"Opportunities and Challenges in the US-China Economic Relationship"

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Chairman Kerry, Ranking Member Lugar and distinguished members of the Committee, thank you for the opportunity to testify before your Committee on this important relationship.

The US-China economic relationship is the most important bilateral economic relationship in the world. China is the third largest and the fastest growing major economy in the world. At current growth rates, it will pass Japan later this year and reach the size of the US economy by 2020 or sooner. The US is China's second largest export market and China is America's third largest export market – and has been the fastest growing market for US exports since the late 1990s. China accounted for 18% of US imports and for 36% of the US trade deficit over 2008-09. China has emerged as the center of a complex global supply chain for manufactured goods in Asia. A significant share of the value of US imports from China represents intermediate inputs and components produced throughout Asia and assembled into final products for export to the US. China is the largest destination for foreign direct investment, much of it from companies headquartered in the US. More than half of all US imports from China come from companies that are partially or completed owned by foreigners, including US companies. This share is significantly higher for US imports of high-technology products like computers and smart phones. And China has $2.4 trillion of foreign exchange reserves, by far the largest such portfolio in the world. Most of these reserves are held in

dollars or dollar-denominated assets. China owns about 25% of all US Treasury debt held by foreign investors.

China and the US both reap substantial returns from the large trade and capital flows that link their economies. But these cross-border flows are lopsided: the US runs a large trade deficit with China and China runs a large trade surplus with the US; the US is a debtor and China is a creditor. The US relies on its deficit with China as a means to satisfy spending of consumers and businesses and China relies on its surplus with the US as a means to sustain its production and export-oriented economy. The unbalanced nature of these flows complicates the relations between the US and China and contributes to tensions between them. Despite these tensions, however, both countries are major beneficiaries of globalization and both share interests in promoting a strong global recovery and fostering sustainable and better balanced global growth. The Strategic and Economic Dialogue (S&ED) is an important forum through which the US and China can ameliorate the tensions in their relationship and cooperate on policies to foster a balanced and prosperous world economy. In addition, the US and China are cooperating within the G20 and other multilateral institutions and are committed to strengthening these institutions to address shared global challenges.

In this testimony, we examine some of the US policy priorities that were the focus of the most recent S&ED meetings: macroeconomic policies to promote and rebalance global growth; the currency issue – especially in light of recent adjustments in China's exchange rate regime; and policies to reduce barriers to trade. We also assess the possibility that China might sell some of its US government debt or slow down its purchases of such debt to influence the outcome of a foreign policy dispute with the US or to retaliate against a US action that China deems to be an assault on its sovereignty. We conclude with recommendations for US policy.

I. US-China Cooperation to Promote a Strong Global Recovery and Sustainable Balanced Growth

1. China's Rebalancing Challenge

In recent G20 discussions and in the latest S&ED discussions, China has committed to cooperate with the US to promote a strong global recovery and to foster more balanced, sustainable global growth. Chinese authorities have adopted ambitious policies that are consistent with this commitment and that have already delivered measurable results. As a result of its unprecedented monetary and fiscal stimulus measures, China recovered more rapidly than expected from the global slowdown in 2009, ending the year with a growth rate of 8.7 %. China's strong recovery boosted global growth by providing strong demand for exports from the US and from China's other trading partners. US exports to China have rebounded much more rapidly than overall US exports during the last year and are now about 20% above pre-crisis levels. US exports to China are still growing much more rapidly than US exports to the rest of the world. During the first quarter of 2010, US merchandise exports to China grew by almost 50% from year-earlier levels

while US exports to the rest of the world grew by about 20%. China is now the third largest and most rapidly growing market for US exports, with double-digit growth across a wide range of US products from high-tech manufactured goods to agricultural goods. Whether China's recent stimulus actions will also deliver on its commitment to foster more balanced future growth, however, is not certain. Faced with a dramatic collapse in China's export markets in the wake of global recession, Chinese authorities had little choice but to re-orient their growth policies in the short run. The unprecedented 11.9% drop of world merchandise trade in 2009 choked off China's long vigorous export sector. In the short span of seven months Chinese exports went from boom to bust – a +26% year over year increase in July 2008 gave way to a -27% decline by February 2009. Real GDP growth screeched to a standstill as measured on a sequential quarterly basis, and over 20 million migrant Chinese workers lost their jobs in export-led Guangdong Province. For a nation long fixated on labor absorption and social stability, this was the functional equivalent of China's dreaded recession and called for a massive stimulus response to bolster domestic demand.

Within domestic demand, China's stimulus measures have focused primarily on fixed investment. There are concerns among China's trading partners that this investment is adding excess capacity in manufacturing that will feed another surge of exports – and a renewed widening of China's trade surplus – as the global economy recovers. In fact, most of China's stimulus investment has been directed to massive, multi-year infrastructure projects especially in the western and central regions of the country. (More than 70% of China's stimulus package has been devoted to infrastructure projects, Sichuan earthquake reconstruction and public housing projects.) The surge in infrastructure spending in turn has sparked a pick-up in private-sector investment by augmenting demand for goods and services provided by private firms, especially those in the manufacturing sector. Rapid growth in investment spending has augmented household income growth, especially in urban areas; moreover, growth in household incomes along with targeted pro-consumption incentives for selected consumer durables has supported solid consumption growth.

On the surface, the rebalancing of China's growth toward domestic demand appears to be confirmed by recent data. In 2009, consumption accounted for 4.6 percentage points or about half of China's GDP growth, and in the first quarter of 2010, consumption contributed a record 6.2 percentage points to China's GDP growth. In 2009, China's current account surplus as a share of GDP fell to 6.1%, down sharply from its peak of 11% in 2007, and dropped further to only about 1% of GDP in the first quarter of 2010. China's overall trade surplus as a share of its economy has fallen sharply by about half during the last two years.

