CHINA'S ROLE IN THE ORIGINS OF AND RESPONSE TO THE GLOBAL RECESSION

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CHINA'S ROLE IN THE ORIGINS

OF AND RESPONSE TO THE GLOBAL RECESSION

TUESDAY, FEBRUARY 17, 2009

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION
Washington, D.C.

The Commission met in Room 562, Dirksen Senate Office Building, Washington, D.C. at 9:45 a.m., Chairman Carolyn Bartholomew, Vice Chairman Larry M. Wortzel and Commissioners Michael Wessel and Daniel Slane (Hearing CoChairs), presiding.

OPENING REMARKS OF CHAIRMAN CAROLYN BARTHOLOMEW

CHAIRMAN BARTHOLOMEW: Good morning, everybody. Welcome to today's hearing on "China's Role in the Origins of and Response to the Global Recession."

I'm Carolyn Bartholomew, the Chairman of the U.S.-China Economic and Security Review Commission for the 2009 reporting year. Today's hearing, the first of our hearing cycle, will be cochaired by Commissioners Michael Wessel and Dan Slane.

For those who are new to our hearings, let me say that we are a bipartisan Commission composed normally of 12 members, six of whom are selected by the Majority and Minority Leaders of the Senate and six from the Speaker and Minority Leader of the House. Commissioners serve two-year terms. We currently have two vacancies.

Congress has given our Commission the responsibility to monitor and investigate the national security implications of bilateral trade and economic relations between the United States and China.

We fulfill our mandate by conducting hearings and undertaking related research as well as sponsoring independent research. We also travel to Asia and receive briefings from other U.S. government agencies and departments. We produce an annual report--normally at this point I hold one up--and provide recommendations for Congress for legislative and policy change.

For those of you who are interested in the report and who might be watching this, our Web site is www.uscc.gov, and our report and our hearing transcripts will be available there.

As I mentioned, this is the first hearing for the 2009 reporting year and the first hearing with the new administration here in Washington. The new administration will have to deal with a lot of critical issues in 2009 along with the worst economic crisis the world has seen in the past 60 years.

Today's hearing is on the global economic crisis, the role that China has played in the global recession, and its role in plans and actions to address the crisis.

The implications of this global recession are enormous. We must think carefully and clearly about rules governing lending and borrowing and trade and investment. The interconnectedness of the U.S. and Chinese economies has been clearly demonstrated in this crisis. How the U.S. and China decide as individual nations and working together to react will define the prospects for the next generation.

Later this year, we will have hearings on the PLA's activities abroad and China's activities in Asia. Furthermore, we intend to hold hearings this year on China's industrial policy and its pillar industries as well as China's internal and external propaganda efforts.

I ask that each of our panelists today speak for no more than seven minutes which will allow us the maximum time for questions and answers, and let me now introduce Commissioner Larry Wortzel, our Chairman from the 2008 reporting cycle and this year's Vice Chairman.

OPENING REMARKS OF VICE CHAIRMAN LARRY M. WORTZEL

VICE CHAIRMAN WORTZEL: Good morning. Thank you, Chairman Bartholomew.

I want to welcome the panelists, the public and the press corps. Chairman Bartholomew mentioned the Web site. I'll mention it again, www.uscc.gov. You'll find our 2008 report on there with its conclusions and recommendations. Within a couple of weeks of this hearing, you will get its testimony on the website.

This hearing is going to provide a wealth of information and we hope different views on the current economic crisis. It's timely in that sense.

I also want to make a couple of administrative remarks. That's the onerous task that falls to the Vice Chairman here. If you are going to be with us for the whole day, we're going to break at 1:15 and resume again at 2:15. There is a snack bar and carry-out down in the basement of the Russell Building and another one in the basement of this Dirksen Building.

We are talking today about the global economic crisis. I would say that this global recession has exposed weaknesses in our economic system, in the global economic system, and it has shown the interdependence between the U.S. and Chinese economies. We're going to try and explore China's relationship to the crisis, the policies that it plans to implement to overcome the crisis, and how those policies may affect the U.S.

With that, let me turn to Commissioner Michael Wessel, one of the Cochairs of today's hearing.

Thank you.

OPENING REMARKS OF COMMISSIONER MICHAEL WESSEL, HEARING COCHAIR

HEARING COCHAIR WESSEL: Thank you all for being here. Thank you, Vice Chairman Wortzel.

I'm very pleased to have the opportunity to cochair today's important hearing along with Dan Slane. Our hearing today is being held against the backdrop of an economic meltdown being felt all across the globe. Millions of Americans have lost their jobs, their homes, their retirement savings. The passage of the economic stimulus package is but one step down the road to recovery.

The housing crisis may have been the precipitating event that brought the financial house of cards down, but the roots of today's economic problems run far deeper and are interrelated.

The crisis was fueled, in part, by a consumption bubble inflated by failed trade policies and unregulated financial markets. Blame can and must be broadly shared.

Today's witnesses will speak on various aspects of the global recession, particularly the role that China played in contributing to the global imbalances that lie at the core of the problem. We'll also hear about China's specific efforts and policies to deal with the global recession and to stimulate its national economy.

We will look, in particular, at China's investment in U.S. debt and Chinese consumption and savings pattern.

As China confronts the challenges it faces, the question is whether it will continue to pursue its expert-led growth policies or whether it will embrace a different strategy that will help restore growth at home and worldwide?

Will China accept the responsible stakeholder mantle or continue on its present course? Successfully overcoming this global recession will depend to a considerable degree on which course China decides to pursue.

The Commission will take all views into account when it later formulates its own recommendations to the Congress. We appreciate the work our distinguished witnesses have put into preparing their statements and we thank them for being here to testify today, and we also want to thank our staff who have put in countless hours preparing for today's hearing as well.

Thank you.

HEARING COCHAIR SLANE: Thanks to everybody for coming and a special thanks to Senator Nelson and the Senate Rules Committee for providing today's hearing venue.

I also want to acknowledge the great job Paul Magnusson and our staff did in putting this hearing together.

During the past year, we have witnessed the worst financial crisis the world has seen since the Great Depression. Today we have three great panels that are going to help us figure a way out of the global recession.

Our first panel for today is going to address among other things the origins of the global financial crisis. In particular, we are interested in hearing about China's specific policies and the degree to which they added to the crisis.

Nicholas Lardy is a Senior Fellow at the Peterson Institute for International Economics. Dr. Lardy has had a long and distinguished career as a China scholar and has written numerous articles and books on the Chinese economy, most recently, China's Rise: Challenges and Opportunities, to which he contributed chapters on China's domestic economy and China in the world economy.

Stephen Roach is Chairman of Morgan Stanley's Asia operations in Hong Kong. Mr. Roach is widely acknowledged as one of Wall Street's most influential economists. His research covers a broad range of topics with recent emphasis on globalization, the emergence of China's productivity, and the macro paybacks of information technology.

Robert Cassidy is an International Trade and Services Professional in the International Trade and Customs Practice Group of Kelley Drye & Warren.

Mr. Cassidy worked in the U.S. government for 30 years and was the chief U.S. negotiator on China's 1999 Market Access Agreement with the United States for China's accession to the WTO.

Welcome, gentlemen. Thank you for coming and we're going to start with Dr. Lardy.

PANEL I: THE ORIGINS OF THE FINANCIAL CRISIS AND LINK TO CHINA

STATEMENT OF DR. NICHOLAS R. LARDY, SENIOR FELLOW, PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS, WASHINGTON, DC

DR. LARDY: Thank you very much. I'd like to thank the commissioners for inviting me to participate in this hearing today.

I'd like to focus my remarks on the actions that China is taking in response to the global downturn and to give an assessment of their likely effects.

I think the key point that I would emphasize is that China is the gold standard in terms of its response to the global economic crisis. If you look at the magnitude of what they are doing in several domains, it is very substantial, and among the economies that matter, at least according to the IMF, China's stimulus program relative to the size of its economy is larger than that of any other country including the United States, and I think they may have underestimated what China is doing.

I would highlight three aspects of what they have announced so far, and I will start with monetary easing since China announced that in September last year. It was one of their first steps that they took, eliminating lending quotas, reducing interest rates, and a number of other steps.

And unlike in the United States where banks for the most part have not been willing to lend, we have seen over the last three months a very substantial increase in Chinese lending to corporates and to households. So the financial sector is responding very well so far to the slowdown in global economic growth.

The second component that I would highlight, and I think this is better known, is the infrastructure investment program that China rolled out in November. We can argue about some of the details, but I think this is going to amount to a stimulus in the neighborhood of two to three percentage points of GDP. It seems very well focused on areas where returns should be high, and I do not think China is going to have the problem of Japan a decade ago of building bridges to nowhere.

The third component which I think has been less widely noted or analyzed is that China has very substantially stepped up its social programs and its transfer payment programs. The social programs are extremely important because they do contribute, I believe they will contribute to rebalancing the economy, will reduce the precautionary demand for savings, and lead households to spend a larger share of their disposable income.

I think the most notable example in this regard is the commitment that they have now made to expand health insurance coverage to include an additional 400 million Chinese which will give them near universal coverage by 2011.

This will mean that the share of total health care expenditures in China paid for by the government is going to more than triple over the next three years. The share paid by households on an out-of-pocket basis will decline very dramatically.

On the transfer payment side, they've done quite a bit. They have some transfer of payment programs for 75 million low-income people. Those people are getting much, much more money this year than they have in previous years, and China has also substantially increased pension payments to pensioners. The increases are several times the rate of inflation.

So I think in all three areas, China has done extremely well. The conclusion I draw from this quite frankly is China has the prospect of bottoming earlier than any other major economy in the globe. I don't know whether it will be this quarter it will be off the bottom or the second quarter, but I'm reasonably confident that either this quarter or the second quarter of this year, China will come up from the 6.8 percent growth recorded in the fourth quarter of last year.

And I say that because China does not have any toxic financial assets. It did not acquire very much from abroad, and its regulators have not allowed the introduction of complex derivative products of any kind, and the result is the central government has not had to inject capital into any financial institution, bank or otherwise, as a result of the crisis, nor have they had to guarantee the liabilities of any bank or other kind of financial institution.

Secondly, China is very underleveraged, particularly by comparison with the United States. This is a theme that I know Steve has written about for years very forcefully, and I can just summarize it in one comparison: debt to GDP, household debt to GDP in the United States is roughly 100 percent; household debt to GDP in China is 20 percent.

We are having a huge contraction because demand is not just slowing but actually shrinking, and consumption demand in China is not shrinking, it is still growing fairly rapidly, and households do not need to deleverage as is the case in the United States. We're going to have a substantial increase in our savings rate over the next few years which is going to mean that our recovery when it does come, will be relatively slow. Just to give you a few further points, the average loan-to-value ratio for a mortgage in China taken out by a household today is 50 percent. They don't have home equity loans. You can't go back and refinance and take your equity out if there's been a price increase.

China is now the largest market for cars in the United States. 90 percent of them are sold for cash. Bank lending or other kinds of lending for financing automobiles is minuscule in China. That contributes to the low household debt.

The corporate leverage has also been falling in recent years, which puts them in a relatively strong position. So, as I say, I don't think consumption demand in China is going to collapse as we've seen in the U.S. It's likely to continue to grow fairly rapidly and put a floor on China's economic growth, and the lack of a need to delever means that consumption can play a more important role for reasons that I mentioned earlier.

I would say finally that China has the prospect of converging back to its long-term potential growth rate much sooner than most other countries in the globe, and in part this is because the government does not have very much debt. Debt to GDP is roughly 20 percent, slightly less, of the government, and going forward, I believe the United States and many other countries are going to have a very substantial medium-term fiscal sustainability issue which is going to restrict government expenditures, require increased taxes, or require higher interest rates.

I do not believe these conditions will prevail in China. Yes, China will run a budget deficit this year, but it will be relatively small and quite easily financed. So I think the prospects are that China will bottom earlier, converge back to its long-term growth potential faster and thus make, since it's the third-largest economy on the globe, thus make a very substantial contribution to the global recovery that we're all looking for.

Thank you.

HEARING COCHAIR SLANE: Thank you, Dr. Lardy.

Mr. Roach.

STATEMENT OF DR. STEPHEN S. ROACH, CHAIRMAN, MORGAN STANLEY ASIA, HONG KONG

DR. ROACH: Thank you very much, and I would also extend my appreciation to the commissioners for inviting me back to testify in front of this Commission.

I have prepared a written document that has been submitted for the record, and I would just like to summarize some of the key points of this document, insofar as how they bear on the global crisis and the interplay that this global crisis has brought about between the United States and China.

While this has become widely known as the subprime crisis, which started in America, it, in fact, is very much a global crisis. It's interesting in looking at the title of your hearing today, "China's Role in the Origins of this Crisis," I spend most of my time in Asia, and if there were a commission like this in Asia, the title would be reversed, "America's Role in the Origins of the Global Crisis."

The blame game is a dangerous and slippery slope for any of us to get involved in, and I would caution the Commission from avoiding that to as much an extent as possible. The facts are very clear here, that all the major economies in the developed world, are in a recession right now. We've never seen that before at any point in the post-World War II era.

In the developing world, all the major economies are either in recession or they're slowing very sharply. This is an extraordinarily synchronous global downturn. While America's subprime crisis may have been the spark, but these recessions that we're seeing or major slowdowns all over the world would not have occurred if there were not problems in economies all over the world. In my opinion, the globalization of this crisis, the globalization of this recession, is very much an outgrowth of the unwinding of massive imbalances that have been allowed to build around the world for a number of years by policymakers who just did not believe that they would prove to be a threat to world economic activity.

No country has been spared from this recession. That includes China. As Nick Lardy pointed out, the growth rate in China slowed very sharply in the fourth quarter of last year to 6.8 percent year-on-year. But that's expressed on a year-on-year basis. If you translate that number into a sequential quarterly number, as we report in the United States and as Japan reported a devastating number yesterday, the fourth quarter growth rates for China, by our calculations at Morgan Stanley, was a number very close to zero.

Now, it's not a precise estimate so it may be off by a percent or two on either side, but the deceleration from now the 13 percent increase that was estimated for calendar year 2007 down to a number close to zero is absolutely stunning.

In terms of diagnosing what's happened to the Chinese economy, it doesn't take a rocket scientist to figure out what's going on. Of all the major sectors of the Chinese GDP, the one sector that has by far increased the most since the turn of the century is exports. The export share of the Chinese economy went from 20 in 2001 to about 36 percent in 2007.

So China turned up the dials on its expert-led economy at just the time when the global trade cycle was booming. The global trade cycle has now gone from boom to bust, and the deceleration in China has been swift and furious. If you don't trust the Chinese numbers to capture this accurately, look at the major suppliers to the Chinese-centric export model in Asia. Taiwan exports to China in December down 56 percent year-on-year; Japan exports to China in December down 35 percent; same number for Korea.

So no matter how you cut it, there's been a massive slowdown in China. The Chinese have responded, as Nick Lardy said, very aggressively. I think this is encouraging. I agree with Nick that their response is very robust, very strong, especially when compared with responses around the world -- not just in the U.S., but also when compared with the responses in Europe and Japan.

The only area that I might quibble a little bit on with Nick Lardy would be the likelihood of a response of internal private consumption to some of the initiatives that were described. I think that consumption culture in China is very undeveloped, and I think, while I agree that the improvement in the medical insurance coverage is encouraging, that's only one small piece of the safety net.

Most of the other pieces are lacking, especially social security, where assets under management in the National Security Fund are only about US$74 billion. That works out to a number significantly below $100 per person, per worker, in terms of lifetime social security benefits in China.

So I think the high levels of precautionary saving that have been inhibiting private consumption in China will continue. That makes the infrastructure-type spending initiatives that have been previously described all the more important in providing temporary support for China.

The key question for China, I think, is do they shift their growth models from export to consumer led? They'd like to. When they released the 11th Five Year Plan almost three years ago, they said they would, but they haven't.

And they've gone back, I think, to the same old game plan of using proactive fiscal stimulus, largely infrastructure, to bridge the shortfall in their economic growth until, they hope, the export dynamic kicks back in.

I agree with Nick Lardy. I think that hope is not going to be realized because the U.S. consumer, which is the main driver of the external demand that China faces, is now in the early stages of what I think will be a multiyear consolidation.

So this raises a real challenge for Chinese policymakers. If they still have sluggish consumption and their export dynamic doesn't come back, do they have to keep upping the ante on infrastructure or other types of actions?

And this, of course, raises the currency issue which is something that we've all talked about in hearings like this, and an issue that has been raised recently by our new Treasury Secretary Tim Geithner, with potentially tough consequences for the bilateral trade and financing relationships between the two countries.

For what it's worth, I would say that--and I'll just conclude on this point--you have to be very careful about pointing the finger at China for causing problems in the United State -- whether it's through trade or funding America's consumption binge. No one forced American consumers to live beyond their means. The Chinese certainly didn't.

You could argue that Chinese buying and other foreign buying of dollar-based assets kept our interest rates lower and our asset markets frothier for longer than might otherwise be the case. But again, no one forced the American consumer to lever all their assets up to their eyeballs and squander the appreciation of those assets on current consumption.

And, yes, the Chinese and the U.S. run a large bilateral trade imbalance, but you have to keep in mind the context of that imbalance. America does not have a bilateral trade problem with China; it has a multilateral trade problem with over 100 nations.

America's trade problem is a saving problem. America’s net national savings rate, the sum total of all the savings in the U.S. adjusted for depreciation, is now decisively in negative territory for the first time in our modern history -- minus 1.8 percent in the two middle quarters of 2008. Lacking in saving, we must import surplus savings from abroad in order to grow and run massive current account and multilateral trade deficits to attract the capital.

We ran trade deficits with a hundred countries last year. So if China gets called on the carpet, as Mr. Geithner said, for currency manipulation, and actions are taken that would inhibit trade flows from China, unless we save, the Chinese piece of our multilateral trade deficit just goes somewhere else. That somewhere else would most likely be to a higher- cost producer, which taxes the same middle class American worker that the Obama administration is so desperate, understandably so, to protect.

So we've got to be pretty careful here in pointing the fingers at the hand that feeds us.

Thank you.

[The statement follows:]

Prepared Statement of Dr. Stephen S. Roach, Chairman, Morgan Stanley Asia, Hong Kong

Since the turn of the century, no two nations have been more important in driving the global economy than the United States and China. The American consumer has been the dominant force on the demand side of the global economy, whereas the Chinese producer has been the most powerful force on the supply side. Few argued with the payback. Over the four and half years ending in mid-2007, world GDP growth averaged nearly 5% – the strongest and most sustained boom in the global economy since the early 1970s.

But now both engines are sputtering, with ominous consequences for a world in its worst crisis since the 1930s. This poses great challenges for each nation, as well as to the bilateral relationship between them. There is hope but it comes with a big "if" – if China and the United States pull together in forging common solutions. However, if these two nations end up at odds with one another, they will both suffer – with dire consequences for the rest of a crisis-torn global economy. The stakes are enormous. There is no margin for error.

A World in Crisis

No nation has been spared the impacts of this wrenching financial crisis and recession. While America's so-called subprime crisis may have been the spark that ignited the inferno, every region in this globalized world is now faltering in lock-step fashion. That includes China – long the most resilient economy in an otherwise weakened world. And it includes the rest of an increasingly China-centric Asia, where all economies either have tumbled into outright recession or are slowing sharply. Ten years after the Asian financial crisis wreaked havoc in the region, a new crisis is at hand. Far from having decoupled from the rest of the world, Asia's problems – and China's in particular – are tightly linked to the crisis and recession that started in America and have since spread like wildfire throughout the developed world.

These problems have arisen, in large part, because of the unbalanced state of both economies. America's excess consumption model is in serious trouble because the asset bubbles that have long supported it – property and credit – have both burst. China's export-led growth model is in trouble because it is being adversely impacted by a massive external demand shock that is very much an outgrowth of America's post-bubble compression of consumer demand. The rest of Asia – export-dependent economies, which have become tightly integrated into a China-centric supply chain – has nowhere to hide. Ten years after the wrenching upheaval of 1997-98, Asia is facing another crisis.

Significantly, these imbalances did not occur in isolation from each other. America's consumption bubble was, in effect, sourced by an equally destabilizing Asian export bubble. And now both sets of bubbles have burst – on the demand side as well as on the supply side of the global economy. It had to happen at some point: Long simmering global imbalances have finally come to a head in a post-bubble world (see Figure 1).

China: Unbalanced and Unstable

During the boom, China's imbalances actually worked in its favor. Over the 2001 to 2007 period, the export share of Chinese GDP nearly doubled from 20% to 36% while the global export share of world GDP went from 24% to 31% (see Figures 2 and 3). In other words, China's timing was perfect. It upped the ante on its export dependence at precisely the moment when global trade enjoyed its most spectacular growth. That effectively turbo-charged China's benefits from the strongest global boom since the early 1970s, powering GDP growth at a 10.4% average rate in the seven years ending in 2007.

That was then. Reflecting the impacts of a rare synchronous recession in the US, Europe, and Japan, the world trade boom has now gone bust. And Chinese exports, which had been surging at a 25% year-over-year rate as recently as mid-2008, reversed course with a vengeance – ending the year in a mode of outright contraction, falling by 2.8% in December.

With exports such a large and rapidly expanding slice of the Chinese economy, little wonder measures of aggregate activity slowed in an equally dramatic fashion. Industrial output increased only 5.7% in December – one-third the average 16.5% growth pace of the preceding five years. And real GDP growth ended the year at just 6.8% – in sharp contrast to the nearly 12% pace of the preceding three years.

