needed to repay our Japanese and other foreign creditors just won't be there. There will be other jobs in a full employment economy – but they will be less productive and less good paying. All of this because of the foreign exchange operations of the Bank of Japan that have pushed down the yen in order to promote the export-competitiveness of their industries.

In contrast to our own government, many countries are deeply concerned about the unfair competitive advantage Japan is offering its vehicle and parts makers by means of a weak yen policy. Germany, France, and other European nations have repeatedly urged that the undervalued yen be addressed by the G-7 nations. Regrettably, Japan, and it appears the US too, have blocked such discussion of the misaligned yen in this setting.

Economists across the globe fear that Japan's vast sums of currency reserves and its dominant role as the go-to point for overseas investors on the hunt for cheap loans – the so-called carry trade – present dangers to the global trading system. Editorial opinion in the major international financial press (including *The Economist and the Financial Times*) has called for urgent attention to today's huge global currency distortions. The International Monetary Fund (IMF) has been charged with providing recommendations for much stronger action to deal with huge currency misalignments this year.

As Treasury Secretary Paulson has noted the yen trades in a global market. There is no good reason for Japan to hold any significant level of foreign currency reserves, let alone the $875 billion (80% in U.S. dollars) it built up in earlier years to keep the yen from appreciating. There can be only one reason to hold such levels of reserves and that is to continue to encourage speculators engaging in the carry trade to borrow in yen – to go short on the yen – while investing in and going long on the dollar.

Should the Government of Japan be allowed to continue to maintain a weak yen policy that gives billions of dollars in windfall subsidies to its auto industry to the detriment of its competitors? We think not.

So, what's to be done? There needs to be a realignment of Asian currencies against the dollar. We strongly believe that Japan's currency policies should be addressed first. Japan is both the largest economy in Asia and the richest. Many Asian economies have emulated Japan's policies. Thus, unless Japan can be persuaded to change its policies, others will remain reluctant to change.

It is time for U.S. policy to place the needs of its own manufacturing sector first. To do so will require the U.S. to demand that Japan allow the yen to regain a market-determined value. Japan must be pressed to bring its currency into alignment and to trim its excessive currency reserves and trade surpluses. To begin this process, the U.S. should insist that the International Monetary Fund publish its estimate of fair market values for major currencies.

Congress should insist that the Treasury Department accept its responsibility to report accurately when countries are manipulating their currencies to gain a trade advantage. The U.S. should join European finance ministers in calling for yen currency misalignment to be put on the table at the next G-7 meeting.

We would hope that by shining a bright light on the yen policy of the Government of Japan, a coordinated international effort would result in a yen that appreciates to the level of perhaps 90 yen to the dollar.

Should none of these actions bear fruit, we would ask Congress to consider legislation that would view currency manipulation of this nature as an unacceptable trade practice enforceable under U.S. trade law.

Thank you for your time and attention. We very much appreciate your ongoing support on this critical issue.