Some observers express concerns that these trends are temporary and that the rebalancing of China's growth strategy will end when the global economy recovers and global markets for China's exports rebound. In fact, the May trade surplus widened to $19.5 billion from a surplus of $1.7 billion in April and a modest deficit in March. These results are consistent with these concerns and suggest that it may be premature to celebrate the onset of a sustained structural rebalancing of the Chinese economy. But we

believe that China's rebalancing is likely to continue over the long term out of both design and necessity. For an externally-dependent Chinese economy, the latter motive is especially germane in the post-crisis era – an era that is likely to face lingering headwinds from sluggish demand in the developed world. If there was any doubt about the state of global demand in the aftermath of the global recession in 2009, recent problems in Europe should dispel a false sense of optimism. First, the United States and now Europe – the growth in global final demand that was the sustenance of China's export growth is in serious trouble. And there are compelling reasons to believe that such trouble will not be fleeting – that it will be an enduring feature of the post-crisis environment for several years to some. In order to avoid a sustained shortfall of export-led growth and the social instability it would imply, China needs a new source of growth. And it needs one quickly.

A significant rebalancing of the Chinese economy is really the only answer to China's post-crisis wake up call. GDP growth needs to shift away from the export- and investment-led dynamic that powered the economy so successfully over the past 30 years toward the sector that has been left behind – internal private consumption. At their peak in early 2007, exports and fixed investment totaled 75% of Chinese GDP – more than double the 35% share going to private consumption. To some extent, the low share of consumption is the result of high household precautionary saving rates necessitated by the lack of a social safety net – social security, private pensions, medical and unemployment insurance are all lacking for most Chinese citizens. But consumption also has been held back by slow income growth, with wages increasing much more slowly than productivity and rising profits feeding high enterprise saving rates. Enterprises now generate more than half of China's saving.

There are signs that this situation may be changing. There have been recent significant increases (20% or more) in minimum wages in key places like Beijing and Guangdong province, and several strikes have ended with sizeable wage increases. The number of young people entering the workforce is slated to decline by almost 30% over the next ten years, and survey evidence indicates that increasingly scarce younger workers may expect higher wages and better working conditions before they are willing to migrate to factory jobs far from their homes. Fully 40% of China's population remains in low-productivity agriculture, so there is still a lot of surplus labor. But there are growing signs that the reservation wage for surplus labor is increasing, and this may be another factor that helps rebalance China's future growth.

China's infrastructure-led stimulus policies are building a foundation for strong future growth in domestic consumption through job creation and through projects that not only bolster the development potential of the western and central regions of the country but also reduce physical bottlenecks to rural consumption and rural-urban migration. These are the regions where most of China's surplus labor is located. There is good reason to believe that China will use its upcoming 12th Five-Year Plan (2011-16) to lay out a broad framework to continue this pro-consumption rebalancing. The five-year planning cycle has long been Beijing's principal means for refocusing and redirecting the economy. That purpose seems all the more meaningful in a post-crisis global climate that

challenges one of the critical assumptions that has underpinned the export-led growth dynamic for 30 years –the vigor of support from external demand.

China's pro-consumption plan is likely to have three major macro goals – to reduce precautionary household saving; to temper widening income disparities; and to uncover new sources of job creation. Each of these goals will require major policy initiatives. On the saving front, it's all about the social safety net – namely social security, private pensions, medical, and unemployment insurance. China has taken only small steps in these areas. It now needs to take big convincing steps in order to reduce the excesses of fear-driven precautionary saving. At the same time, income inequality can only be addressed if China tackles the serious problem of lagging rural incomes – the some 700 to 800 million Chinese who still live at relatively impoverished income levels in the countryside. Several policy initiatives will be required here – especially tax rebates to rural families, rural land and ownership reforms, IT-enabled connectivity of agricultural communities, and ongoing incentives to sustain rural-urban migration, which is essential to boosting agricultural productivity. Finally, on the job creation front, China needs a blueprint for the development of large-scale, transactions-intensive services industries such as wholesale and retail trade, domestic transportation, supply-chain logistics, and leisure and hospitality. China needs to shift its development strategy away from labor-saving manufacturing for export toward labor-intensive services for domestic consumption.

If the 12th Five-Year Plan contains half of the initiatives outlined above, we believe that China will make important progress in shifting sustained support of its macro economy from external to internal demand. As a share of GDP China's current account surplus has already shrunk from an 11% peak in 2007 to slightly over 1% in the first quarter of 2010. Although a significant portion of this reduction is cyclical as we noted above, there is good reason to believe that China's external imbalance has peaked and that a consumer-led rebalancing will mean a significantly lower current account surplus in the years ahead.

Nor do we believe that Chinese families are culturally predisposed toward high and rising personal saving – suggesting that this transformation will take decades to occur. With the right incentives and job-creation initiatives, we would not be surprised to see the consumption share of the Chinese economy rise from 35% currently to the 42% to 45% range by 2016 – still low by international standards but a major increase from current levels. The key for the 12th Five-Year Plan is to move the needle from the old growth model to the new growth model – setting in motion a powerful rebalancing momentum that will sustain Chinese growth for years to come.

2. The Role of China's Exchange Rate Policies in Global Rebalancing

Exchange rate policy has proved to be a lightening rod in US-China economic relations in recent years. We applaud China's June 19 announcement to end the crisis-induced re-pegging of the renminbi-dollar cross rate which has been in place since July 2008. By

returning to the "managed float" foreign exchange regime which it first adopted in July 2005, China has signaled both flexibility and practicality in dealing with a very contentious global issue. Although the full extent of the resulting Chinese currency adjustment is unknown, it should be stressed that this is the same regime that resulted in a 20% appreciation of the renminbi versus the dollar in the three years ending July 2008. Under the presumption of a sustainable recovery in the global economy, there is good reason to expect that a resumption of gradual RMB appreciation will track a similar trajectory in the years ahead. China should be commended for having taken a very important first step in the right direction.

It was actually an auspicious time for China to act – not just because of mounting global pressure on the eve of the G20 meeting in Toronto but also because market conditions may work in its favor. Recent turbulence in global currency markets caused by the flight from the euro to the dollar, combined with China's reduced trade and current account surplus, gives China an opportunity to reform its currency regime at a time when there is less upward market pressure on the RMB.