China's growth compression as reported on a year-over-year basis masks the severity of its recent downshift. A translation of these figures into sequential quarterly changes, such as those reported by the United States, suggests that Chinese GDP and industrial output growth were in the flat to slightly negative territory as 2008 came to an end. As seen from this real-time perspective, the Chinese economy hit a wall late last year. Such an abrupt downshift implies it will be extremely difficult for China to achieve the government's 8% GDP growth target for 2009. An outcome closer to 6%, or even lower, is a distinct possibility. China is hardly an oasis of prosperity in a crisis-torn world.

For a nation long focused on social stability, this growth shortfall is a worrisome development. It has already taken a serious toll on Chinese employment. The government has now acknowledged job losses in coastal export manufacturing businesses of over 15% – or 20 million workers – of the nation's pool of some 120 million migrant workers. If the export and GDP shortfall persists, more slack would open up in the Chinese labor market – raising long dreaded risks of worker unrest. I remain convinced that the Chinese leadership will do everything in its power to avoid such an outcome. But in this global recession, the challenge is daunting, to say the least.

Asia: China-Centric and in Peril

It has become conventional wisdom to proclaim that the 21st century would be the Asian Century. China's miraculous development story is central to this vision – a transformation that many believe would inevitably push the pendulum of global power from West to East. It's hardly an exaggeration to claim that such a tectonic shift would turn the world inside out. The Asia Dream is an exciting and powerful story – a magnet to financial and human capital from all over the world.

I suspect it may be premature to crack out the champagne. The Asian century is hardly as preordained as most seem to believe. The main reason, in my view, is that the region continues to rely far too much on exports and external demand. Developing Asia's export share hit a record high of 47% last year – up ten full percentage points from levels prevailing in the late 1990s (see Figure 4). That hardly speaks of a true economic power that has become capable of standing on its own.

At the same time, there can be no mistaking the increasingly China-centric character of the Asian economy – another dimension of the region's search for growth. As China boomed, the rest of Asia was more than happy to go along for the ride. A China-centric supply chain led to increasingly tighter pan-regional integration, with assembly lines in China drawing freely on inputs and components from Japan, Korea, Taiwan, Malaysia, Singapore, Indonesia, and elsewhere in the region. Yet that dependence cuts both ways – a two-way causality that is now complicating the here and now of the Asian century. As noted above, the China boom was itself very much tied to the record surge in global trade. But now with global trade contracting for the first time since 1982, China's export-led impetus has been quick to follow.

This has hit China-centric Asia extremely hard. The December 2008 export comparisons were nothing short of disastrous for the other major economies in the region: For example, Taiwan's exports were down an astonishing 42% y-o-y, with the Chinese piece off 56%; Japan's exports plunged 35%, with the Chinese piece off 35%; and Korean exports fell 17%, with the Chinese piece also off 35%. In all three of these cases, China had become each country's largest trading partners in recent years – accounting for 28% of total Taiwanese exports, 23% of Korean exports, and 16% of Japanese exports. But now that the Chinese export machine has screeched to a standstill, the rest of the region has weakened even more. This puts an Asian spin on an old adage: When China sneezes, the rest of Asia catches a bad cold.

I am convinced that the Asian century is coming. But the risk is that it may take a lot longer than widely presumed. All this underscores the biggest test to the Asian century – the ability of the region to stand more on its own in the event of an external shock. In the late 1990s, it was an external funding shock. Today, it is an external demand shock. These developments should put the region on notice that its leadership agenda is far from complete. Until export-led growth gives way to increased support from private consumption, the dream of the Asian century is likely to remain just that.

America: Bubble-Prone and Externally Dependent

There can be little doubt that this global crisis started in America. The ever-deepening recession in the US economy is very much an outgrowth of a massive post-bubble shakeout. It began with housing but has now spread to the biggest sector of all – the American consumer. At is peak in early 2007, US consumption accounted for fully 72% of real GDP – a record for the United States, and for that matter, a record for any major economy in the modern history of the world (see Figure 5).

The problem with this consumption binge is that it was not supported by the US economy's underlying income generating capacity. In the now-ended expansion, private sector labor compensation expanded at an unusually sluggish pace – falling over $800 billion (in real terms) below the trajectory of the previous four business cycles (see Figure 6). The confluence of subpar job growth and relative stagnation of real wages left consumers well short of the labor income that would typically support booming consumption. But that didn't stop the American consumer. Drawing freely on asset appreciation – first equities and then housing – consumers uncovered new sources of purchasing power. The credit bubble was icing on the cake – enabling homeowners to extract equity at little cost from ever-rising home values and then use the proceeds to fund current consumption and build saving for the future. Net equity extraction soared from 3% of disposable personal income in 2000 to nearly 9% in 2006 (see Figure 7).

There are important consequences of such a bubble-dependent consumption and saving strategy. Significantly, by shifting the mix of consumer support from income to assets, the United Sates drew down its domestic saving rate to rock bottom levels. The net national saving rate – the sum of household, business and government saving after adjustment for depreciation – plunged to a record low of 1.8% of national income over the 2002-07 period, and then actually tumbled into negative territory in 2008 (see Figure 8). The global consequences of this development are profound: Lacking in domestic saving, the United States was forced to import surplus saving from abroad in order to grow – and run a massive current account deficit in order to attract the capital.

The saving shortfall of a bubble-prone US economy is a major source of vulnerability. During good times, it made America increasingly dependent on foreign lenders, such as China, to fund economic growth. During bad times – especially in the aftermath of the bursting of the property and credit bubbles – it triggered a massive consolidation of asset-dependent US consumption. Real consumption expenditures fell at a 3.6% average annual rate in the final two quarters of 2008 – the first time in the post-World War II era when consumer demand fell by more than 3% for two consecutive quarters.

Despite the unprecedented contraction of consumption in late 2008, there is good reason to believe the capitulation of the American consumer has only just begun. The consumption share of US GDP has fallen only about one percentage point from its 72% peak – still leaving this gauge four full percentage points above the pre-bubble norm of

67% that prevailed from 1975 to 2000. On this basis, only about 20% of the consumer's mean reversion has been completed. Notwithstanding the extraordinary monetary and fiscal stimulus measures that have recently been put in place by US authorities, the post-bubble deleveraging of the American consumer is likely to be an enduring feature of America's macro landscape over the next 3-5 years.

Therein lies the essence of a massive and sustained global demand shock. The American consumer is the biggest consumer in the world (see Figure 9). And US consumption growth has long outstripped far more sluggish gains elsewhere in the developed world. Little wonder the post-bubble capitulation of the American consumer proved so decisive in undermining the external demand underpinnings for China and for the rest of export-dependent Asia. Nor is it likely to be over quickly. This multi-year headwind imparted by a sustained weakening in the growth of US consumption could well be the most powerful force shaping the demand side of the global economy for years to come.

Mounting Bi-Lateral Tensions

The current global crisis poses new challenges to the relationship between the United States and China – quite conceivably the world's most important bilateral relationship of the 21st century. Those challenges were underscored in the recent Senate confirmation hearings of America's new Treasury Secretary, Timothy Geithner, when he accused the Chinese of currency manipulation. Moreover, with the US in recession and unemployment high and rising, there is good reason to fear that Geithner's comments were just a warning shot of more China bashing on the horizon.

This is an unfortunate outgrowth of the blame-game mentality that has long been prevalent in Washington. During tough times, US politicians apparently need scapegoats to deflect attention away from the role they have played in creating serious problems. Wall Street is being singled out for causing the financial crisis – despite regulatory and central bank complicity – and China, with its large bi-lateral trade deficit with the United States, is being blamed for the pressures bearing down on American workers.

Washington's "logic" for turning tough on China trade policy is based largely on three factors – an outsize bilateral trade deficit between the two nations that hit a record $256 billion in 2007, long-standing claims of RMB currency manipulation, and a seemingly chronic stagnation of real wages for American middle class workers. Fix the China problem, goes the argument, and unfair pressures on US workers will be relieved.

This argument is deeply flawed. The main reason is that the US-China trade deficit did not arise in a vacuum. As noted above, a bubble-prone, saving-short US economy needs to import surplus saving from abroad in order to keep growing. That also means it must run massive current account and trade deficits to attract that capital. The US-China trade deficit, along with deficits with 100 of America's other trading partners is, in fact, an important outgrowth of that problem. America has a multi-lateral trade imbalance – not a bilateral problem driven by unfair Chinese competition. China has the largest bilateral piece of America's multilateral deficit – not because of the value of its currency but mainly because of conscious outsourcing decisions of US multinationals.

Nor is the evidence on the so-called undervaluation of the Chinese renminbi nearly as conclusive as many US experts seem to believe. For starters, the RMB is up nearly 21% against the US dollar (in real terms) since China abandoned its currency peg over three years ago. Moreover, recent academic research puts the RMB's multilateral undervaluation on the order of only 10% – hardly a major advantage for China (see Yin-Wong Cheung, Menzie D. Chinn, and Eiji Fujii, "China's Current Account and Exchange Rate," a January 2009 working paper of the US National Bureau of Economic Research). Significantly, these same researchers go on to demonstrate that China's bilateral and multilateral trade flows are not nearly as sensitive to movements in its currency as the RMB bashers would want to believe.

Nevertheless, if US-China trade is diminished or closed down through forced RMB revaluation, tariffs, or other means, a saving-short US economy will still need to run a large multi-lateral trade deficit. That means it will simply end up shifting the Chinese piece of its external imbalance to another trading partner. To the extent that shift is directed toward a higher-cost producer – most likely the case – the outcome will be the functional equivalent of a tax hike on the already beleaguered American middle class. But it won't stop there. Undoubtedly, Chinese currency managers would retaliate by reducing their purchases of dollar-denominated assets. And that would push the world's two great powers all the closer to the slippery slope of trade protectionism.

Avoiding such an outcome – strikingly reminiscent of the trade wars of the 1930s triggered by America's infamous Smoot-Hawley tariffs – poses a major challenge to the body politic of both nations. That's particularly true for America's new president. Campaigning on a platform of support for beleaguered middle-class American workers, Barack Obama underscored his concerns about real wage stagnation in an era of unfettered globalization. The real wage issue is a serious issue. However, the challenge for Washington is to determine the linkage between this issue and trade policy. It may well be that real wage stagnation is related more to America's under-investment in human capital – especially, lagging educational reforms and re-skilling programs in an era of rapid IT-enabled globalization – than it is to cross-border trade pressures. It may also be that trade deficits are far more a function of flawed policies that discourage saving – a problem that s now going from bad to worse in an era of trillion dollar budget deficits. Resolving this dilemma, without derailing globalization, will be an early and important leadership test for President Obama.

Don't Count on Symbiosis

In economic terms, there can be no mistaking the natural symbiosis that has long existed between America, the consumer and low saver, and China, the producer and high saver. But this complementarity cannot be taken for granted as a co-dependence that will forever cement the bi-lateral ties between these countries. In fact, it may well be that US-Chinese symbiosis is nothing more than passing phase – reflecting a coincidence of mutual interests that will exist for only a relatively brief period of time. Yes, as long as a saving-short US economy continues to run massive current-account deficits to support the excesses of personal consumption, it needs a lender like China to provide foreign capital. And as long as an excess saving Chinese economy needs export-led employment growth to maintain social stability, it needs the world's largest consumer to absorb its output.

But what happens if those conditions change? If America starts to save more – a distinct possibility for its over-extended post-bubble consumers – the need to borrow surplus saving from China will diminish. Conversely, if China starts to spend more – an equally likely possibility in light of its excessive reliance on exports and investment – it will have less surplus saving to lend to the United States. If both of these adjustments are perfectly timed to occur at precisely the same moment, it is possible to envision an uninterrupted symbiosis. The odds of such an exquisitely synchronized rebalancing of both economies are extremely low, in my view. That suggests the growing likelihood that symbiosis is likely to give way to disequilibrium – adding a new source of tension to the US-China relationship.

Unfortunately, that's not the only source of economic tension between the United States and China. Over the 2005-07 period, fully 45 pieces of anti-China trade legislation were introduced in the US Congress. While none of these bills passed, that may change. As the US unemployment rate now mounts in an ever-deepening recession, the politics of trade frictions may well gather greater support. Treasury Secretary Geithner's warning on Chinese currency manipulation is especially worrisome in that regard. The same can be said of the "Buy America" provisions that have slipped into America's recently enacted stimulus package.

At the same time, China must also be sensitive to the impacts of its export-led growth model on its trading partners. Any subsidies – either to its own domestic wages or to its currency – take on heightened importance as China's stature in world trade grows. As now the second largest exporter in the world, China can hardly afford to take that responsibility lightly. Moreover, if China competes unfairly by ignoring environmental degradation and pollution, the world pays a much greater price for the cross-border labor arbitrage than a simple comparison of wages would suggest. To the extent that cost-effective outsourcing ignores environmental considerations, the real wage squeeze in relatively "greener" economies may be all the more acute.

Resolving the complexities of the US-China economic relationship is an urgent challenge for an unbalanced global economy. As a crisis-torn world now moves into a severe recession, the stakes can only grow larger. As both the US and Chinese economies evolve and change, a fleeting state of symbiosis could well give way to heightened tensions. The time to diffuse those tensions is now – before it's too late.

China's Policy Imperatives

Ironically, China saw many of these problems coming. Two years ago, Premier Wen Jiabao warned that the Chinese economy was "unstable, unbalanced, uncoordinated, and unsustainable." Similar vulnerabilities were anticipated in the 11th Five-Year Plan enacted in 2006, which stressed China's need to embark on a major structural transformation from export- to consumer-led growth.

But the government's execution of this aspect of its plan was lacking. In particular, it failed to build out an institutionalized safety net – the support system necessary to temper the fear-driven precautionary saving that inhibits the development of a more dynamic consumer culture. As a result, the consumption share of Chinese GDP fell to a record low of 36% in 2007 – underscoring the dark side of China's macro imbalances that is now so problematic in this global crisis (see Figure 10). A severe external demand shock found an unbalanced Chinese economy without a back-up plan.

A pro-consumption rebalancing is the only sustainable answer for China. Pro-active fiscal stimulus measures, such as the recently announced RMB4 trillion infrastructure-led investment initiative, can help temporarily. Such efforts borrow a page from China's counter-cyclical script deployed in the Asian financial crisis in the late 1990s and again in the mild global recession of 2000-01. But these actions are not enough to compensate for the structural vulnerabilities that China's externally-dependent growth model now face as American consumers begin a multi-year retrenchment.

China needs to be bold and aggressive in framing pro-consumption policies. It should start by announcing major initiatives on the safety net front. Specifically, China should sharply expand the funding of its national social security fund, which currently has only a little over US$70 billion in assets under management – not even enough to provide $100 of per capita lifetime retirement income for an aging Chinese population. China also needs to move quickly in establishing a comprehensive private pensions scheme, as well as broaden its support to nationwide health and unemployment insurance. Recent passage of an RMB850 billion three-year medical reform plan is an encouraging , but small, step in that direction.

The bottom line for China: Its unbalanced economy must be rebalanced. The export-led growth formula, which served the nation well for three decades, must now give way to the internal impetus of consumer-led growth. For China, the imperatives of such a rebalancing have never been greater. For the rest of Asia – to say nothing of an unbalanced global economy – China's post-crisis economic leadership role hinges importantly on this critical rebalancing.

Policy Risks

Needless to say, a weakened economy usually doesn't take kindly to suggestions that it ought to increase the value of its currency. That's especially the case for an export-led Chinese economy, where sequential growth slowed to a virtual standstill in late 2008. With overall economic growth remaining weak in early 2009 and currently running well below the 6-8% zone that China requires to absorb surplus labor and maintain social stability, the pro-cyclical implications of a tighter currency policy would only add to mounting downside risks.

Little wonder that US Treasury Secretary Geithner's recent remarks on currency manipulation were met with an incredulous response in Beijing. While such strident rhetoric hardly implies action, it is worth considering the consequences if the war of words leads to outright trade sanctions. The impacts would be felt immediately in financial markets. Given America's reliance on China's funding of its external deficit – a reliance that can only grow in an era of open-ended trillion dollar budget deficits – the US is in no position to risk reduced Chinese buying of dollar-denominated assets. Yet that is exactly what might occur if a proud but wounded China retaliates to currency-induced trade sanctions imposed by Washington.

Such retaliation could take the form of a China that simply doesn't show up at an upcoming US Treasury auction. That's hardly a trivial consideration for a United States that needs about $3 billion of capital inflows each business day to fund its current account deficit. If China fails to provide its share of America's external funding, the dollar could plunge and real long term interest rates could rise. A dollar crisis is the very last thing a US in recession needs. But it could happen if the US turns rhetoric into action in the form of imposing sanctions on Chinese trade. In short, Washington is treading on increasingly thin ice in blaming the Chinese currency for America's woes. A post-bubble US economy is suffering from a major shortfall in domestic demand that is unlikely to be remedied by China bashing. Saber-rattling in this climate is both ill-advised and dangerous.

At the same time, it is equally important to underscore what China should not do. First and foremost, Chinese policymakers must not be overly-optimistic in counting on the old external demand model to start working again. A multi-year weakening of the US consumer is tantamount to a global consumption shock that will impart a protracted drag on any export-led economy. As such, the imperatives of Chinese rebalancing have never been greater. It is increasingly urgent that China shift its growth model from one that has been overly reliant on exports to one that draws increased support from private consumption.

Nor should China be tempted to use the currency lever or other subsidies to boost its export sector. In an era of rising unemployment and mounting concerns in the developed world over the benefits of globalization, such efforts could be a recipe for anti-China trade sanctions. As previously noted, those actions might then prompt China to reconsider its role as one of America's most important overseas lenders. And then, as was the case in the 1930s, the race to the bottom could be on.

Wake-Up Call

There has long been a dispute over the English language translation of the Chinese word for crisis. One popular view is that "*wēijī*" roughly translates into the compound phenomenon of both danger *and* opportunity. Unfortunately, that meaning – correct or not – has been lost on a world in crisis. Today, more than ever, a world in crisis and recession needs to pull together – not push itself apart. Globalization and its cross-border connectivity through trade and capital flows leave us with no other choice.

The blame game is completely counter-productive in this environment. Those blaming surplus-saving economies such as China for America's unsustainable spending binge ought to be embarrassed. This is a US problem and one that must be addressed at home with a new and disciplined approach to monetary policy, tough regulatory oversight, and more responsible behavior on the part of consumers and businesses, alike. A bubble-dependent economy that lived beyond its means for a dozen years must now accept the reality of having to live within its means – and not holding others accountable for this painful yet necessary adjustment.

Similarly, China needs to accept that the export-led growth formula always had its limits. An unprecedented external demand shock driven by unheard of synchronous recessions throughout the developed world drives this point home with painful clarity. Economic development is not just about producing for others – especially if those "others" are living beyond their means. In the end, export-led growth must eventually give way to the internal demand of a nation's private consumers. China is ready for this transition and must begin the process as soon as possible.

In short, it is high time for an unbalanced world to begin the heavy lifting of global rebalancing. By framing such an adjustment in the context of the United States and China, the verdict is clear: America needs to save more and consume less, while China needs to save less and consume more.

Easier said than done. But a world in crisis can no longer afford to perpetuate an unstable *status quo*. Global rebalancing is not a quick fix – and therefore, is not all that appealing to myopic politicians. But in the end, it is the only way to put the world back on a sustainable growth track. If there is a silver lining to this crisis, it must be in the wake-up call that it sends to politicians and policy makers throughout this unbalanced world.