China's shift in currency policy also seems well aligned with the broader strategic objectives of the Obama Administration. In recent Congressional testimony (June 10, 2010), Treasury Secretary Timothy Geithner argued that over time a more flexible market-driven RMB will be good for the global economy because it will facilitate more balanced and sustainable global growth. He also argued that it would serve China's interests because it will support China's rebalancing agenda and because it will enable China to pursue a more independent monetary policy. Secretary Geithner did not argue that greater flexibility in the RMB exchange rate would reduce the US bilateral trade deficit with China. Nor did he call for an appreciation of the RMB. Rather he noted that a stronger RMB as the result of market forces within a more flexible exchange rate system would benefit China and promote global rebalancing. We agree with the conceptual arguments and recommendations made by Secretary Geithner in his written testimony and we applaud his discussion of China's currency policy from a multi-lateral perspective rather than from a contentious and misleading bi-lateral one.

In that vein, it is essential to put the currency issue in the context of the world's broader rebalancing imperatives. An RMB-dollar adjustment is not the only option that China has to address its fair share of the global rebalancing agenda. The key challenge for all unbalanced economies – including China and the US – is to reduce their global imbalances. That is true whether those imbalances take the American form of a saving gap and current account deficit or the Chinese form of a saving excess and a current account surplus.

In the case of China, the structural policies that we suspect are likely to be featured in the upcoming 12th Five-Year Plan could well be far more effective than the more circuitous option of a currency adjustment. It is up to China to decide which of those options – or which combination of them – works best. The rest of the world has a right to insist that China face up to its saving imbalance, but does not have the right to insist on the precise mechanism that China employs to accomplish this task. The same argument, of course,

also applies to the tactics and strategy that the United States employs to cut its budget deficit and boost domestic saving. While the rest of the world has a right to insist that America take its rebalancing imperatives seriously, it is the sovereign right of the United States to decide on the best ways to accomplish this objective.

That's not to say there isn't a compelling domestic rationale for China to allow a stronger RMB. Indeed, RMB appreciation would certainly complement China's domestic rebalancing agenda both by boosting the purchasing power of Chinese consumers and by encouraging Chinese producers to shift production away from exports toward domestic markets. Moreover, a stronger currency would temper the impacts of imported inflation – hardly inconsequential in light of China's recent cyclical upsurge in inflation to 3.1% in May 2010.

Reforming the exchange rate regime in a way that allows the RMB to appreciate gradually in response to market forces also gives China time to liberalize its capital markets to prepare for greater exchange rate flexibility. We do not endorse the view expressed by many that China should make an immediate large upward adjustment in the RMB-dollar exchange rate. China's June 19 policy pronouncement, which stresses a return to pre-crisis "floating bands," all but rules out such an action. And with good reason: As a developing economy with a still embryonic financial system, China must continue to focus on financial stability and potential vulnerability to speculative capital flows. For that consideration alone, there is ample justification for China to view a tightly managed band on the dollar-RMB relationship as an important stability anchor.

Bilateral political tensions aside, we agree with Secretary Geithner that it is critical to assess the currency ramifications of global rebalancing from a multilateral perspective. In this regard, it bears noting that on a broad trade-weighted basis, the RMB is up 7% (in real terms) from its late 2009 low and up 19% from its early 2005 low. In other words, despite the re-pegging of the RMB to the dollar over the past two years, it is factually incorrect to maintain that the RMB has not moved in a broader global context. It is equally important to stress that there are long and uncertain lags associated with the impacts of a shift in relative prices between China and the rest of the world on global imbalances. The example of Japan in the late 1980s raises serious questions about whether a sizeable appreciation of the RMB against the dollar over the next few years would have a sizeable effect on these imbalances. After all, while the yen more than doubled in value relative to the dollar from early 1985 to late 1988, Japan's outsize current account surplus barely budged.

China's decision to return to its pre-crisis system and allow the RMB to fluctuate against the dollar within a tightly managed band is unlikely to eliminate US concerns about the RMB-dollar exchange rate. A renewed post-crisis rebound of Chinese exports, in conjunction with sluggish US job growth and unacceptably high unemployment, has fueled Congressional frustrations about the persistence of a large bilateral trade deficit with China. As a result, pressures on China for a major RMB revaluation – or for the US Treasury to name China as a currency manipulator if that doesn't occur – have intensified. Many members of Congress believe that a sizeable RMB appreciation relative

to the dollar would be an effective way to ease the plight of America's beleaguered middle class. They also believe that if China does not act voluntarily to relieve those pressures, the US should take offsetting action. At least, China's June 19 adjustment of its currency policy sends an important signal to US policymakers that the Chinese leadership takes these concerns seriously.

Unfortunately, a significant appreciation of the RMB-dollar exchange rate – or the countervailing trade sanctions that might occur in its absence – might well backfire. Much of the growth in US imports from China has been the result of production moving to lower-cost China not from the United States but from other higher-cost foreign countries especially in Asia. China has become the center of a global supply chain that enhances efficiency, keeps production costs down and supplies US consumers with attractively priced products, purchased in large amounts by low and middle-income families. A significant share of the value of US imports from China represents the value of components produced in other countries and assembled in China for sale in the US. China's share of the value-added for some products may be only 20-30% of the total value of US imports from China. Tariffs imposed on Chinese exports to the US in an effort to offset the so-called RMB currency subsidy would raise the prices of these products for US consumers and drive their production not back to the US but to other emerging market countries, reducing the efficiencies of the supply chain and increasing production costs. The increase in prices on US imports that resulted would be the functional equivalent of a tax hike on both US companies and American consumers.