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Charts to Accompany:

A Wake-Up Call for the US and China: Stress Testing a Symbiotic Relationship

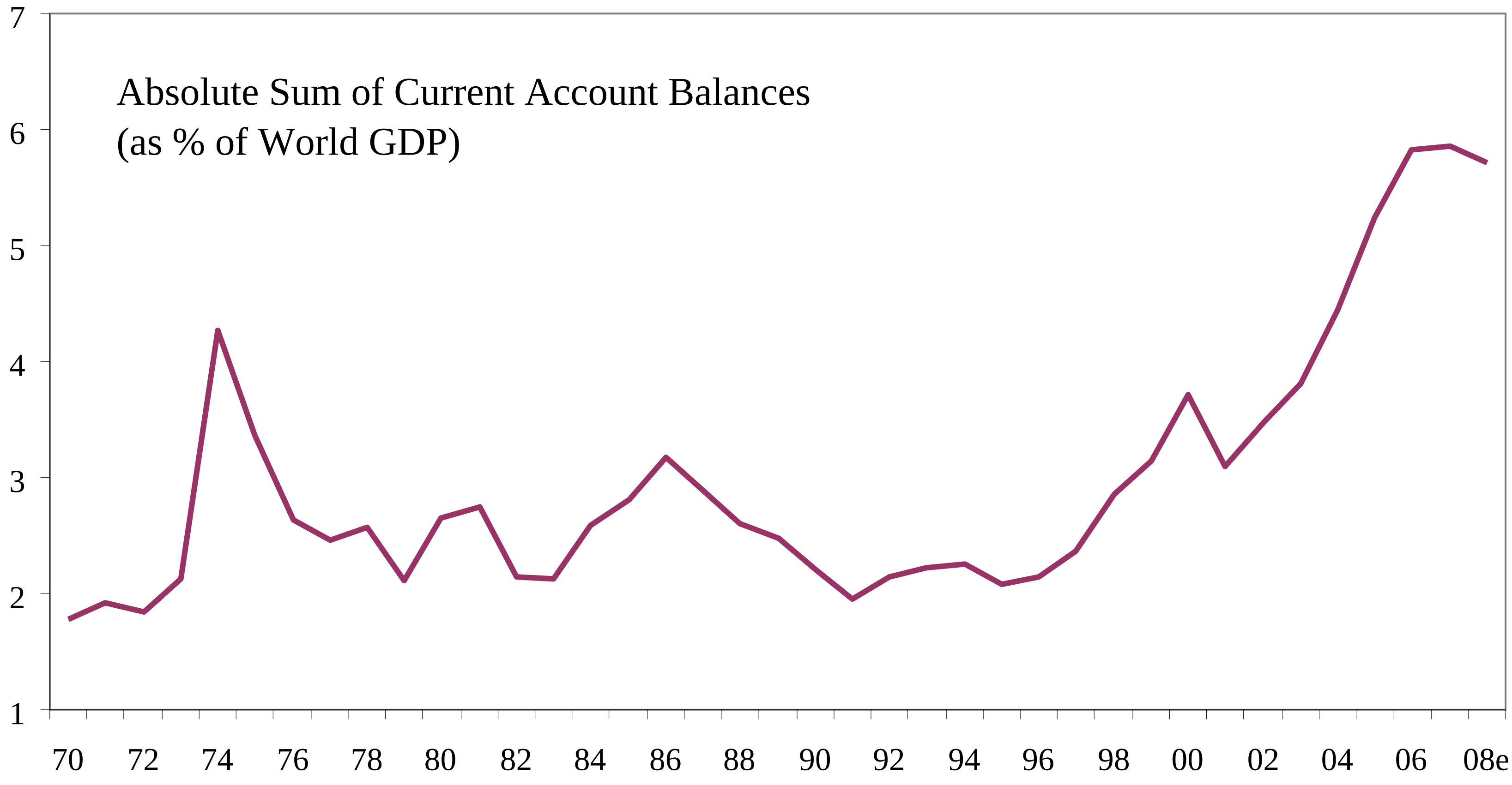
Stephen S. Roach
Chairman
Morgan Stanley Asia

Presented before
The US-China Economic and Security Review Commission
of the
US Congress

Hearing on
"China's Role in the Origins of and Response to the Global Recession"

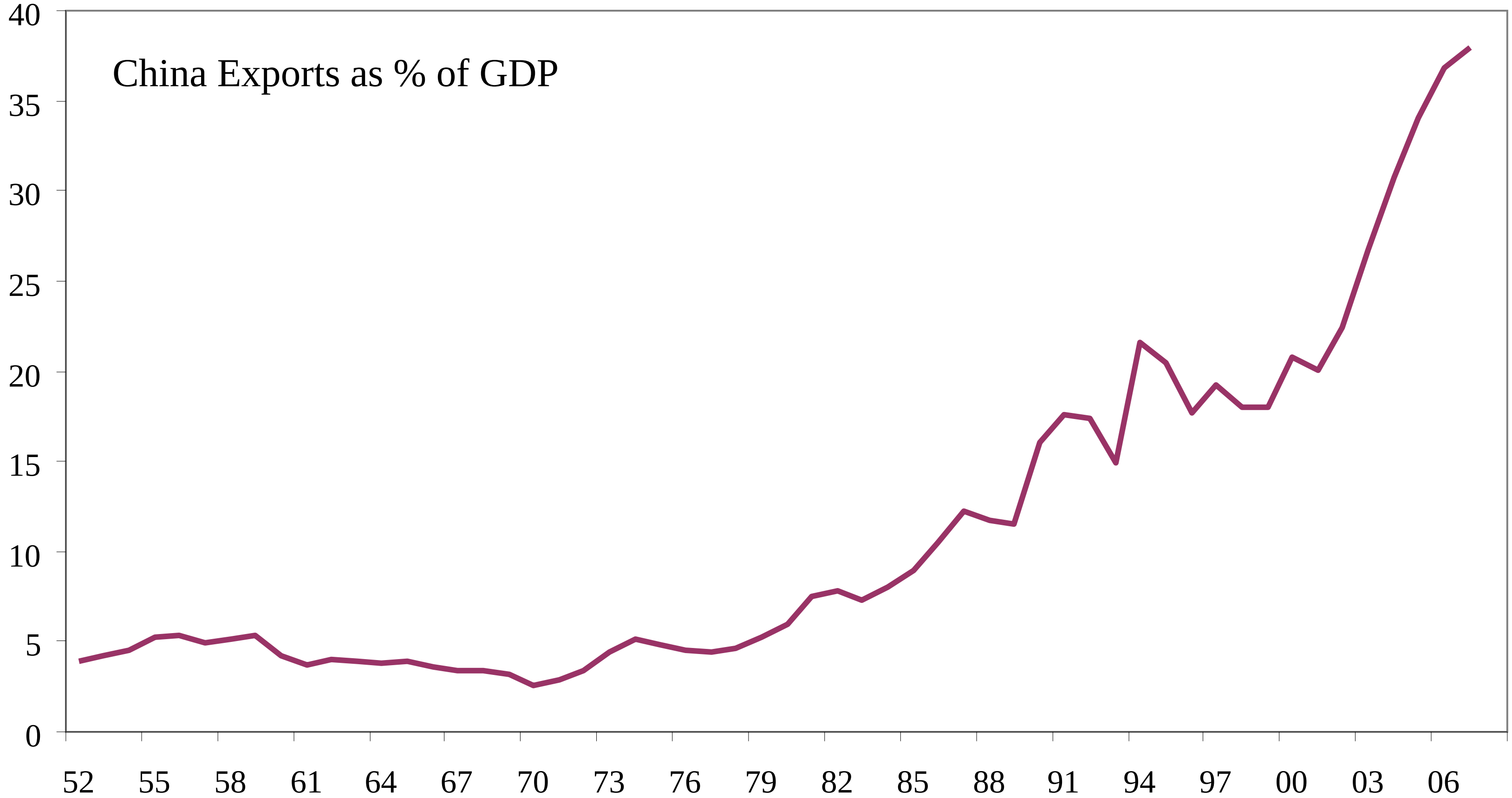
February 17, 2009
Washington, DC

Figure 1: Global Imbalances



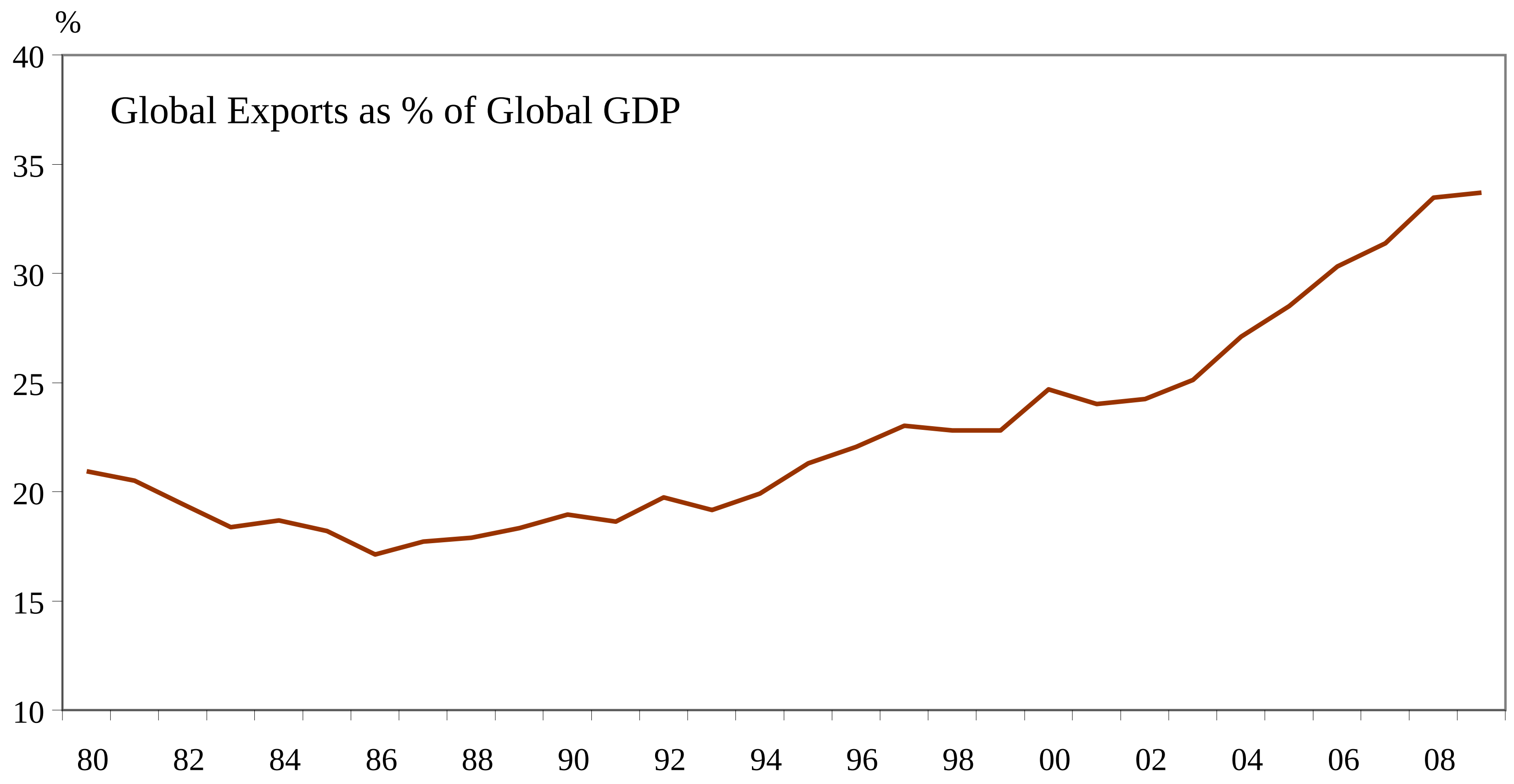
Source: IMF and Morgan Stanley Research

Figure 2: Chinese Export Surge



Source: China National Bureau of Statistics and Morgan Stanley Research

Figure 3: The Great Boom in Global Trade



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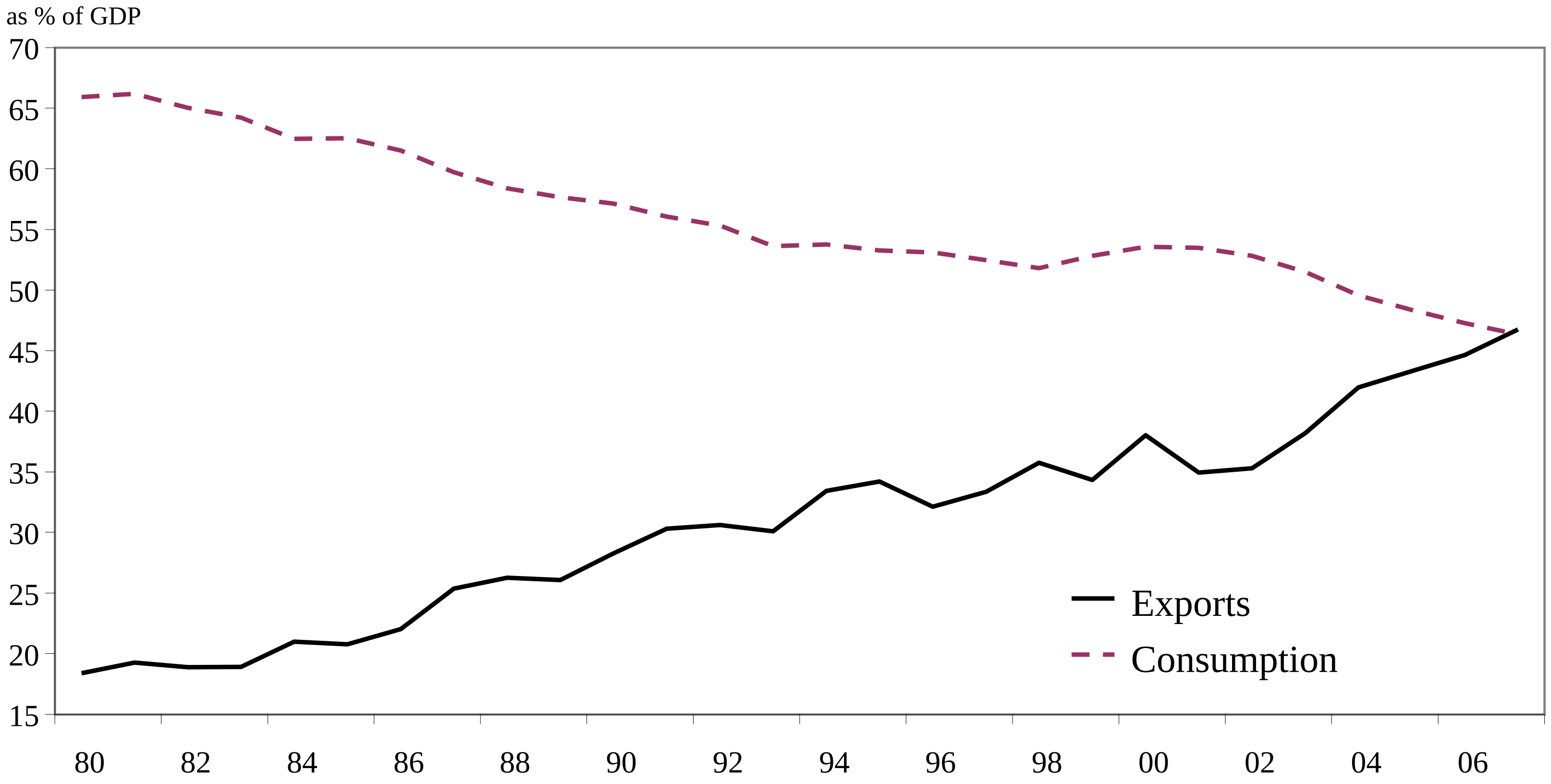
Source: IMF, Morgan Stanley Research

Figure 4: Export-Led Developing Asia



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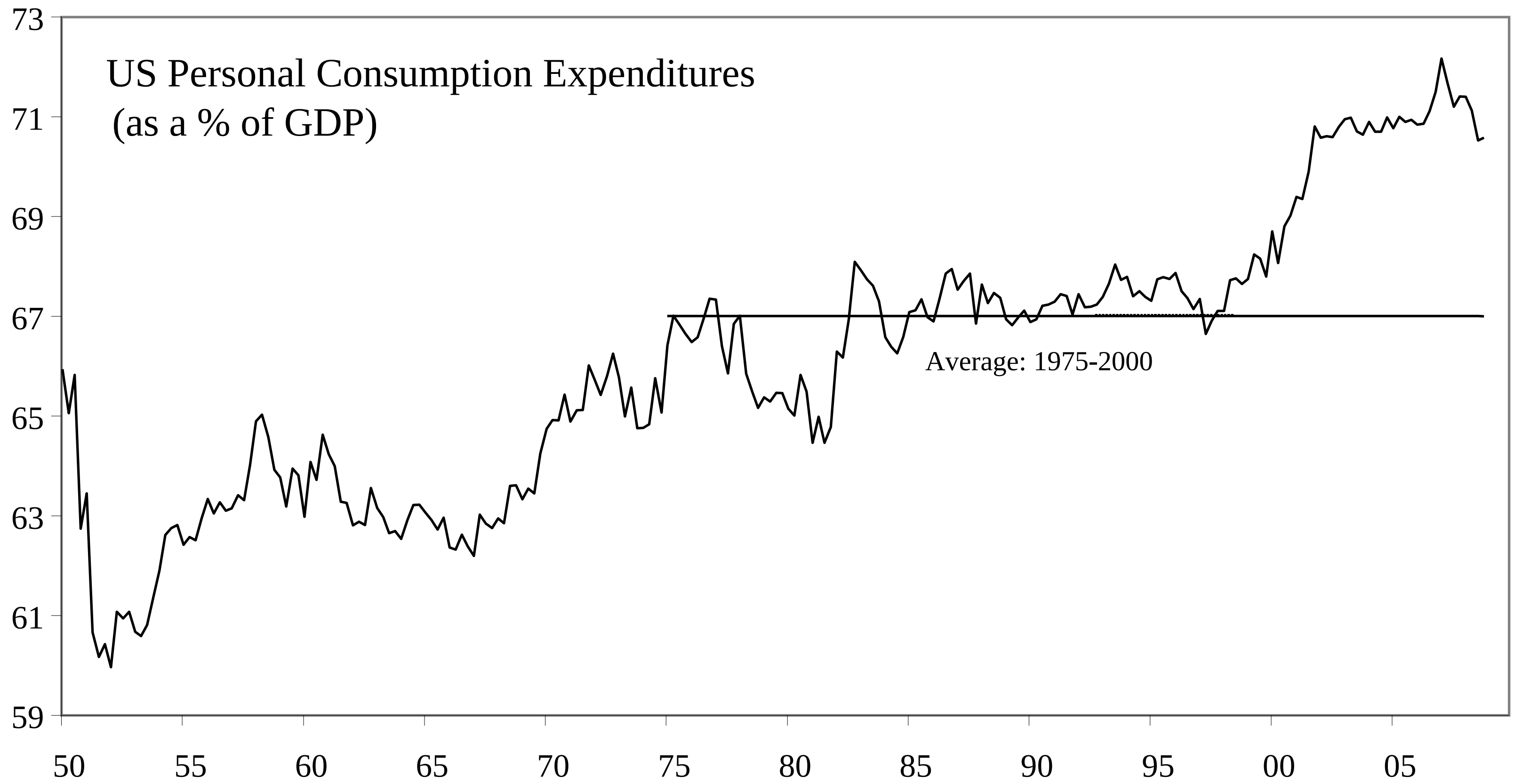
Source: IMF, Morgan Stanley Research

Figure 5: US Consumption Binge



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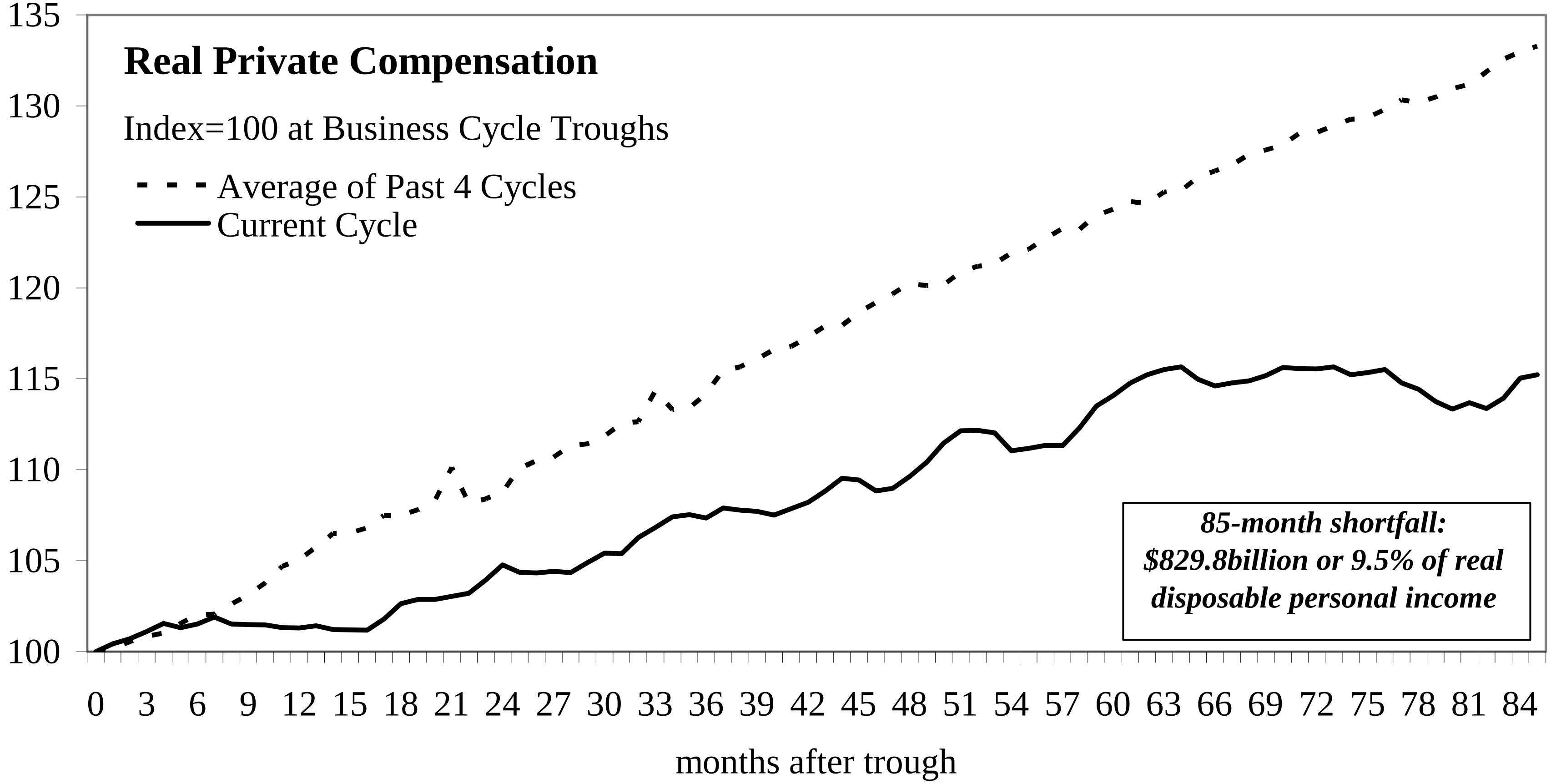
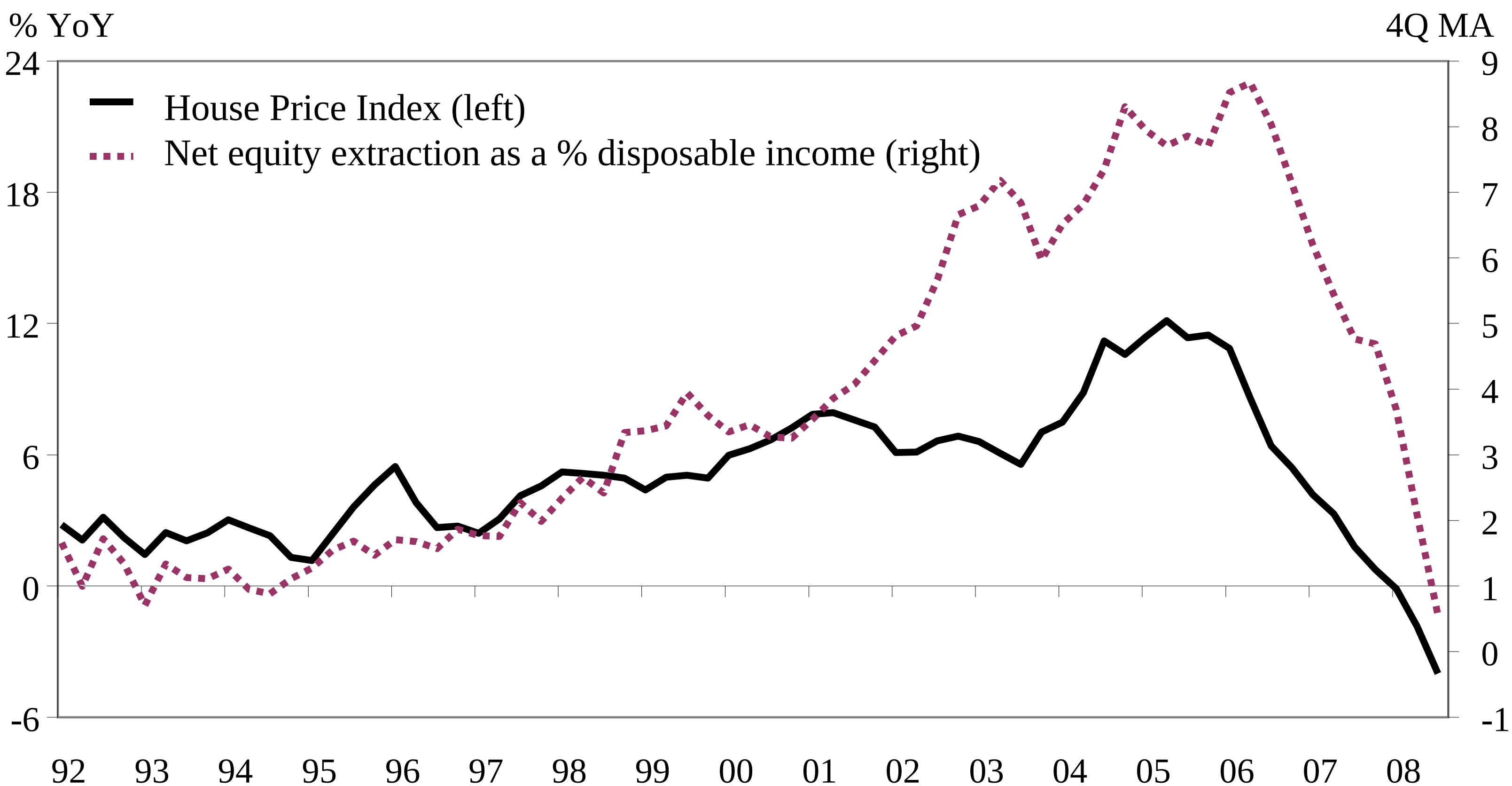
Source: Haver Analytics, Morgan Stanley Research