Moreover, there are other equally serious analytical pitfalls to a bilateral assessment of the China problem. Yes, China accounts for the largest piece of America's trade deficit – some 36% of the average merchandise trade gap over 2008-09. But the key point to stress here is that the United States had trade deficits with over 90 countries during the same period – a multilateral imbalance that stems from the unprecedented shortfall in US saving discussed below. Lacking its own saving, the only way for the US to keep growing is to import surplus saving from abroad and run a large current account and multilateral trade deficit in order to attract foreign capital. The Chinese piece may account for the largest share of this multilateral imbalance but that is more likely traceable to conscious outsourcing decisions of US multinationals and strong consumer preferences for low-cost, high-quality goods made in China than to unfair trading practices. The bottom line is that America's multilateral trade imbalance cannot be addressed by putting pressure on a bilateral foreign exchange rate with China.

Finally, it is important to emphasize that if the US Congress were to impose trade sanctions on imports from China, it is highly likely that China would retaliate. That retaliation could take one of three forms: lodging a WTO complaint; imposing tit-for-tat trade sanctions on US exports to China; or reducing demand for US government securities. The latter two options would hardly be inconsequential for the United States. Tariffs on US exports to China would hit America's third largest export market – a serious problem for the Obama Administration's goal of doubling US exports over the next five years. Similarly, reduced Chinese buying of US Treasuries would be highly problematic for the funding of the federal deficit at attractive interest rates and could

trigger a spike in US interest rates, a sharp drop in the dollar's value and renewed instability in global financial markets. (The possibility that China might respond to US pressure on its exchange rate policy by adjusting its demand for US Treasuries is discussed below.)

3. The US Rebalancing Challenge

Rebalancing growth was a major topic at the recent S&ED meetings and US officials agreed on the need to rebalance growth of the American economy away from consumption and large federal government deficits toward higher household saving rates, greater reliance on exports and investment, and sustained deficit reduction. US officials emphasized the Obama Administration's multi-year plan to achieve $1 trillion in deficit reduction over the next decade. The plan includes freezing non-security discretionary spending for three years, reducing defense spending in Iraq and Afghanistan, and allowing the 2001-2003 tax cuts for households earning more than $250,000 to expire. According to the Administration's latest projections, this plan would reduce the deficit from 10.6 % of GDP in 2010 to 3.9% by 2015, a record five-year reduction that would occur despite an average unemployment rate of 7.9% during the period. If adopted, this plan would be a significant step toward rebalancing the US economy, but it would leave the US with a projected average deficit of 3.9% of GDP between 2015 and 2020, and it would not stabilize the federal debt to GDP ratio, which would continue to rise through 2020 and beyond. As long as the debt to GDP ratio is rising, US fiscal policy is not on a sustainable long-run path. This could prove problematic for global investors, including the Chinese, who are currently willing to purchase US government debt at interest rates that are at or below historical averages.

During the S&ED discussions, US officials assured their Chinese counterparts that the Obama Administration is committed to reducing the deficit to 3% of GDP and stabilizing the debt to GDP ratio by 2015. President Obama has created a special bipartisan National Commission on Fiscal Responsibility and Reform charged with the task of proposing additional spending cuts and/or revenue increases to bring the primary budget deficit into balance and thereby stabilize the debt to GDP ratio in that year. Primary balance requires that total federal government spending excluding interest payments on the debt, equal total federal government revenues. According to the Administration's latest projections, the primary deficit will be around $174 billion in 2015; by contrast, according to the most recent Congressional Budget Office projections, the primary deficit will exceed $250 billion in that year, and many private sector projections are even larger.

A recent study by the Center for American Progress (CAP) found that closing a primary budget gap of $250 billion in 2015 by spending cuts alone would require a cut of almost 7% in every area of federal spending, except interest payments on the debt. If cuts in Social Security spending, additional cuts in Medicare and Medicaid spending beyond those in the health care reform, and additional cuts in defense spending beyond those in the President's budget are excluded, balancing the primary budget by spending cuts alone would require a 16% cut in the rest of government spending. CAP estimates that closing

the primary budget gap by revenue increases alone would require a 7.3% increase in all federal taxes and fees. If those making less than $250,000 a year are excluded, taxes and fees collected from those making more than $250,000 a year and from US corporations would have to increase by almost 25%. These calculations make it very clear that balancing the primary budget by 2015 will require some combination of very painful spending cuts and revenue increases.

The Commission is charged with making recommendations in December 2010. Given the size of the fiscal problem and the highly charged partisan atmosphere— a climate that may well worsen after the November elections – it is unlikely that the Commission will be able to agree on major recommendations and that such recommendations will be adopted by Congress. So even though the deficit as a share of GDP is likely to decline significantly as the economy recovers and as temporary stimulus and recovery measures die out, the US will face significant challenges to deliver on its commitment of rebalancing the US economy through fiscal consolidation.

Rebalancing US growth also requires more than a sustainable fiscal path. It also requires reducing the gap between the growth of spending and the growth of income in the US, and this requires an increase in national saving. America's net national saving rate – the sum total of deprecation-adjusted savings of households, businesses and the government sector – turned negative in 2008 before plunging to a record low of -2.6% of national income in 2009. This is the most serious shortfall of domestic saving by a leading nation in modern history. Just as China must reduce its saving surplus to deliver on its rebalancing commitments, the US must reduce its saving gap to do the same. Between 2000 and 2008, US saving declined both because of increases in the federal budget deficit—a measure of government disserving—and because of a dramatic drop in household saving. During the recession, the household saving rate has recovered somewhat, rising from essentially zero in 2007 to about 4% in 2008-2009 before falling back to about 3.6 % in April 2010. Many economists predict that the household saving rate will rise during the next several years to its historical average of about 7%, but there is considerable uncertainty about this. In the S&ED discussions, the US promised to introduce policies to reinforce rising household saving rates but did not offer any specifics, and policies tried in the past have not been very effective.

As part of its rebalancing agenda, the Administration has also set a goal to double US exports over the next five years and has introduced supporting policies and organizational changes. An active US trade policy to reduce access barriers to US exports in rapidly growing emerging markets including China is essential to realizing this goal. We discuss trade policy in US-China relations in the next section of this testimony. Unfortunately, since Europe is a major destination for US exports and since European companies are major competitors of US companies in China and other rapidly growing export markets, the recent slowdown in Europe and the sharp drop in the value of the Euro pose serious downside risks to strong US export growth over the next few years.

Nor would such growth ensure a sustained reduction in the US trade deficit and current account deficit as the economy recovers. The size of these deficits depends on both

exports and imports and reflects the size of the US saving gap, or the gap between how much the US produces and how much it spends. During the recession, this gap, as measured by the current account deficit as a share of GDP, declined significantly to 2.9% in 2009 from its 2007 peak of 6% of GDP. This drop in the saving gap is primarily the result of a sharp reduction in private sector spending relative to private sector income, as US households and businesses have curtailed spending to rebuild balance sheets and deleverage their financial positions. Despite the retrenchment in private sector spending relative to income, the current account deficit, which is a measure of the national saving gap, has remained sizeable because the government deficit has increased as a result of tax cuts and spending increases to combat the recession.

Most forecasters predict that the US will continue to run a significant current account deficit around 3% of GDP for the next several years if the fiscal deficit is reduced and if the household saving rate increases from its historic lows of the 2002-2007 period. A deficit of this size would roughly stabilize foreign US debt as a share of GDP. Provided the US convinces China and other global investors of its commitment to a sustainable long-term fiscal path, it is likely that the US can finance a current account deficit of this size with reasonable long-term interest rates on US government debt in the 4%-5% range.

What happens to the US trade and current account deficits and to US borrowing requirements from the rest of the world depends primarily on what the US does to increase private saving and to reduce government dissaving. China's trade and exchange rate policies are of second-order importance. If the US fails to sustain a significant reduction in its saving gap, its trade and current account deficits will rise again as a share of GDP as the economy recovers. That will be the case even if China succeeds with its own rebalancing agenda and reduces its current account surplus as a share of its GDP and even if China moves to a pure market-determined exchange rate. The risk in this case would be that of an "asymmetrical global rebalancing" – a scenario in which China makes more progress in transitioning to a consumer-led economy than the US makes in closing its saving gap.

The odds of an asymmetrical rebalancing scenario should not be minimized. China's stimulus policies and the likely components of the 12th Five Year Plan indicate that China could well make significant progress in rebalancing its economy over the next several years. In contrast, the stimulus policies in the US, while essential and justifiable to combat the recession, have exacerbated the long-run saving gap and have not rebalanced growth away from consumption toward exports and investment. Moreover, given the partisan atmosphere in Congress, passage of a credible multi-year deficit reduction plan to reduce the nation's saving gap on a sustained basis once the economy has recovered seems unlikely, at least in the near future.

II. An Activist Trade Policy to Level the Playing Field in China and Support US Rebalancing

China is now the largest exporter and the third largest importer in the world. It is the third largest and fastest growing market for US exports in a wide range of products. If the US is to succeed in rebalancing its growth – shifting from credit-driven consumption and housing toward investment and exports – continued rapid growth in US exports to China is essential. China also receives a major share of the foreign direct investment of US multinational companies, many of which have extensive and growing operations there. Offshore Chinese production platforms are critical to efficiency solutions for high-cost US manufacturers and support their production, employment, profits, R&D and investment in the United States. Access to China's large and growing market is a significant factor in the success of many US businesses, both large multinational companies and many small and medium-sized companies as well. Reducing barriers that impede the access of US companies to China's markets is and should be a major objective of US trade policy. The Obama Administration rightly accorded priority to this goal in the recent S&ED discussions, focusing in particular on the effects of China's innovation policies, government procurement policies, and foreign direct investment policies on American companies exporting to and/or producing in China.

During the last few years, many American companies (along with European and Japanese companies) have raised concerns about China's so-called "indigenous innovation" policies to promote the development of Chinese owned technology and intellectual property and to reduce China's dependence on foreign technologies. Initially, the call for indigenous innovation was more hortatory than real. But recently the call has been given practical effect through policies that include not only strong incentives for innovation by Chinese companies but also policies that discourage the participation of foreign companies in technologies or sectors deemed to be strategic by the Chinese government. In a recent survey of 388 US companies conducted by the American Chamber of Commerce in China, 28% said that they are already losing business as a result of China's indigenous innovation policies, and 57% of high-tech companies said that they expect to lose more business in the future as these policies are fully implemented.

Seven of the eight top challenges to doing business in China identified by the survey's respondents relate to obstacles posed by the policies of the Chinese government in a wide range or areas, including procurement, standard setting, intellectual property protection, subsidies and approvals for foreign direct investment. These survey results reveal a growing concern among American businesses that China is adopting more restrictive promotional policies that favor Chinese companies and that pose significant access barriers to foreign companies doing business in China. There is mounting evidence that China's trade and industrial policies are changing in ways that are impeding access of foreign producers to China's market and that fall outside of WTO rules and enforcement procedures.

Preference in government procurement has recently become a key weapon in China's arsenal of indigenous innovation policies. According to China's long-term plan for

scientific and technological development, the government should establish a priority procurement policy for important high-tech products and equipment developed "by domestic enterprises with independent intellectual property." Since China is not a signatory to the Government Procurement Agreement (GPA) of the WTO, its procurement procedures are not covered by the agreement and not actionable at the WTO. But China's preferential treatment of its domestic producers in government procurement is not an isolated development. Indeed, China's preferential procurement policies were given an implicit green light in 2009 when several nations that are GPA signatories framed their stimulus actions to provide support to their own companies and workers. (The "Buy America" provisions of the US stimulus package are a case a point. Although these provisions did not have a significant effect on procurement and trade in the US, they did send a strong signal to China.)

In November 2009, several of China's most powerful ministries issued a joint circular, announcing the intent to create a national catalogue of "indigenous innovation" products for government procurement," and proposing accreditation conditions to determine whether particular products qualified for inclusion in the catalogue. Although the accreditation conditions do not include explicit restrictions against the products of foreign-owned companies, they effectively deny access to such products if the technology does not originate in China—even if the products are entirely produced in China, with 100% local content. That's because most of the products sold by American companies in China embody many technologies sourced from the US and other locations and also because American companies are reluctant to develop technologies in China as a result of inadequate intellectual property protection there.