Figure 6: US Labor Income Shortfall



Source: Bureau of Economic Analysis, Morgan Stanley Research

Figure 7: US Wealth Shock



Source: OFHEO, Federal Reserve, Morgan Stanley Research

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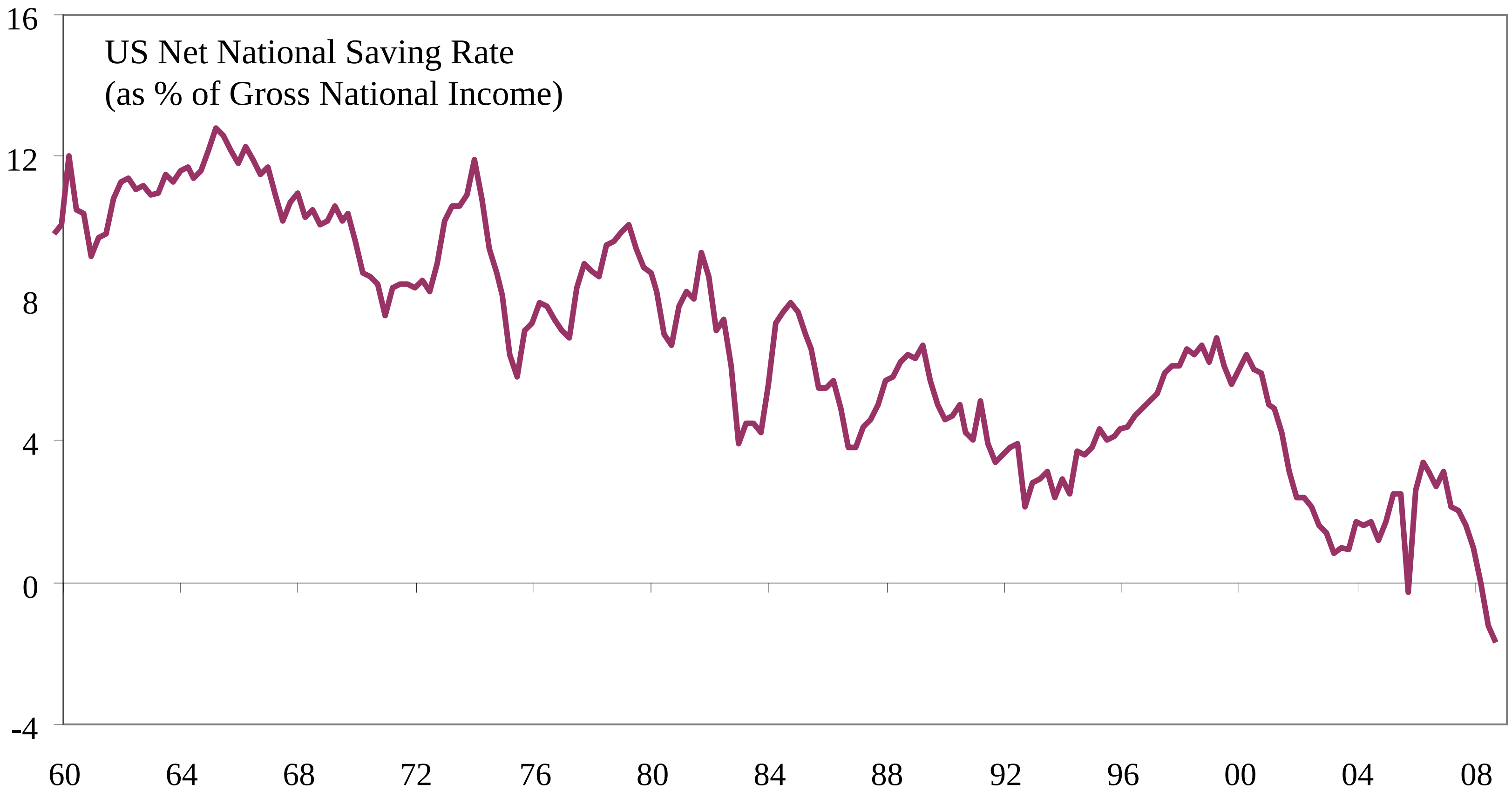
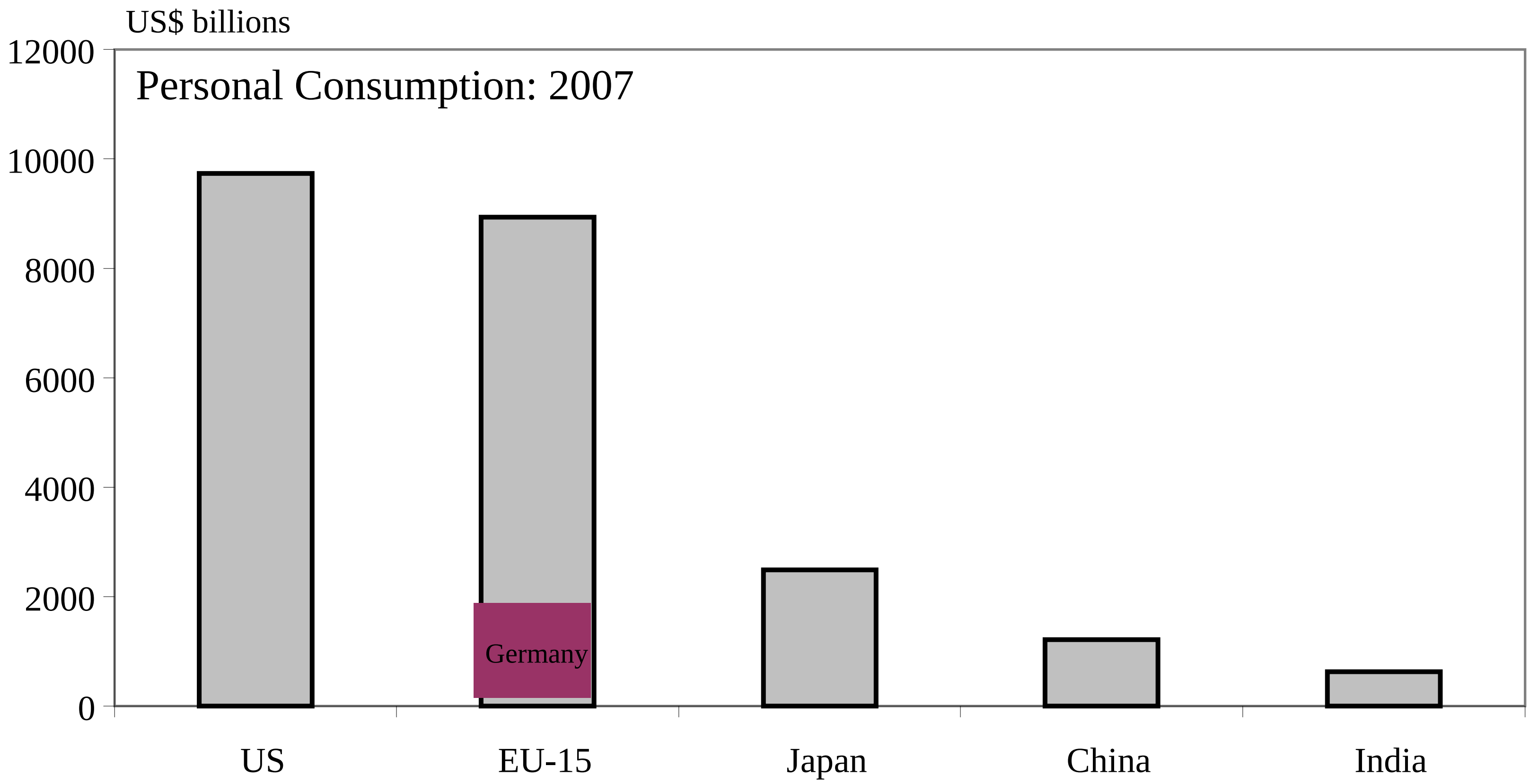
Figure 8: America's Saving Shortfall



Source: US Bureau of Economic Analysis, Morgan Stanley Research

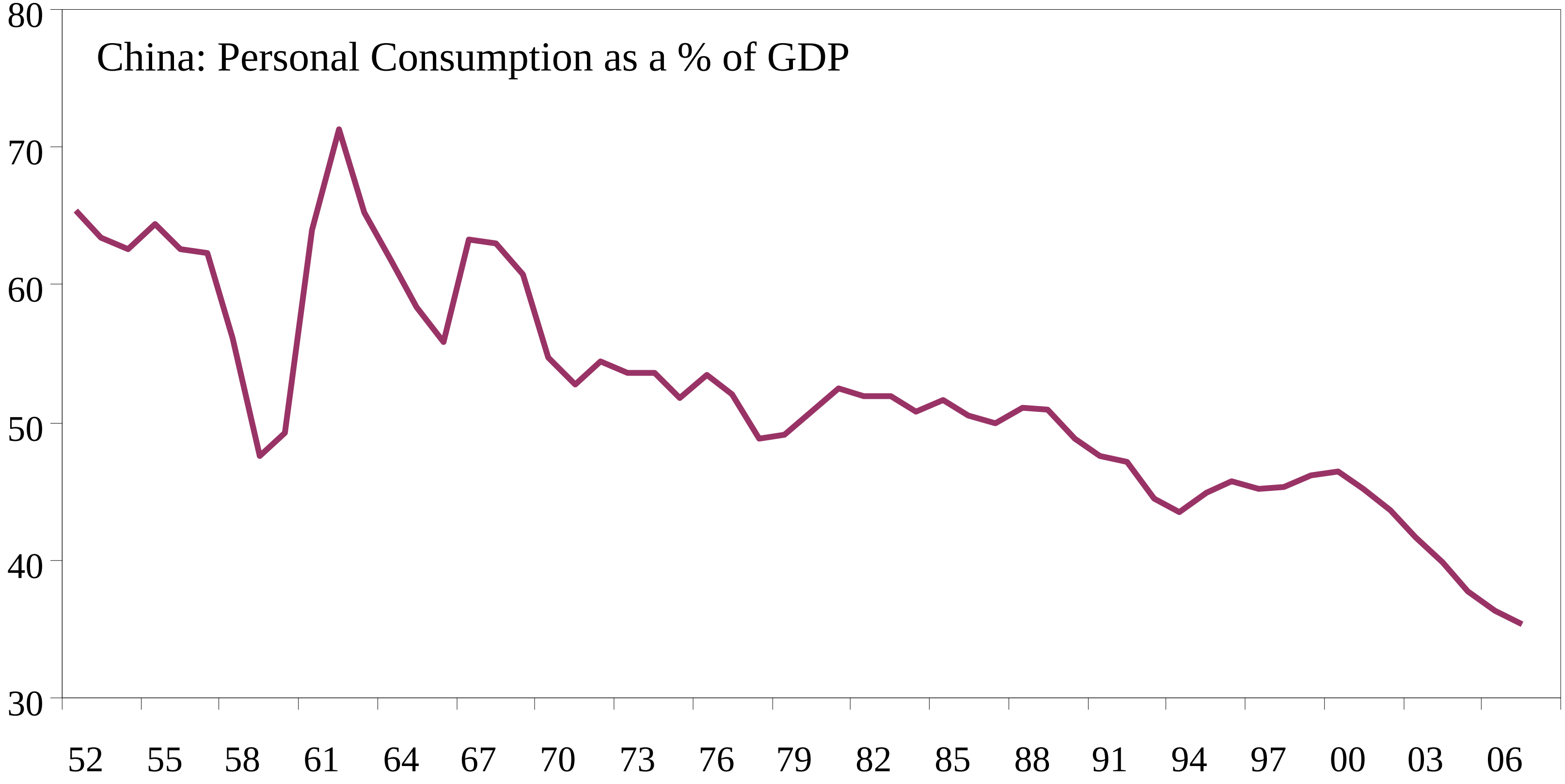
Morgan Stanley

Figure 9: The Global Consumer



Source: *National Sources, UN, Morgan Stanley Research*

Figure 10: Chinese Consumption Shortfall



Source: China National Bureau of Statistics and Morgan Stanley Research

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HEARING COCHAIR SLANE: Thank you, Mr. Roach.

Mr. Cassidy.

STATEMENT OF ROBERT B. CASSIDY
DIRECTOR, TRADE AND SERVICE, KELLEY DRYE & WARREN PLLC, WASHINGTON, DC

MR. CASSIDY: Thank you very much. I would like to thank the Commission for inviting me to speak today on the origins of the current financial and economic crisis and the role China has played.

I am particularly pleased to be included on a panel of such distinctive and knowledgeable scholars on China, especially the financial institutions of China.

For my part, I come here from a very different background than finance and have observed the emerging the financial crisis and the current economic crisis through observations on a somewhat different set of statistics, mostly the trade side and through trade policy.

I think most of us, as the new administration coming in, listened to all the leaders and the ministers and various other officials in Davos trying to shed the blame as to who was responsible for the crisis. As Mr. Roach points out, it's a global crisis; many are responsible.

I think there is a broader explanation of the origins of the crisis. We tend to look at things in a short-term perspective, while I think it would behoove us to look at a somewhat longer-term perspective, and I think this is where China's role comes in; not just China's role I should say other countries as well. But this Commission is focusing on China and its trade role that is appropriate; but as the other panelists have mentioned, this is not just a China issue; this is a global issue.

Let me begin in 1994. In 1994, China unified and depreciated its currency by 50 percent. What we noticed on the trade side was that our trade balances with other parts of Asia started to improve. In fact, some of them went into surplus. What we saw essentially was jobs moving from other parts of Asia to China, and we saw the beginning of China becoming the central hub of Asia, where products were coming into China, manufactured and exported abroad.

In my view, this was the beginning of the Asia financial crisis, and this created the instability that occurred where other countries then depreciated their currencies to align with China. So consequently we had a whole Asian market because the Chinese yuan was pegged to the U.S. dollar in 1994, and it hadn't significantly changed since that time--I think it changed once in that period of time--we saw that the rest of the Asian economies were also beginning to align with the United States.

So if you remember--at least I remember because I was there in some of the meetings where the U.S. Secretary of the Treasury was going to China and requesting that China not depreciate its currency further so that we would not have a further depreciation of the currencies China agreed to --so China did step up and take that leadership role. And then we saw after the turn of the century two other factors that came into play.

One was China's accession to the WTO. China then eliminated or reduced its barriers to trade so solidifying in a sense the role that it played as a hub because most of the barriers, well, certainly most of the tariffs that were reduced were reduced on the raw products, semi-finished products that were coming into China while the barriers were higher on the finished goods.

And so we saw that China became much more of a hub than it was before. We saw at this time also the tax cuts in the United States; the Iraq War. We saw that all of this exacerbated the problem. And we saw the emergence of huge current account deficits with China. China turned to a surplus country, but to a large extent much of this, I think, can be attributed to China's undervalued currency as the cornerstone of an export-led growth strategy.

That became the basis on which would happen in the rising current account deficit. In 2005, China changed its peg to a basket of currencies. It appreciated by, I think, 2.1 or 2.2 percent--I can't remember the exact number--and then began a period of gradual appreciation of its currency.

Remember, an undervalued currency is essentially a subsidy for exports; thus, the export-led portion of its policy. It's a subsidy for investment as well because investment that comes in is essentially subsidized. It's also a tax on other countries' exports to China so our exports are taxed by them now.

Now, we can all disagree on what the level of the undervaluation is. Some of those estimates are as high as--I've seen estimates as high as 75 percent, some as low as ten percent. The China Currency

Coalition thinks it's around 40 percent. But in any case, this undervaluation does create distortions in trade.

Let me address what I think needs to be done, and I don't think it's too different than what the panelists have said before. In 2001, I was asked the most interesting question during a tour that I was making of China on the 1999 Market Access Agreement and what WTO accession meant to China. The student asked me that if I could renegotiate anything in the agreement that I wanted to redo, what would I renegotiate?

I was stunned because that agreement, to so many people in the administration, was the ultimate agreement. It involved unilateral concessions on the part of China. It was so broad; it was so comprehensive. We even did things that were not supposed to be included in a WTO accession agreement. So what else could there be?

It dawned on me that the one thing that we didn't cover and perhaps would not cover, in an accession agreement, is we needed to open China to China. This was the one thing that we didn't do. Because of the export-led growth strategy that China had, all of the efforts were made on opening China as a market for exports. So if I were to say what we need to do from a policy perspective, is that we need to focus on those aspects. China needs to begin to continue to appreciate its currency. It currently has stopped that appreciation. It's slowed down, if anything, to a trickle, maybe even regressed a bit. I know critics are going to be somewhat critical about that policy. They're going to say, well, China may then change its composition of its foreign exchange reserves, which now total about $2 trillion, far exceeding that of Japan by about a trillion dollars?

So they say, well, they'll change the composition; that will have a major effect on the U.S. dollar. Well, quite frankly, China has been changing the composition of its foreign exchange reserves. So that's not new.

The notion that China not should continue to appreciate it current --well, it has been appreciating its currency so why not continue to do that.

And the third point I would say is I can't see the logic of why they would want to divert from U.S. dollar holdings to others because all it's going to do is simply depreciate the dollar further and contribute to their greater foreign exchange reserves. So I don't see the logic in that argument.

The second point I would suggest to doing, and this is where I think Nick Lardy's points are absolutely right on, is that China has taken a stimulus role of essentially opening China to China, or, as Steve Roach said is encouraging consumption, consumer demand in China because the policy needs to be better balanced. I remember when I was doing these negotiations, we looked at what the costs were of distributing products in China. They are 16 percent more in China because of tolls, shakedowns, different labor requirements in one city versus another city. All of these things add 16 percent to the cost compared to what those distribution costs would be in an OECD country of about four percent.

So I think these are the things--in fact, China is concentrating on those now, and hopefully we can bring better balance to the growth because for the United States, it's critical.

The U.S. is going to have to be led out of this recession through the export sector. It's absolutely critical for any long-term stability.

Thank you very much.

[The statement follows:]

Prepared Statement of Robert B. Cassidy, Director, Trade and Service, Kelley Drye & Warren PLLC
Washington, DC

February 17, 2009

Robert B. Cassidy
Director, Trade and Service
Kelley Drye & Warren PLLC
Testimony before the
U.S.-China Economic and Security Review Commission

China's Role in the Origins of and Response to the Global Recession

I would like to thank the Commission for inviting me to speak today on the origins of the current financial and economic crisis and the role that China has played. I am particularly pleased to be included on a panel with such distinctive and knowledgeable scholars on China's financial institutions. For my part, I come here from a very different background of trade and have observed the emergence of the current crisis through observations on a somewhat different set of statistics, mostly trade..