We are encouraged that the recent S&ED discussions made some progress on the indigenous innovation and related government procurement issues, although China did not agree to a US request for full suspension of its indigenous innovation policy. Instead, China confirmed its commitment to innovation policies consistent with the principles of nondiscrimination, intellectual property protection and market competition and agreed to hold high-level bilateral talks on such policies. China also agreed that the terms of technology transfer should be shaped by agreements among companies without government interference. In response to US concerns, China removed several troubling conditions from its product accreditation circular, including the requirement that products be patented or trademarked in China, and agreed to delay final implementation of the national catalogue to assess public comments.

China also promised to submit a revised offer to join the WTO Government Procurement Agreement by July. Given the importance of the government and of state-owned companies in the Chinese economy, China's participation in this agreement should be a major objective of US trade policy. As part of its WTO accession agreement, China committed that state-owned and state-invested companies would make their decisions solely on commercial considerations and that the government would not attempt to influence these decisions either directly or indirectly. In principle, these commitments are enforceable through the WTO dispute settlement mechanism. But US companies frequently complain that the procurement decisions of state-owned companies either

follow the decisions of state agencies or are influenced by government actors. A convincing bid by China to join the GPA could help assuage these concerns.

In response to Chinese concerns, the US softened its position on two key issues of long standing interest to China. First, the US promised to ease restrictions on some high-technology exports to China. While this is a priority issue for China, US controls on such exports have only a small effect on US trade with China. According to recent estimates, only about 0.3% of all US exports to China and about 0.6% of all US advanced technology exports to China require an export license. The figures for Europe are comparable: 0.2% of all US exports and 0.4% of all US advanced technology exports to the EU require a license. Moreover, around 80% of the exports to China that require a license receive a license exemption and the value of all denied licenses is minimal. Second, the US agreed to consult with China on its desire to be accorded "market economy status" within the WTO and scheduled consultations for the fall meeting of the US-China Joint Commission on Commerce and Trade. In its original accession agreement to the WTO, China agreed to be treated as a non-market economy in anti-dumping and countervailing duty cases. As a result, the US or any other WTO member can initiate an anti-dumping investigation against Chinese products using the product prices of a third country as a benchmark. This makes Chinese firms especially vulnerable to anti-dumping cases and the imposition of anti-dumping tariffs on its products. As part of its WTO accession, China also agreed to annual compliances reviews of its implementation of its accession agreement.

So far, the US has been reluctant to recognize China's status as a market economy and has posed several conditions that China must meet including the adoption of a market-based exchange rate regime. Now the US will have to decide whether China's decision to allow the market to determine the RMB-dollar rate within a managed band satisfies this condition. We think it should and we think it sets the grounds for progress on China's bid for market access status during the upcoming JCCT consultations. The US will lose it ability to use the market access issue as a bargaining chip with China in 2016 when it will be accorded such status automatically.

Both the US and China have been major beneficiaries of the growth in world trade and foreign direct investment triggered by the WTO and both have been active users of WTO enforcement to address trade disputes, including bilateral disputes. In recent testimony, Alan Wolff, co-chair of Dewey & LeBoeuf's International Trade Practice Group, examined the history of US-China trade relations within the WTO and concluded that the US has enjoyed "reasonably positive results." The US has brought WTO cases against China when the US government has the support of the relevant businesses or industries and when it believes it can persuade a WTO panel that China is violating its WTO obligations. China has often ceased the practices in question without going through a formal dispute settlement panel process.

But the future is likely to be more challenging because many of the practices at the center of US-China trade frictions and many of the promotional policies playing a more prominent role in China's development strategy are either inadequately covered or are

difficult to enforce by the WTO. These practices include indigenous innovation policies, discriminatory procurement behavior by state-owned enterprises, national standards that favor national champions, lax enforcement of intellectual property protection and implicit or explicit local content rules for participating in major economic sectors like wind and other renewable energies. Such practices are a violation of the spirit and in some instances the law of China's WTO commitments and harm not just US companies but companies from other developed and emerging market nations. That's why the US should continue to treat market access barriers as a priority issue in the S&ED discussions, should continue to lodge WTO cases against such barriers when they violate China's WTO commitments, and should encourage China's other trading partners to address such barriers in regional and multilateral discussions .

III. China's Holdings of US Debt and US-China Relations

As of April 2009, China's held over US$2.4 trillion in foreign exchange reserves, by far the largest in the world. Its holdings of US Treasury debt totaled $900 billion, or about 11% of total UST debt held by the public and about 25% of total UST debt held by foreign investors. (China also holds around $405 billion or about 6% of US agency debt, primarily Fannie Mae and Freddie Mac debt). At current trends, even with continued rebalancing in China and smaller current account surpluses as a share of GDP, China's FX reserves will continue to grow, albeit at a slower pace, and are likely to top $3 trillion by 2011. Given the lack of attractive non-dollar currency alternatives, exacerbated by the uncertainty and turbulence in euro-denominated assets, it is likely that a significant share of China's growing reserves will continue to be held in US government securities. And even if there is a sustained increase in US private saving and a significant reduction in the federal budget deficit—both of which are far from certain – it is highly likely that the US will continue to run a significant current account deficit in the 3% to 4% range and will continue to depend on foreign investors, including China, to finance its saving gap. Moreover, given the sheer size of China's holdings of US dollars and government securities, a precipitous action by China to shift out of US dollar assets could cause a sizeable increase in long-term interest rates in the US, and a sharp decline in the prices of US government securities and the dollar's value. Even cutting the share of China's holdings of US Treasury securities by five percentage points would probably be enough to rock global financial markets, with damage on both the US and China. China would sustain capital losses on its large dollar holdings as a result of falling prices on US government securities and a drop in the dollar's value.

Despite the prospect of such capital losses, would China be willing to sell some of its dollar holdings to respond to a foreign policy dispute with the United States or to retaliate against what it deemed to be an assault on its sovereignty? For example, if the US enacted broad-based trade sanctions on China's exports because China does not succumb to US pressure for a sizeable RMB appreciation, would China retaliate by selling some of its stock of US government assets or reducing its future purchases of such assets? Many observers believe that China would not take such actions, at least not on a meaningful scale, because they would impose painful capital losses on China. Even if such losses

were significant, however, China might be willing to bear them in retaliation for what is perceives to be unfair trade or other policy sanctions that infringe on its sovereignty. There is every reason to believe that China would view such US actions as an act of economic aggression. Nationalist sentiment inside of China is very high – suggesting that Beijing would be under considerable pressure to take retaliatory measures irrespective of any potential portfolio losses. There is far more to China's FX management objectives than simply seeking optimal rates of financial return.

Moreover, as Professor Eswar Prasad explained in recent testimony before the *US-China Economic and Security Review Commission*, the potential for losses in the value of China's foreign exchange reserves could prove to be quite modest for three reasons:

1. A spike in US interest rates in response to a sell-off of US assets by China would impose a capital loss on the value of China's US Treasury holdings on a mark to market basis. But given its large stock of reserves and the fact that it has no obvious liquidity needs, it is likely that China values its assets on a hold to maturity approach rather than a mark to market approach.

2. A decline in the value of the dollar against other major currencies triggered by China's action would reduce the RMB value of China's dollar-denominated holdings, if the RMB appreciated relative to the dollar. Otherwise, China would suffer capital losses on the value of its euro and yen assets as the dollar declined, but it would benefit from enhanced competitiveness if the RMB declined with the dollar against the currencies of its other major trading partners.

3. A sizeable appreciation of the RMB against the dollar would lead to a sizeable capital loss on the value of China's dollar holdings measured in local currency. But the loss could be offset over time as China moves forward on exchange rate flexibility, capital market liberalization, and reserve currency status.

Prasad concludes that a threat by China to move away from US Treasuries is a credible threat that should be taken seriously by US policymakers. We agree. And under current market conditions, such a threat could trigger investor concern about the huge financing needs of the US government, causing a sharp spike in interest rates and a crisis of confidence in US sovereign debt.

China has repeatedly expressed its desire for FX portfolio diversification – namely, to put in place a disciplined program to reduce its existing holdings of US government securities and to slow down the acquisition of new holdings. It has been attempting to do this in part through the establishment of the China Investment Corporation, a sovereign wealth fund with an initial capital base of $200 billion. But this is a small amount relative to China's overall dollar holdings. The real problem for China is that there are no relatively safe investments other than US government bonds that are deep and liquid enough to absorb a significant share of the massive inflow of dollars that enter China each year as a result of its large trade surplus, inward foreign direct investment and hot money in anticipation of a significant RMB appreciation. And the dollar-recycling

strategy is, of course, heavily dependent on Beijing's desire to maintain a relatively tight relationship between the RMB and the dollar. Overall, that means that China is likely to continue to hold large amounts of dollar assets and that these holdings will grow each year by a sizeable amount.

IV. Recommendations

The S&ED is an important forum through which the US and China can ameliorate the tensions in their relationship and cooperate on policies to foster a balanced and prosperous world economy.

The US should continue to cooperate with China in the G20 on macroeconomic policies to support a strong global recovery and to foster more balanced global growth in the future.

China's stimulus policies fostered a strong rebound of the Chinese economy and boosted global growth by providing strong demand for exports from the US and China's other trading partners in 2009 and through the first half of 2010. China's stimulus policies helped rebalance China's growth away from dependence on exports and toward domestic demand. In 2009, consumption growth accounted for about half of China's GDP growth and China's current account surplus as a share of its GDP declined by nearly 50%.

We recommend that China continue to rebalance its future growth in order to increase the contribution of consumption and to reduce the contribution of exports, and we believe that China will do so out of both necessity and choice. The likelihood of slower consumption growth in both Europe and the US over the next several years will mean slower growth in the demand for China's exports. To preserve social stability, on which the legitimacy of its leadership depends, China must boost domestic demand to absorb its growing labor force, to move surplus labor from low-productivity agriculture to higher-productivity manufacturing and services, and to reduce rural-urban income gaps.

We believe that China's infrastructure-led stimulus policies are building the foundation for strong future growth in domestic consumption. We also recommend and expect that China's upcoming 12th Five-Year Plan will spur accelerated pro-consumption rebalancing through investments in China's social safety net, through policies to promote services industries and through tax and other policies to reduce urban-rural income inequality.

We believe that as a result of its consumption-led rebalancing, China's multilateral trade and current account surpluses will be significantly lower as a share of GDP in the future than they were in the peak years of 2006-2008.

China's exchange rate should be assessed from a multilateral perspective rather than from a bilateral, dollar-centric perspective.

We applaud China's June 19 decision to end its crisis-induced RMB-dollar fixed peg and return to the "managed float" foreign exchange regime it first adopted in July 2005. A more flexible RMB driven by market forces benefits the global economy because it facilitates more balanced, sustainable global growth. It is also in China's interest because it supports China's rebalancing goals and it allows China to pursue a more independent monetary policy. At the same time, a tightly managed band on the dollar-RMB exchange rates is an important stability anchor for China's transition to more open capital markets. China's decision to return to a more flexible currency regime and allow the RMB-dollar rate to move within a managed band will allow the RMB to appreciate gradually in response to market forces. Over time, a stronger RMB will contribute to China's rebalancing by boosting the purchasing power of Chinese consumers and by encouraging Chinese producers to shift production toward domestic demand and away from exports.

We do not endorse the view that China should make a large adjustment in the RMB-dollar rate at this time. The RMB has already appreciated significantly in real terms on a multilateral trade-weighted basis. The key imperative for China is to reduce its saving surplus and rebalance its macro structure. Pro-consumption policy initiatives will be more important than changes in the RMB's trade-weighted exchange rate in achieving these goals. The US should refrain from making explicit demands about how China should go about implementing its rebalancing agenda. In particular, the choice between pro-consumption structural adjustments and the RMB-dollar exchange rate should be left to China.