I read with interest the plethora of dignitaries proclaiming in Davos that the United States was, without doubt, the cause of the current financial crisis. Clearly, the United States has played a major role in the evolving financial crisis but I think there is a broader explanation of the causes of the current crisis, an explanation that recognizes the global nature of our economies and the critical linkages that exist. This explanation also looks at the economic dislocations in a much longer time frame which in my view indicates that systemic and secular factors must be addressed if long-term stable growth is to be achieved.

During the time that I served as Assistant USTR for Asia and Pacific beginning in 1992 and later as Assistant USTR for China, I observed a number of trends in Asian trade and currency alignments. In 1994, China unified its exchange rate and depreciated the currency by about 50% against the U.S dollar and, with only a slight modification, maintained that peg until 2005. In doing so, China instituted instability within the foreign exchange markets, particularly in Asia. We on the trade side noted that trading relationships with the rest of Asia improved while at the same time noting our deteriorating trade relationship with China. During this period, jobs moved from other parts of Asia to China as China became the manufacturing and assembly hub of Asia.

The economic and financial dislocations from China's depreciation of the Yuan was one of the major contributing factors in the Asian Financial Crisis. That crisis resulted in Asian economies depreciating their currencies so that they were aligned with the Renmenbi and, as a result of the peg, with the U.S. dollar. Following the Asian Financial Crisis, the Asian economies had a stronger link to the United States via their exchange rates, nearly all essentially linked or pegged to the U.S. dollar. The surplus savings of Asia were now available to be tapped by the U.S. capital markets.

Two significant developments set the stage for the evolving drama that has turned into a tragedy. First, China acceded to the WTO making unilateral concessions to other WTO members by

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opening markets and eliminating market regulations that restricted trade. The China accession to the WTO further enhanced the linkages between China and the rest of Asia, solidifying the China hub at the center of Asia. Second, the United States legislated major tax cuts that reversed the emerging government surplus into a deficit thus requiring the United States to import savings from abroad to finance those deficits. The War in Iraq further exacerbated the government deficit which required that more savings from China needed to be imported to finance government institutions. Without those savings, the United States would have had to have higher interest rates in order to finance those deficits, thus crowding out the private sector access to capital. In short, China and parts of Asia provided the necessary savings to finance the U.S. government and as well as the expansion of the U.S. capital market.

The extent of the savings gaps can be seen in both in China's current account and in its accumulation of foreign exchange reserves. Figure 1 shows China's current account surplus and figure 2 shows China's foreign exchange reserves. Both show dramatic increases since 2001 when China acceded to the WTO. In the case of China's foreign exchange reserves, China has purchased government securities mostly in the form of U.S. dollar denominated securities. Consequently, in the current financial crisis, the value of China's reserves have not depreciated although the return on those assets has decreased. The increase in China's current account balance and in foreign exchange reserves is directly attributed to China undervalued currency. At almost $2 trillion, China has more foreign exchange reserves than any other country, eclipsing even Japan.

While the undervalued exchange rate creates problems in the trading sector, the real policy problem is that China manipulates it exchange rate. China manipulation to maintain an undervalued currency is effectively a policy to subsidize its exports, subsidize foreign direct investment, and to tax China's imports. An undervalued exchange rate is the cornerstone of it's export led growth strategy. Beginning in July 2005, China appreciated the Yuan and instituted an exchange rate mechanism based on a basket of currencies. The exact composition of the basket is still unknown. Even then, China only allowed the exchange rate to appreciate modestly over time. Figure 3 shows the increasing bilateral deficit with China and figures 4 and 5 show how China's exchange rate has appreciated in nominal terms since 2005 and in real terms since 2000.

Because of the negative impact the currency has on the current account, it is no wonder that critics challenge U.S. trade policy, specifically China's accession to the WTO. When China joined the WTO in 2001, it made unilateral concessions to open its markets by reducing and, in some cases, eliminating its tariffs and its non-tariff barriers and to bring its domestic laws into conformity with WTO rules. Expectations were raised that these unilateral concessions might reduce the bilateral trade deficit with China or, if not, at least significantly reduce the growth rate of the deficit. U.S. exports to China increased faster than to any other country. However, they increased faster to China because they increased from a very low rate. Out exports to the EU rose by 70% more in absolute terms and to Canada by 40% and neither of those countries made any concessions to the United States.

The problem for China, as for many other countries, is that the need to create jobs has forced them to adopt export led growth strategies based on an undervalued currency. While these policies can have dramatic and positive effects over fairly long periods of time, eventually the policies fail. China has to create millions of jobs every year in order to absorb new labor entering the jobs market in China. The export led growth strategy was effective in increasing employment but now the financial crisis is having an adverse economic impact on China's employment, as it is around the globe.

The undervalued currency is still serving China well since those reserves have not decreased but probably have increased, although at a lower rate. While China's exports have decline, so too have imports so that China's foreign exchange reserves are still increasing. The current financial crisis probably has resulted in less foreign exchange reserves flowing into China via the capital account.

What China Needs to Do

The economic and financial crisis presents a set of unprecedented opportunities to initiate programs that otherwise policy makers would avoid. Obviously, current policies in China have contributed to the current financial crisis and steps need to be taken to reverse the effects of those policies. In particular, the current crisis presents an opportunity for China to play a global economic leadership role by restructuring its development programs in ways that will generate greater growth of its domestic economy as well as the global economy.

First, China needs to continue and even accelerate the rate of appreciation of its currency. The undervalued currency is the cornerstone of its export led growth strategy and it simply exports its savings to the United States rather than using those funds for domestic investment. If China is unprepared to make those steps, then the United States and other countries should consider initiating, in a progressive manner, stronger actions against China's beggar-thy-neighbor policies.

Critics argue that any serious action by the United States on China's manipulated currency would jeopardize China's holding of U.S. financial assets. First, China has already been broadening the composition of its foreign exchange reserves so that would not be a new development only a newer trend. Second, China has already been appreciating its currency although at an anemic rate. Thus appreciation of its currency is not the issue only, once again, the rate of appreciation. Third, critics argue that assertive action by the United States would anger China forcing them to see U.S. dollar denominated assets faster. However, such action would only serve to depreciate the dollar further and, due to the informal peg, depreciate the Yuan further thus increasing its foreign exchange reserves.

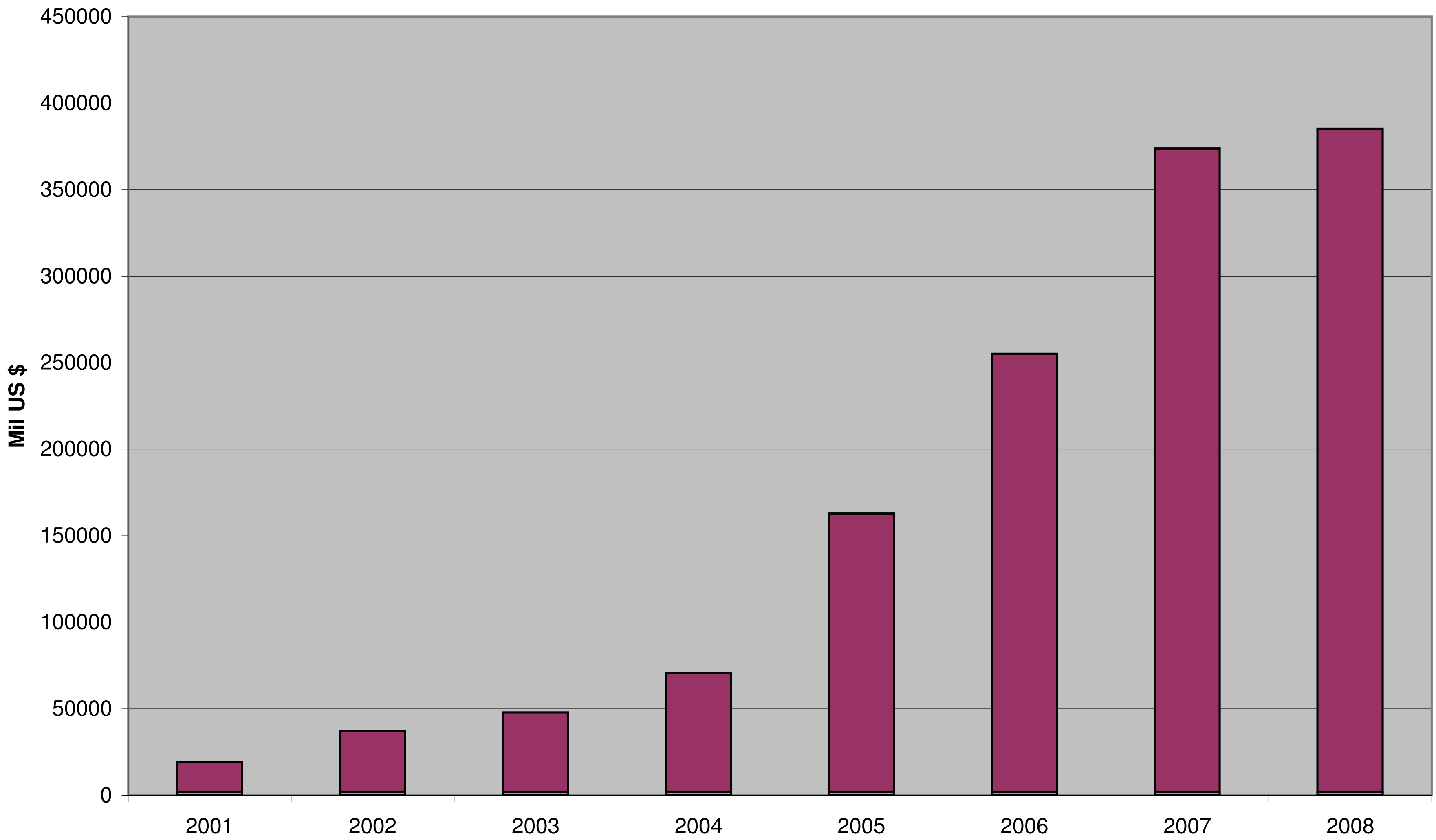
Second, China needs to dismantle the internal obstacles to trade within China -- China needs to open China to China. The marketplace is riddled with barriers. The combination of provincial restrictions in the form of tolls, shakedowns, out right prohibitions on using the roads, labor problems in loading and unloading freight and the lack of an adequate road/rail infrastructure make it difficult for Chinese and foreign companies to establish an efficient nationwide distribution system. According to some estimates, these barriers can add about 16 percent to the cost of the product compared to roughly four percent in developed countries. China has made some progress in this area since it acceded to the WTO but China's recovery program offers an excellent opportunity to address some of the more costly infrastructure impediments. A more open China will develop geographically isolated parts of China to economic growth thus expanding the Chinese domestic economy.

For the United States, we are already seeing that of all the sectors that have performed the best during this recessionary period, the export sector has been the strongest. Stable long-term economic growth will require that the export sector lead the way and to do that other countries will have to adopt policies that will create the conditions for more stable growth. A continuation of the current beggar-thy-neighbor policies where currency undervaluation is the key component of export led growth will only contribute to further instability in financial and commercial markets.

Conclusion

Since the mid 1990s, government officials have proclaimed that China's growing trade surplus with the United States was unsustainable. Nevertheless, the deficit continued to more than double every five years as China transferred its vast savings to the United States via the pegged exchange rate. The current crisis demonstrates that the current account imbalances were indeed unsustainable. And while the United States on track to set its house in order, the stability of the global system requires that other countries similarly use this opportunity to alter their economic policies.

Figure 1: China's Current Account Balance's
(2008 ESTIMATED)



Year	Mil US $
2001	212165
2002	289407
2003	403251
2004	609932
2005	818872
2006	1066344
2007	1528249
2008	1946030

Figure 2: China's Foregn Exchange Reserves

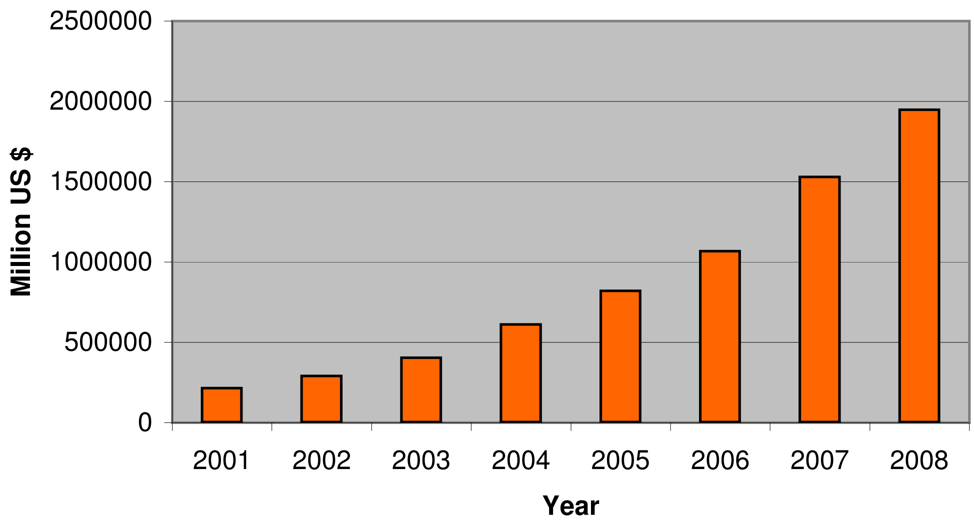
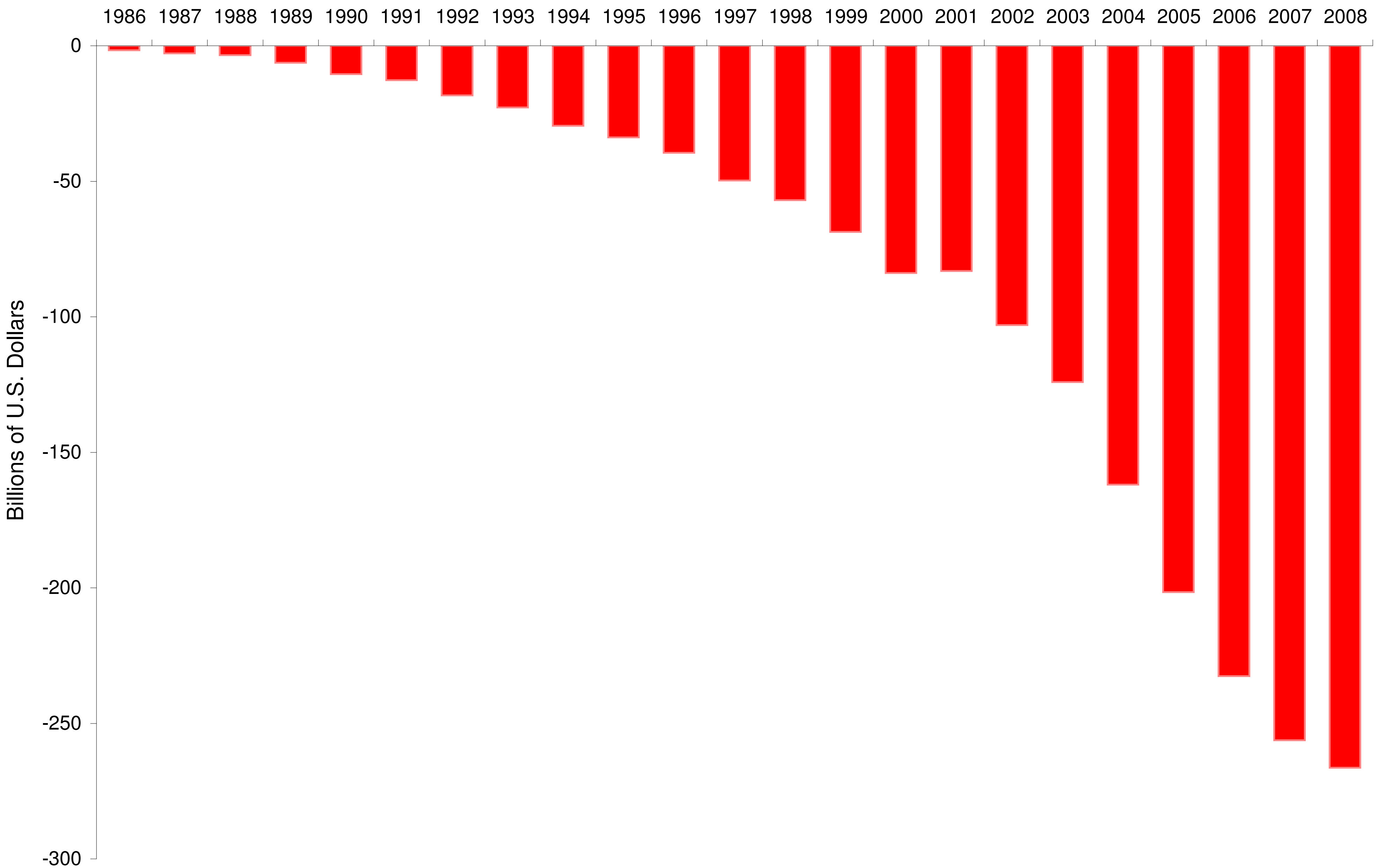


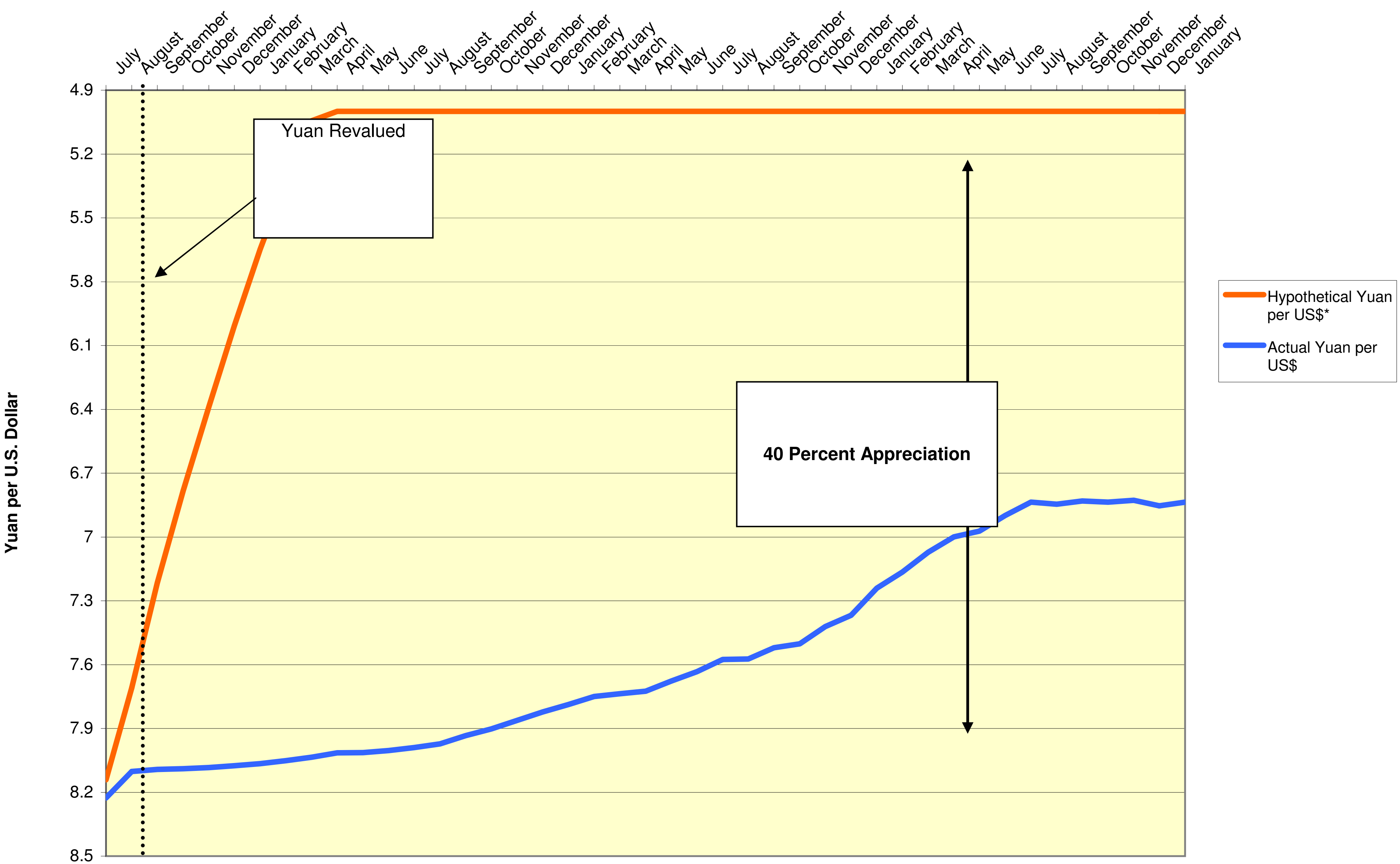
Figure 3: U.S. Trade Deficit (In Goods) with China