A significant appreciation of the RMB relative to the dollar will not have a significant effect on the US trade deficit or on US employment. Much of the growth in US imports from China has been the result of production moving to lower-cost China not from the US but from other higher cost countries, especially in Asia. And China's bilateral trade deficit with the US needs to be seen as but one piece of a much broader multi-lateral problem, reflecting America's large saving gap.

The US should not impose tariffs on Chinese exports if there is not a significant appreciation of the RMB. Such tariffs would drive production to other emerging market economies not to the US. In addition, China would retaliate in one of three ways all of which would be damaging to US interests: lodging a WTO complaint that would almost certainly prove successful; imposing tit for tat tariffs on US exports to China; or reducing demand for US securities.

Section 3004 (b) of the Omnibus Trade and Competitiveness Act of 1988, which requires the Treasury to issue a biannual foreign exchange report assessing whether US trading partners are "manipulating" their exchange rates vis a vis the dollar, has become dangerously politicized and should be repealed or revised. Currency values should be assessed on a multilateral basis rather than a bilateral basis, and the International Monetary Fund, rather than the US Treasury, is the appropriate multilateral organization for evaluating the exchange rate policies of member countries.

The US current account deficit is the result of the nation's saving gap or the gap between how much the US is producing and how much it is spending. To reduce this gap, the US must reduce the federal budget deficit and, as the economy recovers, must increase the household saving rate, which fell to nearly zero during the 2001-2007 period. A higher household saving rate will require that the US rebalance growth away from consumption toward reliance on exports and investment.

During the recession, the US saving gap has declined relative to GDP, primarily as a result of a sharp temporary increase in private saving as households and businesses deleverage. But the saving gap has remained substantial as a result of stimulus policies that have caused a big increase in "dissaving" by the federal government. What happens to the US current account deficit in the future as the economy recovers depends on what the US does to reduce its saving gap. China's trade and exchange rate policies are of second-order significance. If the US fails to reduce this gap, its trade and current accounts deficits will rise again as a share of GDP even if China succeeds in rebalancing its economy.

The possibility of an asymmetrical global rebalancing scenario remains a very real risk. China's stimulus policies and the likely pro-consumption thrust of the upcoming 12th Five-Year Plan indicate that China should make significant progress in rebalancing its economy over the next several years. In contrast, the stimulus policies in the US, although essential and justifiable to offset the 2008-2009 recession, have exacerbated the long-run saving gap and have not rebalanced growth from consumption toward exports and investment. And given the partisan atmosphere in Congress, passage of a credible multi-year deficit reduction plan to reduce the saving gap on a sustained basis once the economy has recovered seems unlikely – at least in the near future.

According to projections by the OMB, the CBO, and private forecasters, US fiscal policy is not on a sustainable path: in the absence of additional deficit reduction policies, the federal government's debt will continue to rise relative to GDP through 2020 even if the economy recovers from the 2008-2009 recession.

At the S&ED discussions, the US committed to adopting policies to achieve fiscal sustainability in the medium to long run and to stabilize the debt-to-GDP ratio. Given the size of projected federal government deficits, these policies will require some combination of painful spending cuts and revenue increases. We recommend that the Congress work with the Administration to pass a credible multi-year deficit reduction plan to stabilize the debt to GDP ratio. This plan should take effect gradually as the economy recovers: policies to reduce the deficit too quickly will slow the recovery and increase the losses in potential output from high unemployment and excess capacity.

Access to China's large and growing market is a significant factor in the success of many US businesses, both large multinational companies and many small and medium-sized companies as well. Reducing barriers that impede the access of US companies to China's markets is and should continue to be a major objective of US trade policy.

China's industrial policies appear to be changing in ways that are reducing access of foreign producers to China's market and that fall outside of WTO rules and enforcement procedures. Indigenous innovation policies, discriminatory procurement behavior by state agencies and state-owned enterprises, national standards that appear to favor national champions, lax enforcement of intellectual property protection, and implicit or explicit local content rules in strategic activities like renewable energy are areas of growing concern to US companies. The US should continue to negotiate with China to reduce these barriers both in the S&ED discussions and in regional and multilateral discussions that include China's other trading partners who are also disadvantaged by such barriers.

Given the importance of the government and of state-owned companies in the Chinese economy, China's participation in the Government Procurement Agreement (GPA) of the WTO should be a major objective of US trade policy. The US should negotiate with China to ease US security controls on exports to China and to advance the timing for the recognition of China's market economy status in the WTO (currently scheduled for 2016) in return for a strong offer by China to join the GPA. A bargain along these lines could also help revitalize the Doha talks, something the US and China committed to do at the recent S&ED meeting.

The US should take the lead in negotiating a Trans-Pacific Partnership agreement as a major step to the creation of a free trade area for the Asia Pacific. Several bilateral and regional preferential trading agreements have recently been signed in Asia, and the region is heading toward the de facto creation of an economic bloc that would be discriminatory against the US. The completion of a Trans-Pacific Partnership agreement would arrest this disturbing trend and could re-ignite APEC's role in global trade liberalization. In the 1990s, APEC played a key role in the negotiation of a global agreement liberalizing trade in information technology products. A revitalized APEC could play a similar role in the creation of a global agreement on trade in "green" technologies and products.

A threat by China to shift the allocation of its vast foreign exchange reserve portfolio away from US securities to respond to a foreign policy dispute with the US or to retaliate against a US policy deemed to be an assault on China's sovereignty is a credible threat that should be taken seriously. Even the suggestion of such a move could trigger concerns among global investors about the huge financing needs of the US government, causing a sharp spike in interest rates, a crisis of confidence in US sovereign debt, and a collapse in the dollar. As the world's largest external borrower, the United States must exercise great caution in exerting undo pressure on its most important foreign lender.

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