Annual 1986-2008



<u>Figure 4:</u> U.S. Dollar Exchange Rate for the Yuan

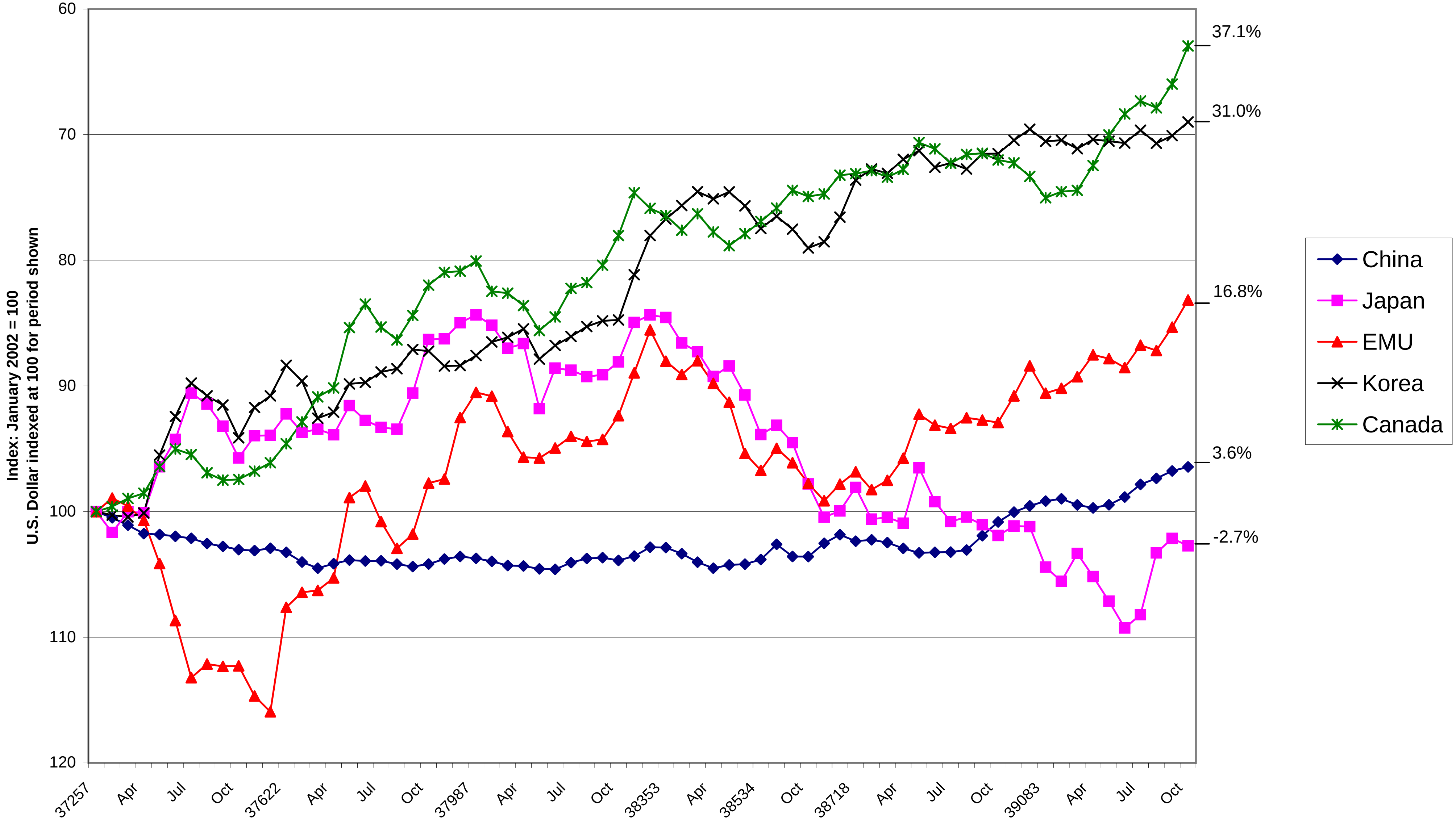
Monthly, July 2005 - January 2009



* Hypothetical value of the Yuan derived by assuming full 0.3% maximum daily appreciation against the US$, as announced by the People's Bank of China on July 21, 2005.

Changes in Selected World Currencies with Respect to the U.S. Dollar in Real Terms[1]

January 2002 - October 2007



[1] The exchange rates are adjusted for inflation as reported in each country's consumer price index (CPI), indexed to January 2002.

Source: IMF, International Financial Statistics

Prepared by Georgetown Economic Services

Panel I: Discussion, Questions and Answers

HEARING COCHAIR SLANE: Thank you, Mr. Cassidy.

We're going to start our questioning with Vice Chairman Wortzel.

VICE CHAIRMAN WORTZEL: I want to thank all of you for some very thoughtful and thought-provoking remarks.

Mr. Cassidy, one of the things that I read preparing for this myself is this February 7 Economist article. That magazine estimated that the yuan is only five percent undervalued. So we just have a huge fluctuation in estimates.

I think Dr. Lardy's comments, particularly about providing health care in China, are very important. It seems to me if China is going to reach a point of internal-led spending and growth it will require a health “safety net.” Up to this point, that wasn't happening, as you and I know, and people had to pay in advance, out of their pocket, for any medical care they needed--so if they're able to get that from the state, it might free up some money.

In 1997, China really acted very responsibly and helped all of Asia out of that financial crisis. We can probably expect equally responsible actions from Beijing at this time.

I would ask all of you, are foreign reserves being drawn down in any way to cover the Chinese stimulus package? How is it being covered domestically? Finally, is that large stimulus package likely to create serious inflation in China, which was the source of an awful lot of instability in 1989?

DR. LARDY: I think the short answer to your question is that it is extremely difficult for China to finance its stimulus using its foreign exchange reserves. Virtually everything they need to do and everything they are doing requires expenditures denominated in domestic currency in RMB.

So if they were going to use their reserves, they would have to take the reserves to the foreign exchange market, buy up domestic currency which would cause an appreciation. So unless they're willing to allow their currency to appreciate at a more rapid rate, they are basically stuck holding their reserves in dollar form.

Now, there are other things they could do with the reserves. Maybe they could finance the build-up of their petroleum reserves. There are a few things they could do. But basically what they need is domestic expenditures, and that's what they have been doing, and they're financing it through government revenues, some deficit spending, as I indicated, which means an increase in issuance of bonds this year will be quite significant compared to recent years when their deficit has been extremely modest.

Thirdly, it's going to be partly financed through a substantial increase in bank lending, which, as I indicated, is already underway.

Will there be an inflation problem at some point in the future? Well, certainly there is a potential for one, but it's going to be far, far less than, for example, in the U.S. where we're talking about deficits that are very, very much larger and perhaps sustained for a longer period of time than we're likely to see in China.

DR. ROACH: Look, I agree with that. It's important to note that, as Nick said, to tap foreign exchange reserves for any purpose in supporting the domestic economy has both currency and/or monetary policy implications. Reserves are not a discretionary fund that can just be drawn down to buy things. They're an outgrowth of both your currency and your domestic monetary policy.

It's interesting to note that the rate of currency appreciation is already slowing right now in China, in large part, I think, reflecting a slowing of capital inflows into the economy in light of the global slowdown.

And the inflationary point that you raised, this is a point that is getting raised all over the world, especially in the developed world with public sector debt-to-GDP ratio is likely to be at a record in every single developed economy coming out of this crisis.

But the issue comes in the tradeoff between resolving these debt burdens and the slack that is getting opened up in the global economy right now.

2009 will be the first year since the end of World War II where world GDP is down. We've never seen that before in the modern post-World War II period of the global economy. That opens up an enormous margin of slack between the global economy's potential and the sharply depressed level of world GDP. That slack will continue to widen, I'd say, for the next two to three years, and that will certainly inhibit inflationary pressures in the broader global economy of the United States and China.

I would worry, and I agree with Nick, that if you're going to worry about inflation, I'd worry more about the U.S. than China in that respect, but the globalization of our product markets and our pricing decisions suggests that when you think about inflation, you must think about it in a global as opposed to an economy-specific framework as well.

MR. CASSIDY: Let me just address one of the questions that you raise. My understanding is, is that China's foreign exchange reserves are continuing to increase although the increase is at a much slower rate than it had been before, but it has been still increasing.

HEARING COCHAIR SLANE: Thank you.

Commissioner Wessel.

HEARING COCHAIR WESSEL: Thank you, gentlemen, and Bob, I know how hard you worked while you were in government. We were former neighbors, and I don't think I saw you for four or five years while you were negotiating all of this.

CHAIRMAN BARTHOLOMEW: He didn't want to see you, Mike.

HEARING COCHAIR WESSEL: Maybe that's true. Your public service is deeply appreciated.

Dr. Roach, I understand and appreciate your comments about blame. At the same time, people are now looking for answers about how do we learn from what has happened and what do we do to make sure that it doesn't happen again?

I don't perceive that other than the short-term stimulus programs that China has put in place, some of which people, reporters, have indicated are simply iterations or reiterations of what they had previously announced, that they have not changed their external policies to try and continue their growth.

We've seen them do massive export tax rebates throughout the latter part of last year going into this year. We had seen right after PNTR many of U.S. companies flock to China and other nations' companies flocked there believing that the consumer market would be a huge opportunity, and we saw that their sales were not as robust as they may like or had hoped, and 58 percent of China's exports are from foreign- invested enterprises, as I understand it.

I don't see that China is pursuing a different approach; that export-led growth is going to continue to be their model. You point out that the U.S. is at fault, and I agree. We have become consumption junkies, but in part we have had massive dumping, massive subsidies, massive export-led policies that have helped fuel that, have made those policies and those prices very attractive to our consumers and those of the world.

What should we be expecting China--and this is to all of the panelists--to do differently going forward or should we--is it all on our side that we have to change what we do? Should we be much more aggressive in terms of how we respond to their illegal activities?

DR. ROACH: I'll take a shot at that first. I think both Nick Lardy and I have indicated that the strategy of China is clear, and that is that beginning with the enactment of the 11th Five Year Plan three years ago next month, the Chinese laid out a blueprint for shifting their growth model from export and investment-led to one driven more by internal private consumption.

The execution of that model has not been optimal. In particular, I think the failure to build out the safety net and therefore reduce precautionary saving has been disappointing. That is being addressed now in China, and the crisis and its impact that it's taking on this export-led growth dynamic has certainly galvanized a lot of attention in Beijing over the need to emphasize this transition to an internally-driven economy even more. That is very clear.

In Chinese, the word for crisis is "weiji." While this translation is subject to some dispute, "weiji" is a compound word that describes both danger and opportunity. And I think the Chinese do view this crisis as providing both of those characteristics.

With all due respect, though, I would take strong exception to the final piece of your question, and that is that China's mercantilist trade policies were just producing things that were too tantalizing for Americans to resist. Keep in mind that Americans went into debt to a level that no consumer in the world has ever done to buy these tantalizing and irresistible flat screen TVs and other goodies that were dangled in front of their eyes by Chinese and other producers.

I would not portray American consumers as innocent victims of Asia or Chinese mercantilist policies. We made dumb mistakes that were reinforced by I think poor policies and poor behavior across our economy, from politicians to central banks to regulators to Wall Street to Main Street, and I think it is really incorrect to even think that the Chinese are responsible for those poor decisions.

HEARING COCHAIR WESSEL: Other witnesses?

DR. LARDY: I would say in response to your question what should the Chinese keep doing, what should they do to get back to a more balanced growth path, I think they need to continue to build out the social safety net, as I mentioned earlier and Steve has talked about.

They plan to do quite a bit in health. They've eliminated school fees in the countryside for primary schools over the last few years. That has been helpful, but they need to do more on other aspects of the social safety net.

They need to do more on transfer payments, though I think they're moving strongly in the right direction on that today.

I would say, secondly, they need to allow their currency to continue to appreciate. It is true that over the last six months, their currency has been basically static against the U.S. dollar, but over this period as the dollar has strengthened, the Chinese currency on a trade-weighted basis, which is what really matters, has actually appreciated more rapidly than in any six- month period since they began their so-called "new currency regime" in the middle of 2005. I hope that continues because I do think it will contribute to rebalancing economic growth.

Another area where they have made some progress is under pricing of energy. As the price of energy has come down dramatically in the global market, they have not reduced their price. They didn't raise it as much as they should have two and three years ago and a year ago, but now as the price is going down very dramatically, they've held the price up.

So energy is much less underpriced in China, and I think one of the causes of the imbalanced growth is that energy was underpriced which was basically a subsidy for the manufacturing sector. Unlike our country, very little fuel goes to transportation. It's mostly going to manufacturing.

The area where they need to do more, I would say, is liberalization of their interest rates. Again, they've moved in the right direction. Real interest rates are higher today than they were a year ago because inflation has come down so dramatically, but the long-term tendency in China has been for lending rates that are too low, which provides a subsidy to the manufacturing sector, and I think that's one of the reasons, along with the undervalued currency, why manufacturing has grown so rapidly and the services sector has grown relatively slowly.

The counterpart of relatively slow growth of consumption is that the service sector as a share of GDP since roughly the turn of the century has been shrinking. Its share has been shrinking, which is quite unusual I think for an economy at China's current level of economic development and its pace of growth.

So they're doing very good things on building out the social safety net. That should continue. They're moving to some extent in the right direction on their currency even in recent months as it's been fixed against the dollar. I think it should continue, and the thing to really watch is what happens if the dollar over some sustained period starts to give back some of the gains.

If they stay pegged to the dollar, then their currency will be depreciating on a trade-weighted basis, and I think that would be the wrong way for them to go. I think they're moving for the most part in a good direction on prices. The one which I should mention is electricity is still significantly underpriced in China, and the interest rate has not been, interest rate structure has not been liberalized.

And for most of the last five or six years, this control of the interest rate has imposed a very substantial tax on households. They have huge savings; they earn very little. And one of the reasons that consumption is weak in China is that interest income relative to the size of the economy or relative to the magnitude of household savings has gone down. So disposable income as a share of GDP has been going down in large part because interest income has been declining even though the magnitude of financial savings has been going up.

MR. CASSIDY: Let me just concentrate on the last part of your question since the previous speakers did such a great job on the things that China can do.

In a recession, of course, or in a crisis like this, it's terrible really to waste the opportunity. So for China, for the United States, for all the countries that are involved in this global crisis, this is an enormous opportunity to begin to fix things, and so I think that that's, in a sense that's what Nick was referring to.

But, there have been occasions where China has been reluctant to make reforms and to move forward, and this I think can be encouraged actually by U.S. taking certain actions. I note that over the last eight years that USTR has not accepted any 301 petitions despite the complaints against China. I note that there are actions that could be taken on the currency side, on countervailing duty, antidumping, so these are actions that could be taken.

If China is not prepared to move, then I think it's appropriate for the United States, for those who are adversely affected by the policies of China, to be able to take actions that defend themselves against those unfair trade actions. Those are some steps that this administration or others could consider doing.

Thank you.

HEARING COCHAIR WESSEL: Thank you. Hopefully, we will have a second round of questioning if time allows.

HEARING COCHAIR SLANE: Chairman Bartholomew.

CHAIRMAN BARTHOLOMEW: Thank you very much. And thank you, gentlemen, for appearing today and for bringing us directly the benefits of your expertise. We see many of you on TV and it's great to have the opportunity to be able to interact a little bit.

There are so many issues that have been raised already. I have two sets of questions. I think I'll start with the first one. Dr. Lardy, I was particularly interested in your mention of the fact that there are no toxic financial assets in China's system given that as recently as several years ago those of us who had been raising concern about currency for a number of years were essentially told we can't do anything about the currency because China's financial system is in such bad shape, and up to 40 percent of the loans might be bad, and we can't afford for that system to come tumbling down.

If there are no toxic financial assets, it's been a pretty fast turnaround. How did it happen? Are there lessons that TARP could take from this and, finally, how much of the redemption of what was perceived to be China's bad loans in its banking system was made by U.S. financial institutions that right now might be seeking bailout money or getting bailout money?

DR. LARDY: Well, let me say the premise of your question is completely correct. China's banks ten years ago were insolvent and they had a tremendous program starting in the late '90s to inject capital to restructure the banks in terms of their ownership. Many of them were ultimately listed on markets in China and in Hong Kong. They changed their corporate governance. They changed their accounting.

They've had an extremely strong regulator, the Chinese Bank Regulatory Commission, which was created during this period that has imposed very tough accounting standards, both in terms of the classification of nonperforming loans and the amount of provisioning that's required for nonperforming loans.

So these banks have all been dramatically transformed over the last ten years, and their capital adequacy rates today are relatively high. All of the big banks have capital adequacy in the neighborhood of 12, as much as 13 percent. They have a lot of liquidity. That's one of the reasons they can increase and step up their lending as they've done over the past three or four months.

A great deal of public money went into this in order to wipe out the bad loans. So when I say they don't have any toxic financial assets, I'm thinking of the kinds of derivative products, collateralized debt obligations, subprime, Alt-A, et cetera, et cetera, that were, shall we say, created in such huge quantities in the United States and to some extent elsewhere but then sold on into many, many markets.

I think Asian banks in general did not buy very much of these particular types of assets and the Chinese bought extremely little. The total exposure of their single largest bank, which has been the largest bank in the world in recent years, to these types of assets, everything from what I've mentioned, Lehman paper, et cetera, et cetera, is 0.02 percent of their assets, and it's about 80 percent already reserved for. So they're going to write it all off from their internal earnings.

They still, of course, are at risk from just plain vanilla domestic loans that might go bad, particularly as the economy continues to soften. Lots of lending into the export sector where earnings are obviously down dramatically, perhaps too much lending to the property sector, which may or may not be in the early stages of a correction. We're certainly witnessing a slowdown in the property market.

So Chinese banks could easily have more nonperforming loans, but of domestic origin, not related to derivative or other complex products, but just loans that might have looked good when you're growing at 12 or 13 percent that won't look so good when your growth collapses.

CHAIRMAN BARTHOLOMEW: And the issue of U.S. financial institutions' investment in China, did that help clear up some of the banking system? I'm thinking particularly of Bank of America.

DR. LARDY: Well, what really happened in that case, and I'm sure Steve can go into more detail, is that the basic clean-up had already occurred prior to the time U.S. and certain other international financial institutions made their investments. The bad loans had been written off; the capital had been injected; certainly the IPOs were more successful because of their ability to attract strategic foreign investors, Bank of America in one case.

So it contributed to their international credibility and, as you know, I'm sure, many of these institutions now, whether it's RBS or Bank of America or others, had been selling off part of the investments that they made prior to the IPOs, and they've made a very substantial amount of money on those investments.

CHAIRMAN BARTHOLOMEW: Dr. Roach, anything to add?

DR. ROACH: Not really. I think Nick has painted a very accurate picture. Just to add a tiny bit, and he laid this out, is that for each of the four major state-owned former policy banks during the nonperforming bank loan crisis of the late '90s, an asset management corporation was set up. There were four of them that were set up, and the bad loans--very different, as Nick said, than the toxic paper that's held in Western institutions, primarily U.S. and Europe--were transferred to the asset management corporations and a fairly robust auction process was established to sell the loans to investors, some including Western investors at market-clearing prices.

This was China's version of a TARP and it worked quite effectively for awhile. But I think this reflected a very aggressive approach to cleaning up a banking system that was in serious difficulty in the late '90s and now has emerged in a much, much stronger position.

I would just echo Nick's point that the risk to the new modern banking system in China over the next few years is likely to come more from the Chinese business cycle rather than from the credit market contagion that is still evident with great intensity in the United States and in Europe.

CHAIRMAN BARTHOLOMEW: Thank you.

Mr. Cassidy? No.

Thanks. I'll have a second round of questions.

HEARING COCHAIR SLANE: Thank you.

Commissioner Fiedler.

COMMISSIONER FIEDLER: Thank you. Three quick questions. First question is when do you expect China not to have an export-led economy? You talked about a stimulus, you talked about all their plans, and you talked about how it was not happening right away. When? When do you expect it to happen? One.

Two, someone made reference--I think it was Mr. Roach--to Secretary Geithner's comments pre-confirmation on China's, quote-unquote, "manipulation of currency." So we've had a discussion about appreciation of their currency. There's been estimates anywhere between five and 40 percent differences so that economists clearly have wide-ranging disagreements.

Also, after Mr. Geithner was confirmed, his tone seems to have changed. So I'd like some of you to talk about the politics of why everybody is always so afraid to confront the Chinese directly on the appreciation question of its currency? Is it because we're worried about the impact on Chinese stability? Or are we worried about something else?

And thirdly, a quick question is the net benefit to the average American. Has China's WTO accession and the trading relationship since accession to WTO been a net benefit to the average American? And if so, how?

DR. ROACH: And you want brief answers to each of those questions?

COMMISSIONER FIEDLER: Yes. We have a lot of economists come through, but I actually know that you could be brief. Having spoken to you before, Steve.

DR. LARDY: I can try to be brief. First of all, economists have a lot of different definitions of what export-led growth is, and we could go into the fine details of that at very boring length. I think in the short run, we will see over the course of this year shrinkage of China's external surplus.

Their external surplus has been growing almost continuously in absolute terms for many years, six or seven years, and as a percentage of GDP, it was growing until last year, but I do believe because of what's happening globally, that the external surplus will begin to shrink in the second half of this year.

So exports, net exports, are going to no longer contribute very much to Chinese economic growth, and they will probably become a drag on China's economic growth by the second half of this year. So on that criteria, China will be out of export-led growth.

It would still have a large trade surplus so if your metric is when China has balanced trade, that could be years and years, but I don't think that's really the right metric. If they have reduction in their trade surplus that continues for several years, I think they will be moving in the right direction. This is a very big economy, the third largest in the world, and as Steve has already indicated, you can't just dial up and dial down to rebalance. They're taking some strong steps, but they'll take a couple of years to come into effect.

A lot will depend on what happens on the exchange rate. As I indicated, the pace of appreciation the last six months has been much more rapid than any six-month period and about actually three, four times more rapid than any previous six- month period since the middle of 2005. So if that were to continue and the other steps continue to be taken, I think for effective purposes, I think within two to three years, China could be out of export-led growth.

DR. ROACH: Okay. I would just underscore that right now it's rather interesting that the export share of Chinese GDP is just about equal to the private consumption share of the Chinese GDP. Both numbers are around 36 or 37 percent. The export share has been rising. The consumption share has been falling. I think cyclically Nick is entirely correct, that you're about to see a reversal of both of those shares. The question is what happens after the cycle settles down, which I think is something you're more interested in than just some short-term moves.

COMMISSIONER FIEDLER: Absolutely.

DR. ROACH: I think that if you look at those shares through the cycle, that will give you the best answer, and I think maybe in about three years, you will begin to see more strength in private consumption and less strength in gross exports. I think the point on net exports being positive for a longer period of time is reasonable.

You would need to invite Mr. Geithner to this forum to ask him why his tone has changed in the very short period of time when he was the Secretary of Treasury designate as to why he's sort of speaking--

COMMISSIONER FIEDLER: Please do speculate.

DR. ROACH: --a little differently now that he's Treasury Secretary. His comments did not go over well, not just in Beijing but around the world. To suggest that any economy that is in the midst of a slowdown, with a large export share, consider a sharp further currency appreciation is probably not going to go over too well in most economies with those characteristics. The Chinese were upset about it, and others in the international community were upset about it.

The point has been made by Mr. Cassidy and others that the Chinese should face up to having to deal with these issues. I just go back to the point that I made in my prepared statement as well as in my opening comments. I would urge this Commission not to look at the bilateral imbalance between the U.S. and China in isolation from America's saving and multilateral trade problems. It needs to be understood in that critically important context.

MR. CASSIDY: Let me just state that I don't think I ever said that -- tough to the Chinese on the currency issue. I don't recall having said that, and I certainly, if I did, I would like to withdraw that comment, but I think that that is not what I said.

I have said, however, that there are steps that the United States can take or the companies can take that are being adversely affected by Chinese actions that they could take to defend their own interests, and that's a very different issue.

I think the two questions you asked, the issue of currency manipulation and Secretary designate Geithner's comments and the issue of net benefits of WTO, are somewhat interrelated. I've done a little bit of analysis, not as comprehensive as perhaps some of the more econometric type that economists would do, but I've done analysis on what are the benefits; who did benefit from the WTO accession because, remember, these were unilateral concessions on the part of China.

We didn't have to give anything on that agreement. Logic would have said that the United States would have benefited from the agreement in some way. Now, admittedly, we never said that the deficit would decline, but we didn't expect the deficit to increase double every five, more than double every five years, which is what it did.

Now, I know that USTR will say -- and it's true -- that our exports grew to China faster than to any other country in the world. But the fact is it grew to China because it grew from a very low level.

Our exports in absolute terms grew more, by 70 percent more, to the EU and I think 50 percent more to Canada. And they made no concessions. So who benefited from this? This is what I would like to find out. It didn't happen--I didn't see it on the trade side.

Certainly corporations did benefit from this. There's no doubt about that. And I think that's part of the reason that gets to the other question, is that the financial institutions that financed all these imports, they benefited. The corporations benefited, but I'm not so sure that the average person on Main Street gained a lot of benefits from the agreement.

I can't show it. I would love to be able to prove it. After all, I was involved in the negotiations. I would like to be able to say that, oh, yes, indeed, everybody is better off because of China. I still believe that to be the case, that everybody is better off with China being in the WTO abiding by international rules and principles.

But I can't prove it, and I think the overriding reason for this is on the monetary and fiscal side. It's on the currency issue that, when you have such a distortion there, it distorts everything, and so consequently markets are not actually working or they're working, but they're working based on a distorted mechanism, manipulated currency.

So Secretary Geithner was attacked by China. Well, first of all, anytime anybody criticizes China, China attacks back. We should expect that. Nobody should be surprised with that. I don't know if any other country would react any differently.

The second thing is that I think corporations were the ones that reacted violently. I'm not too sure that other countries reacted violently to that criticism. Why? If the yuan is pegged to the dollar, who are the currencies that are being even more affected by it? It's the euro. It's the British pound. It's other currencies. Because they have to make more adjustments in their exchange rates because there isn't an appropriate adjustment taking place between the yuan and the dollar.

So I think it's very complicated for Mr. Geithner. Yes, if China were to appreciate and continue to appreciate its currency, we would see gradual return to balance, and that's something that corporations can deal with. Their concern is huge changes in the exchange rate that will disrupt their investments, their trading opportunities, et cetera.

Of course, we're in a crisis now so what logic prevails in a crisis like this? I don't know the solution. I bow to my experts on my left here that they perhaps have greater wisdom on that than I certainly do, but from a policy perspective, I can understand why people would be reluctant to be too critical on this as they just enter office because after all, we have to work out, if we can, a soft landing.

But, in any case, I think that there are steps that the U.S. companies can take those that are adversely affected by it.

Thank you.

COMMISSIONER FIEDLER: Thank you. I'll come around again.

HEARING COCHAIR SLANE: Thank you.

Commissioner Reinsch.

COMMISSIONER REINSCH: Thank you.

I'm going to do my best to set a precedent and stick within the five minutes if possible, and you all are going to help me.

Nick, I have a first question is for you. I was intrigued by your prediction that Chinese recovery will be faster than elsewhere, which I infer from the other things you said means that they'll be successful in moving toward a domestic consumption-led standard because you don't see our economy recovering to be a purchaser of their imports any time soon.

Let's assume you're right for the moment, and that's what happens over the course of the next year or so. What are the implications for the United States and for our economy?

DR. LARDY: Let me say my memory is not perfect. I hope I said China has the potential to recover faster. There are no guarantees in the current world obviously. I think the implications for the United States are largely positive because if China does come off the bottom sooner, it is the third-largest economy on the globe, and it's not by PPP or some other magical calculation. This is by exchange rates.

COMMISSIONER REINSCH: You better be careful. Ernie is three rows behind you.

DR. LARDY: So they will be making a net contribution to global expansion which I think will be most welcome. I don't think, by the way when I say they have also the potential to converge back towards their long-term growth potential, I don't think they should be aiming to get back to 13 percent that they had in 2007.

I think on a more sustainable basis with more balanced growth, they should be looking at a long-term growth that's something in the neighborhood--I don't want to get down into the details--but something in the neighborhood of nine to ten percent. It will still be very fast, but I don't think they ought to be aiming to grow at more than ten percent.

So if this emerges and they continue to try to rebalance things, I think it would be quite positive, not just for the United States but for the global economy more generally.

COMMISSIONER REINSCH: Dr. Roach, do you agree with that?

DR. ROACH: I think that the Chinese stimulus is certainly going to produce a stronger second half growth outcome for the Chinese economy than we will see in any other major economy in the world, and there will be important implications of that for other economies who provide inputs into an infrastructure-led stimulus.

There is one critically important caveat here, though, and that is that the United States Congress in its infinite wisdom, or lack thereof, in inserting a "Buy America" provision into America's infrastructure stimulus could set in motion some similar types of efforts by other economies including the Chinese.

I realize that there are a lot of caveats that were inserted into the "Buy America" provisions of our stimulus package that may sort of technically temper the impacts, but you cannot underestimate the symbolic tone of the statement that has been made by Capitol Hill in this regard that could have reverberations around the world, that could also affect the way in which China sources its own infrastructure-led impetus.

But I do believe that without that provision that this is a positive for the global economy, and that China certainly should be credited as being a nation that has taken a much more aggressive tone in stimulating its economy with important implications for the world than is the case elsewhere.

COMMISSIONER REINSCH: Thank you. And thank you for bringing up the "Buy America" issue. I think you made a good point. I suspect some of my colleagues don't, and I'll leave it to them to argue with you about that.

Bob, do you agree with Nick's point about the last six months of RMB appreciation on a trade-weighted basis? It seems to me that undercuts some of your arguments about the state of the bilateral exchange rate.

MR. CASSIDY: Our analysis shows that it hasn't really appreciated on a real basis as much as certainly the nominal increase has been. But it depends upon what period you take because if you go back--it depends on what the estimates are on--

COMMISSIONER REINSCH: So he's wrong?

MR. CASSIDY: Pardon me?

COMMISSIONER REINSCH: He's wrong?

MR. CASSIDY: My economists in the office might say he's wrong, but we'd have to compare our numbers. The fact is, is that, look, they may--

COMMISSIONER REINSCH: You're becoming an economist.

MR. CASSIDY: When we start using increases, when you start using percentage increases, it's distortion in a sense because we're not really getting to the basic numbers that each one of us is using, and so, yes, it may have appreciated faster than any other currency currently, but has it appreciated enough? That's it.

Let me just say one other thing. China’s undervalued currency is the best "Buy China" policy that China could have, and so the fact that we had a "Buy America" policy, they have and have had with their undervalued currency since 1994 a "Buy China" policy.

COMMISSIONER REINSCH: Well, you allude in your written statement to things we could do that are tougher than things we have been doing to persuade them to engage in further appreciation. But you don't mention what those things are. What are they?

MR. CASSIDY: Yes, I didn't allude to them. I did to the question. There are some who would recommend taking countervailing duty actions and using undervalued currency as a prohibited export subsidy. Antidumping action. Also, it could be covered as an antidumping action. These are actions that individual industries could take who are being adversely affected -- but they would have to prove injury.

COMMISSIONER REINSCH: Yes, I understand all that. I don't see how that would have a macro effect on the overall rate. I can see why it would have a relief effect for the individuals.

MR. CASSIDY: But I think that would be a way for encouraging China to start taking action on its currency.

COMMISSIONER REINSCH: Well, my time is--

MR. CASSIDY: It depends upon how extensive the actions are. There are other actions the United States could take in concert with other countries. Take China to the WTO.

COMMISSIONER REINSCH: Okay. I think my time is up. I'd like to continue that but not right now.

Thank you.

HEARING COCHAIR SLANE: Commissioner Mulloy.

DR. LARDY: Mr. Chairman, can I just make a point of clarification on the exchange rate? I don't estimate how much China's currency has appreciated over any given time period, but I do look at the estimates that are made by Citibank, J.P. Morgan and the Bank for International Settlements, and if you look at the period from the middle of last summer, the Chinese currency vis-à-vis the dollar, it was at 6.83 or 6.84, and it has been basically unchanged for the following six months, and I didn't look at the last week so maybe it changed a little bit. But basically they have stopped appreciating vis-à-vis the dollar.

When you look at the trade-weighted indices calculated by those three organizations, they all show very, very rapid appreciation of the RMB on a trade-weighted basis.

At an annualized rate, the appreciation they're showing over the last six, seven months--depends on which index you look at, and there are some variations--they use different weights and different price corrections and a lot of other technicalities--but they're all showing annual rate of appreciation over that six-month period between 15 percent and eight percent, which is unprecedented in the years since they changed their policy in July of 2005.

COMMISSIONER REINSCH: Thank you for that.

HEARING COCHAIR SLANE: Commissioner Mulloy.

COMMISSIONER MULLOY: Thank you, Mr. Chairman.

My understanding is during the '30s, one of the things that led to the breakdown of trade and some say the Depression was that countries were under pricing their currencies to gain trade advantage against one another, and after the War, one of the institutions created was the International Monetary Fund to have some role in making sure that that was not taking place. Is that your understanding, each of you on the panel?

DR. ROACH: Yes.

DR. LARDY: Yes.

COMMISSIONER MULLOY: Now my further understanding is that the IMF Charter is a treaty; is that your understanding? That it's a treaty that countries sign on to and pledge to live up to? Do you all agree with that understanding? Mr. Roach, is that your understanding?

Here's why I think Secretary Geithner may be getting a bum rap here for being criticized for the statement he made on China’s currency manipulation. What I want to understand, without playing the blame game, is to understand what factors led us into the current difficulty that the global economy is in.

I was with the Banking Committee in 1988 when Congress wrote the law requiring Treasury to identify countries that were manipulating their currencies to gain trade advantages and to report that to the Congress.

There were no immediate sanctions put in place by that law. It's just a reporting requirement to tell the truth to Congress about what is going on because Article I, Section A of the Constitution gives Congress the role over international trade and finance and they delegate that to USTR on trade and delegate it to Treasury on the finance.

Article IV of the IMF Charter, which is a treaty, says that “countries are to avoid manipulating their exchange rates in order to prevent effective balance of payments adjustments or to gain an unfair competitive advantage over other members.”

Then the IMF further said, okay, how do we understand whether a country is violating Article IV of the treaty? And they adopted some surveillance procedures that said protracted large-scale intervention in one direction in the exchange market is one way of understanding whether a country is violating Article IV.

My further understanding is that China with the dollars that it gets from running massive trade surpluses has intervened in currency markets as a way of propping up the value of the dollar and keeping its own currency underpriced against the dollar.

I note that the head of the IMF, Dominique Strauss-Kahn--he's the IMF's Managing Director--and I'm reading from an article that appeared in Forbes magazine on January 2. It says the IMF Managing Director said recently that the Chinese currency is, quote, "significantly undervalued."

So here's the head of the IMF saying here's what's going on, the Chinese currency is significantly undervalued. You have the Treasury Secretary charged by Congress to tell Congress the truth about whether any country is undervaluing its currency. So what choice would Treasury Secretary Geithner have if this is going on but to tell the truth to the Congress?

Do you understand that and do you quarrel with that type of analysis of what is going on here?

DR. ROACH: Yes, I do.

COMMISSIONER MULLOY: Okay.

DR. ROACH: Yes, I do.

COMMISSIONER MULLOY: Okay. Why?

DR. ROACH: I think, number one, since the new foreign exchange regime was put in place in China of 2005, the appropriate metric to use is the broad trade-weighted index. But you're focusing on the cross rate between the dollar and the RMB and even that gauge is up 21 percent in real terms since that foreign exchange regime was changed.

Now, there was a well-known bill proposed but never taken to a formal floor vote in the Congress by Senators Schumer and Graham that argued for a 27.5 percent appreciation of the RMB as far back as three years ago. So, on the basis of that bill that was proposed, 21 of the 27.5 percent percentage points of appreciation have occurred. So I think it's important to note the progress that has been made against that metric.

But again, the thing that honestly, Commissioner Mulloy, that frustrates me the most is this fixation--and I heard it again, and time and time again today by Mr. Cassidy--on the bilateral imbalance. This fixation presumes that if we can fix the bilateral imbalance and everything is fine.

America, because of its savings shortfall, has a multilateral problem. So you can go after the Chinese piece, but if you don't save, and the “cure” remains elusive. By the way, in a country that's about to run trillion dollar budget deficits for now many years to come, as President Obama has said, we're going to have a savings' problem for as far as the eye can see.

So if you go after the Chinese piece of our multilateral problem, which comes from our savings issue, what have you accomplished?

COMMISSIONER MULLOY: I'm not saying anything about going after anybody. Here's the head of the IMF, he said recently, the Chinese currency is significantly undervalued. Do you agree with the head of the IMF that the Chinese currency is significantly undervalued?

DR. ROACH: No, I do not.

COMMISSIONER MULLOY: Do you, Mr. Lardy?

DR. LARDY: We'd have to define what "significantly" means. They have appreciated a very substantial amount. The rate of appreciation has accelerated in recent times. I still happen to believe that the currency is undervalued. They have a massive current account surplus.

As I've already said, I think it will get smaller in the second-half of this year, but it's still unprecedented in size, and so my view would be that they probably in the long run are going to have to have more appreciation to get closer to equilibrium in their external account.

COMMISSIONER MULLOY: Mr. Cassidy, do you agree with the head of the IMF that it's significantly undervalued?

MR. CASSIDY: Yes. Yes.

COMMISSIONER MULLOY: Just one last follow-up. Mr. Lardy, Dr. Lardy, is one way that they keep it undervalued is by intervening in currency markets?

DR. LARDY: Absolutely. I would say two things. First, the intervention, and then the fact that most of the time they sterilize most of the interventions so that they don't have price inflation. Obviously, a currency can appreciate in real terms either through a change in the nominal rate with stable prices or a fairly stable nominal rate with increasing prices.

So it's not just the intervention that's the problem. It's the intervention plus the massive sterilization program that undermines the adjustment process.

COMMISSIONER MULLOY: So that's why I think Timothy Geithner, if he's charged to tell the Congress the truth, has to tell that the Chinese are under pricing their currency. That's all.

He said recently before the Finance Committee: "President Obama backed by the conclusions of a broad range of economists believes that China is manipulating its currency"--end quote.

Now, he has to give a mandated report to the Congress on exchange rates on April 15. That will be the significant date we're looking for.

Thank you.

HEARING COCHAIR SLANE: Thank you.

I want to talk a little bit about how we get out of this situation. If I understand what you're saying, it is that U.S. exports are going to have to lead us out of this recession. For that to occur, the Chinese domestic market is going to have to open up. What worries me is that for the Chinese domestic market to open up, Chinese savings are going to have to go down. The Chinese people are not going to do that until they perceive that a safety net is in place.

My fear is that this is going to take years. I'd be interested in your comments and whether you think the recession here is going to go on for years if my premise is correct?

DR. ROACH: Well, I made a fair amount of the Chinese safety net point in my written statement that I submitted to this committee. So I will just elaborate on it.

There are two dimensions to the high levels of precautionary saving in China. One is the lack of a safety net, but the other is the massive incidence of layoffs that have occurred during this 12 to 15-year period of state-owned enterprise reform, where in excess of 65 million Chinese workers who had worked for the state with lifetime benefits in terms of labor retirement income as well as provisions for medical care, in some cases shelter and education, losing the jobs that they had for the state. When they lost those jobs, they also lost the "iron rice bowl," the security that went with that. They've been dealt a very powerful shock.

So then when you add in the lack of a safety net, not only will those workers save what little they'll make, but other workers who fear they may be next will elect the same savings' strategy.

What I'm saying and what Nick Lardy is saying, is that the Chinese are mindful of that risk, and they are taking actions, albeit somewhat slower than I would like to see, in dealing with that. But I think the consumer culture that we are asking the Chinese to adapt will take time. This will not be an overnight thing.

It's not as if it is a country like the United States with a thriving and, in fact, an overextended consumer culture, that China can step up in a short period of time. In the case of the Chinese, this will take a lot of time. So in answer to your question, the Chinese consumer and their appetite for American-made products is not something that the U.S. can count on as a source for imminent cyclical revival.

I think we're deluding ourselves into thinking that this is going to be the fix for America's recession.

DR. LARDY: I would just like to broaden the discussion a little bit. We've talked about savings quite a number of times so far, but I think in most, perhaps in even every single case, we've been focusing on the household sector in describing the factors that might lead to a reduction. I think we need to broaden it to consider the fact that China's national savings' rate is now north of 50 percent and is unquestionably the highest of any country in the world, and that's why they have such a huge current account surplus because their consumption share of GDP relative to savings is, there's such a big gap.

But looking forward, rebalancing could occur not only because households might save less, but the corporate sector might save less or the government sector might save less. I think in the current environment, we're going to see a significant decline in corporate savings.

Corporate savings, after all, are retained earnings, and in the slowdown that China is undergoing, profitability is sinking like a rock, and tax revenues are growing relatively slowly as a result. So the corporate contribution to national savings is likely to come down over the course of 2009 and maybe well into 2010.

Government savings--and China has a government that actually has a positive savings rate--that means its current outlays in recent years have been significantly less than its tax revenues so the government has been saving, something that is unheard of in the United States in any recent decade.

So even with the consumer, and I agree with Steve that you don't turn these consumers around instantly, it takes a long time. I think we're going to see a decline in government savings this year; I think we're going to see a decline in corporate savings.

One of the things that's happening with the government is, as I mentioned before, they're spending a lot more on social programs. Government consumption, which is part of the consumption package, has been declining for seven or eight years, but I believe it will go up this year and next year possibly by as much as one to two percentage points of GDP.

That's what happened in the last slowdown in '98, '99, 2000. Government consumption as a share of GDP rose by--I don't remember exactly--but something in the neighborhood of one-and-a-half to two-and-a-half percentage points. I think that's what we're seeing now, and I think we'll continue to see that next year.

So the government will reallocate its budget away at the margin more towards the consumption side. I think corporate savings is going to come down. So I think China is likely to be emerging in a situation in which their current account surplus will shrink as a share of GDP further.

It did shrink a little bit last year. I believe it will shrink more this year so there is some rebalancing going on already. The key thing is the rebalancing is not only at the household sector--don't get me wrong--I don't want to say it's not important; it's critically important. But there are other sectors in this economy that are also part of the savings' investment equation.

MR. CASSIDY: Thank you.

I don't have an awful lot to add to this, but just borrowing a point that Mr. Roach made, is that this is a global issue, and so, yes, there are things that China could do to rebalance its growth so that it's more domestically oriented.

But equally there are so many things that the United States could do, and on that point, on the amount of the debt that the United States has and the deficits that we're running, it does cause one to wonder how this is going to resolve itself because we need to borrow the money from somebody, and so where is that money coming from?

And with 50 percent savings' rate from China, maybe that's the solution. Maybe an undervalued currency is going to be part of the equation for awhile. I don't know. It is an imponderable and one that I think Tim Geithner is worried about because there are huge imbalances in the future.

HEARING COCHAIR SLANE: Thank you.

Commissioner Bartholomew.

CHAIRMAN BARTHOLOMEW: Thanks very much. Thank you, again gentlemen.

Obviously, one of the things we're all struggling with in this new global economy is that we have, and we're seeing, Dr. Roach, of course, the global nature of all of this, and how much government control or influence on economics there is. I think that that's one of the challenges and I agree with you that there needs to be a multilateral approach.

But the Chinese government has more control over the Chinese economy than many other countries do over their own economies and, in fact, they have plans. You made reference to the 11th Five Year Plan. They've got an industrial policy. I'm raising this because there was a very interesting piece on Bloomberg.com late last night, and I looked again this morning and didn't see it, but reporting on some evidence or belief that Chinese companies are using the stimulus package not for the kinds of investments that were originally planned in China, but for equity purchases, and in fact that that might be why the Shanghai stock market is doing better.

What, again, is the parallel to the United States in the sense of this credit crisis. Congress created what was supposed to be investments into banks, and the banks have not been--well, they say they're doing more of it-- making credit available.

If indeed it turns out to be the case that Chinese companies are using that, they're doing equity purchases instead of shovel ready projects or whatever it is that they're supposed to be doing, do you think that there are actions that the Chinese government will take to change that dynamic, and if so, how is that different than what the U.S. government could do in a similar situation?

DR. ROACH: I think the phrase we use to describe this infrastructure plan around the world, whether it's the United States or China, is "shovel-ready" projects.

When the government embarks on shovel-ready projects in the U.S., that's a bit of an oxymoron. It probably takes six months for the government to get a permit to buy a shovel. In China, everybody has a shovel. When the government says dig, they dig. I think you'll see a much quicker response.

As Nick pointed out earlier, there's been a big surge in bank lending directed by the central bank in China. As you know, China is a hybrid economy. There are a lot of private companies or corporatized companies that make discretionary choices outside the purview of the command and control structure of the Chinese economy, and they can't control exactly where those funds go.

But when the Chinese introduce an infrastructure-led stimulus worth four trillion RMB over a couple of years, and direct a large portion of that to be spent by the Ministry of Rail, it will be spent on rail construction, and the question becomes how much of the projects were new, how much of them were previously planned. But you can rest assured that there will be much less slippage than there might be through stimulus via the bank lending route that was described earlier.

I do think that there's a greater likelihood of quicker policy traction from the Chinese stimulus than there will be from a U.S. stimulus. Our systems are different. Our structures are different, and our ability to get more instantaneous results in the United States is more limited.

CHAIRMAN BARTHOLOMEW: Dr. Lardy, anything to add?

DR. LARDY: I don't know all the ins and outs of how bank lending gets transformed into increases in equity prices, but I would just say this. I think the Chinese market, the stock market, the Asia market in particular, has been very liquidity driven since it was created 15, 20 years ago. And once the signal came last fall for a relaxation on credit, I think there's a psychology that people just go back into the market because it is a liquidity-driven market.

We do see a big increase in bank lending, but it can be driven mostly by private individuals or institutions, not necessarily manufacturing companies that are buying more shares.

It's hard to separate it out, but I think it is a liquidity-driven market, and we have a lot more liquidity in China so I'm not surprised that the market is having a bit of a bounce or an increase, but I wouldn't necessarily conclude that a lot of companies that have been given money to undertake investment projects have diverted it into the stock market.

CHAIRMAN BARTHOLOMEW: We'll have to see.

Mr. Cassidy? No?

Thank you.

HEARING COCHAIR SLANE: Commissioner Wessel.

HEARING COCHAIR WESSEL: Thank you.

There are clearly many rounds of questions I think we'd all like to ask, and I'm sorry that Commissioner Reinsch has gone because we could have had a slight discussion of the "Buy America" clause, since I hold a different view on that.

Dr. Roach and the other panelists clearly, as we've all said, understand that this is a global crisis and is not single-factor oriented. At the same time, we are the U.S.-China Economic and Security Review Commission, and that's the lens through which we have to look at it, and to which the Congress looks to us to provide analysis and recommendations.

Going forward, I want to ask a question because we've seen tremendous capacity additions in China over the last several years in a number of very basic but important industries: steel, glass, paper, autos. One could go down the list. The numbers as of last week, if I recall, for U.S. steel blast furnaces were that 16 of 29 are down and not currently operating.

As we look forward, how do we put Americans back to work if we are going to face massive capacity additions in China, if we are going to face the continuing, as I think was noted earlier, subsidies, whether they're energy subsidies, whether they're tax rebates, whether they're inadequate or lax enforcement of environmental laws, all up and down the road?

When our banks look at lending to these steel companies, to the paper companies and others, so that they can get back in business, so that they can revive their capacity, what do the banks look at if, in fact, China is willing to subsidize its manufacturers?

Right now I think capital for most Fortune 500s is probably anywhere from 14 to 18 percent if they're going to be able to float an issue right now, if they can get credit at all.

How do we get Americans back to work if China is always going to be having this price advantage, the ability to continue their export-led growth with the capacity enhancements they have in their own economy? For each of the witnesses, please.

DR. ROACH: Yes, I will just be brief. Before the U.S. entered recession, technically now about a year ago, our export sector was booming. I won't say that smokestack America was back, but we had powerful momentum across the board in U.S. exports for a couple of years, and it was a very important piece in driving overall GDP growth in the United States.

That export boom occurred at a time when there had been lots of accusations made about ongoing subsidies to incremental additions to Chinese capacity. We're now in a horrific recession in the United States. The best thing we can do for smokestack America is to deal with our own problems rather than worry about the issues that you pointed to halfway around the world in China.

China needs to be held responsible and accountable for any actions that it takes that are deemed to be in violation of international trade treaties, but I would--

HEARING COCHAIR WESSEL: If I could just interrupt, though, because time is short. You've said that we have a much led consumer-driven, consumption led. I clearly agree. We need to increase our savings' rate, and I think if one looks at autos, for example, we're not going to have 17 million demand. We're probably going to be in the 13-14. So we're going to have a whole new demand curve here.

How do we get our steel and these other industries back on line, getting people back to work if the demand is going to be lower, which I think has to be, and the China excess capacity that can flood our market fairly easily? You don't flip a switch on a blast furnace and turn it on the next day. You have to have enough forward-looking demand to be able to bring them back on line.

When China has this excess capacity with a export-led economy, which is still part of their approach--not going to end in the best of scenarios of between three and five years--what impact does that have on our people and our market?

DR. ROACH: Again, I'd just say, briefly, the Obama administration has attempted to address that problem in its approach to America's stimulus package which is very much aimed at improving the competitiveness of the U.S. economy by investing in infrastructure, alternative energy technologies, and human capital, reskilling American workers. President Obama has indicated, and I totally agree with him, there is no quick fix.

We're in a tough period, and the American steel industry is not going to come back overnight, but if we stay focused on this strategy, there is hope that U.S. competitiveness will improve and that we will climb back in terms of our share in the global marketplace. And again, I underscore the fact we were doing a lot better until we tipped into a recession of our own making a year ago.

DR. LARDY: A couple of comments. First, I would begin by observing that the U.S. share of global manufacturing output has not fallen over the last two decades. We have remained very--unlike Japan and several other advanced industrial economies--our share of global manufacturing has been unchanged. It's actually up very, very slightly.

So I think our manufacturing sector has done much better than some people recognize. It's a little bit difficult in the face of the headlines of layoffs and so forth and so on that we've seen in recent months, but I think our long-term competitive position in manufacturing has been much stronger than the popular perception.

The other thing I would say is much more China specific. Now, here again I would like to emphasize that in China's infrastructure investment program, part of their stimulus, they are not emphasizing basic industries at all. They're not going to add significantly to their capacity to produce. They've already got too much steel, copper, aluminum, and some of the other industries that you ticked off.

I think what's going to happen in China is that investment in those industries is going to shrink dramatically because a lot of the investment in recent years in those sectors has been financed with retained earnings, and given sharp declines in steel prices compared to where we were a year or so ago, profitability in those industries is falling.

China still has excess capacity in some of these industries and they certainly have the capacity to increase their exports, but I think in the current environment, they're not adding to that capacity, and indeed the government is bending over backward to make sure that banks do not lend more to these industries.

They want them to lend to the infrastructure, the rail that Steve mentioned, which is getting a huge emphasis, the power distribution system, the grid in which they have underinvested in recent years, but they are looking to avoid adding significantly to capacity in basic industries.

MR. CASSIDY: The only point I would make is that I think using your example of steel, the reason that becomes a problem with China is indeed that they have increased capacity, but to the extent that it is excess capacity, unused capacity, that's when it creates a problem in other markets because that's when the product becomes an import into the United States or into some other market and undercuts prices.

To the extent that China adopts a more balanced development program that is not export led--I think the infrastructure program that they have, the increased spending that they are all attributing to greater balanced growth. We are all better off with China growing rapidly. No one should have a policy that looks at China as a way of decreasing China, China's growth. That is not an effective policy. We need to see China growing. We need to see China growing in a way that will expand our opportunities but also not create problems in the United States, and that's where I think the program of infrastructure spending in China is going to help create the demand for products like steel and not create the problems in the United States.

There's a flip side, of course, and that is our program has to work on our side as well because we have excess capacity now so we have to use that. So that would be my response, is that we're not better off with China not growing. But we improve if China's growth strategy can be better balanced than it has in the past.

HEARING COCHAIR WESSEL: Thank you.

HEARING COCHAIR SLANE: Commissioner Mulloy.

COMMISSIONER MULLOY: Thank you, Mr. Chairman. Thank you all for being here. It's been a terrific panel.

I just have another point that I want to help myself understand in what happened here. Going back to currency manipulation, which I don't think is a silver bullet to cure our problem, but my understanding is that the Chinese government ended up because of their policy of currency intervention, ended up with a lot of dollars, and then put those dollars into our Treasuries and Freddies and Fannies, over a trillion dollars probably, somewhere around that range, and that this helped keep U.S. interest rates lower than they would have been if that had not been the case.

Is that a correct understanding, Dr. Lardy?

DR. LARDY: I think roughly yes.

COMMISSIONER MULLOY: Dr. Roach, do you agree with that?

DR. ROACH: Roughly so.

COMMISSIONER MULLOY: And what about you, Mr. Cassidy?

CHAIRMAN BARTHOLOMEW: That was grudgingly.

COMMISSIONER MULLOY: There's a gentleman up at Harvard named Niall Ferguson. He's an economic historian, and he wrote an article in the Washington Post on September 21, 2008. Before quoting that let me say we’ve all agreed now that the currency manipulation helped keep U.S. interest rates lower than they would have been. Housing prices then went up and made Americans feel wealthier than they really were as we now find out when housing prices have come plummeting down.

So that Americans felt that they could buy things, because they felt wealthier, so that's why they bought a lot of things.

Here's what he says:

Low U.S. interest rates have helped make it cheaper for individuals and households to borrow money. This, in turn, helped inflate the real estate bubble which led to the current collapse of the real estate market and the credit crisis.

Now, that's Niall Ferguson, economic historian up at Harvard. Do you three agree with Niall Ferguson, that he has it right, that the currency manipulation was tied to the current problem?

DR. ROACH: I know Niall. He's actually a friend of mine. He's a historian. He is not an economic historian, number one.

Number two, what is missing in the analysis is the execution of the spending binge that you just described. It required American consumers to take their debt-to-disposable income ratio up to 130 percent of disposable income by the end of last year, up 40 percentage points from the level that prevailed ten years ago. The Chinese had nothing to do with enticing Americans to make the dumbest mistake they have made in the history of U.S. household finance, overly indebting themselves at a time of low interest rates, assuming that house prices would go up forever and that interest rates would stay low forever.

Did the Chinese do that, Commissioner Mulloy? Did they force Americans to make that mistake?

COMMISSIONER MULLOY: Are you asking me?

DR. ROACH: Yes, I'm asking you. Can I ask you a question?

You've asked me a lot of questions.

COMMISSIONER MULLOY: I'm just quoting this historian.

DR. ROACH: I understand you are, but I'm asking you a question.

COMMISSIONER MULLOY: I'm just quoting an economic historian. I'm trying to understand what happened here, and that's why I'm here to ask questions.

DR. ROACH: I'm saying that he's missed the most important piece of the equation.

COMMISSIONER MULLOY: Dr. Lardy, do you have anything to add on this?

DR. LARDY: Well, I think, one of the reasons I said basically I agreed with your first question is that if you accept it 100 percent, you have to think that the U.S. Federal Reserve has no control over our interest rates, and I don't believe that that is the case.

If the Chinese were willing to lend us money at low rates, the Fed could still have raised rates. So the problem with his approach is that it makes the United States completely passive and understates the ability of U.S. policymakers, particularly in the Federal Reserve, to respond to whatever is happening in the rest of the world.

We are not passive and have to accept interest rates as a result of what's happening in other countries. Maybe it makes their job a little bit more difficult and that's why I basically agree with the statement.

But I think the problem with this approach is that it implies that there was nothing we could do about it, and I think that is a substantial exaggeration.

HEARING COCHAIR SLANE: Mr. Cassidy?

COMMISSIONER MULLOY: Thank you very much. My understanding is Chairman Greenspan did try to raise interest rates a little bit, but the long rates remained low, and he called it a conundrum. That is my understanding from what I've read, but thank you.

HEARING COCHAIR SLANE: Thank you very much, gentlemen, for coming. It has been a great experience listening to you and we are going to take a five-minute break.

[Whereupon, a short recess was taken.]

PANEL II: CHINA'S SHORT TERM AND LONG TERM ECONOMIC GOALS AND PROSPECTS

HEARING COCHAIR SLANE: We will continue with our second panel, which is "China's Short Term and Long Term Economic Goals and Prospects."

The second panel for today will discuss China's specific efforts to address the effects of global recession on its domestic economy. We are very interested in hearing about China's stimulus plan and other Chinese growth promoting policies.

Ms. Alexandra Harney is the author of The China Price, and she has been reporting on Asia issues and the global implications of business, politics and social issues in this vitally important dynamic region for the Financial Times, the Wall Street Journal, the Times, and the Washington Post.

Gordon Chang is the author of The Coming Collapse of China, and he now blogs at Commentary magazine's site. He lived and worked in China and Hong Kong for almost two decades, most recently in Shanghai as Counsel to the American law firm Paul Weiss, and earlier in Hong Kong as a Partner in the international law firm of Baker & McKenzie.

We are very pleased to have him back before the Commission today.

Dr. Wing Thye Woo is a Professor of Economics at the University of California at Davis and a Senior Fellow at The Brookings Institute. His current research focuses on the economic issues of East Asia, particularly China and Indonesia, international financial architecture, economic growth, and exchange rate economics.

Thank you for coming, and we will start with Dr. Wing Thye Woo.

STATEMENT OF DR. WING THYE WOO, PROFESSOR OF ECONOMICS, UNIVERSITY OF CALIFORNIA AT DAVIS, DAVIS, CALIFORNIA, AND SENIOR FELLOW, BROOKINGS INSTITUTION, WASHINGTON, D.C.

DR. WOO: Good morning. I'm very honored to be here to share with you my assessment on China's role in the current financial crisis, and what China could do to help to remedy the situation.

I think that the Chinese economy is in deep trouble. It is in deep trouble because it has been hit by two negative shocks. First the government engineered a slowdown beginning at the end of 2007 after the present leadership was reinstalled in office. The economy had been revved up for the election, and so right after the election there was a need to slow it down through tighter macroeconomic policies.

Second, there has been a severe collapse of exports at the end of 2008 that caught the government off guard. This is why the nine percent growth rate for 2008 overstates the current situation. The growth in the last quarter of 2008 was less than two percent.

The IMF has projected that China would grow 6.7 percent this year. But at the same time that the IMF made its pessimistic prediction, Wen Jiabao said at Davos that China would achieve eight percent growth.

In my opinion, the outcome will most likely be closer to what Premier Wen said than what the IMF forecasted.

This is because the following scenario will unfold.

The banks had been put under strict credit quota beginning around December 2007, to pull back on the overheated economy. Right now, the banks are told that they should lend as much as they could. For example, the amount of new loans extended in January 2009 was double that in December 2008.

The banks are willing to make big loans because the bankers now know that they will not be held responsible in the future when nonperforming loans appear. They were just following orders. Their friends, the managers of the state enterprise sector will now do what is natural in most state-controlled industries, which is "invest, invest, invest." Investment enthusiasm is high because there has been so much decentralization in the oversight of the state enterprises that positive profits could be privatized through various accounting shenanigans and losses socialized through nonperforming bank loans.

At the same time that investment is encouraged by the collusion between the managers of the state banks and the state enterprises to transfer state assets to themselves, there is also a relaxation of the recently strengthened laws on worker protection, environmental protection, and social insurance to boost investment further. The outcome is that we would see a 2009 growth rate that is above seven percent, likely to be close to 7.5 percent. The cost of maintaining this high growth would be paid in the future in the form of nonperforming loans—that would lead to recapitalization of the state banks once more-- and a more severely depleted natural environment.

While the government might be able to achieve 7.5 percent growth in the short run, the unemployment problem would still be a severe one, largely because the economy growth would have been powered by infrastructure spending and not by consumer spending. $10 billion worth of infrastructure projects would employ fewer people than $10 billion of export goods.

So the unemployment situation would be more serious than what past GDP growth figures would suggest.

As far as China's growth in the long run is concerned, in addition to what I've said about short-run political expediency and the resulting long-run economic inefficiency, the truth is that China's economic growth strategy is environmentally unsustainable. China is running out of water in the north, and without water China cannot grow.

Possibly the other big challenge to long run growth is the big change in social expectations within China about the state. People now expect much better administrative and governance performance than what they have been getting, and I think the current economic slowdown would most likely generate a new wave of social unrest. The unmet expectations, if not handled well by the Chinese government, could result possibly in interruptions to growth.

Roughly speaking, the growth challenges of China could be divided into three classes, if you think of China as a speeding car, which is a good analogy as it has been growing at ten percent a year. The speeding car could crash for one of the following three independent causes.

The first possible cause is hardware failure, a breakdown in the major economic mechanism that is akin to a car tire coming off. A massive banking failure is one example of a hardware failure.

A second cause for the car to crash would be software failure. The car goes off the road because people are fighting inside the car. Social unrest from dissatisfaction with governance issues could derail high growth.

The third cause is power supply failure. Growth stops because the car just ran out of gas. There are two sources of power supply failure: one is environmental exhaustion; and the other is an external roadblock because of trade conflicts conducted either in the name of correcting trade imbalances or in the name of saving the global environment from Chinese industrialization.

A lot has been said earlier this morning about exchange rate manipulation. I think that we should understand that several factors caused the low interest rate we saw. The outcome was due to more than just the flow of Chinese financial opiates to helpless American borrowers. For one thing, Alan Greenspan had pronounced in 1996 that we were in the middle of a period of irrational exuberance, and what was his reaction? He extended more credit to prevent the hedge fund, Long-Term Capital Management, from failing in 1998, and to bail out the speculators after the dot-com bubble burst in 2000.

Then, we also have got these new mortgage-based securities; financial innovations called "ninja bonds- bonds backed by “no income, no job, and no asset”. The bank says: “Here, take a loan without screening by me because I'm going to securitize the loan and unload it to some institutional funds which buy on the basis of the AAA rating given by our vigilant rating agencies.”

Therefore, to say that the flow of Chinese financial opiates was a significant factor, that ranks along with Alan Greenspan's easy monetary policy, the financial innovation in the subprime mortgage market, and the easy behavior of the rating agencies, one would have to claim that we cannot solve the present crisis without also stanching this flow of financial opiates from China.

In other words, we not only need the $787 billion fiscal stimulus; we not only need the Fed to continue its network of financial lifelines; we not only need to reorganize the SEC; we also need to either impose a 27.5 percent tariff on Chinese imports or to force a 40 percent appreciation of the Chinese exchange rate.

In my opinion, this is a case where it is not necessary to start a trade war in the middle of a global recession; it will definitely not help to hasten global economic recovery. Causing a power supply failure in China's growth engine would dim more than a few lights in the U.S.

I think that after events have calmed down, when we could then address the issue of China's exchange rate policy and even then we should be prepared for disappointment. The history of the United States pushing the Japanese to appreciate their exchange rate by 50 percent did not make us any happier in its aftermath. It is true that the U.S. trade imbalance with Japan went down, but we imported more from elsewhere because Japanese companies went to Southeast Asia and started servicing our markets from there, leaving the U.S. overall trade deficit practically unchanged.

So if the U.S. were to force the Chinese to appreciate by 40 percent, our bilateral trade imbalance with China would definitely decline, but our overall trade imbalance would not decline until we do something to address the structural budget deficit of the U.S. economy, which would be very difficult to do if we're expanding the war in Afghanistan and stimulating the economy.

I think that there is a more important task in the U.S.-China relations than forcing China to adjust the exchange rate. The more important task the bigger picture is to see how both countries can cooperate to prevent the global trade system from collapsing along with the global financial system. Reason one, the Doha Round is struck and it has been stuck largely because there has been a backlash against globalization in the United States and other rich countries.

Reason two; China has been very passive in protecting the system from which it has benefited so much. China should become a more responsible stakeholder by working with the U.S. to push the Doha Round to a meaningful conclusion. Of course, this U.S.-China cooperation in trade should be accompanied by new U.S. programs to strengthen its ability to compete in the international markets.

There is another area for U.S.-China cooperation besides WTO negotiations, and this is the G-20 meeting on April 2 in London. The trouble with fiscal stimulus is that if it is done individually by any country, it is doomed to failure. This is because when your economy booms, but the outside world is not booming, you will just import more without increasing exports, causing your trade deficit to worsen; and the result is you cannot continue your stimulus.

The only way for any national stimulus to continue is if there's coordination to generate a global stimulus. The French, the Germans and the British want to talk about a new Bretton Woods. I think we should instead work with China to set up a Global Fiscal Coordination Secretariat so that we can get all the fiscal canons of the world firing simultaneously to get out of this bad economic situation.

Thank you.

[The statement follows:]

Prepared Statement of Dr. Wing Thye Woo, Professor of Economics, University of California at Davis, Davis, California, and Senior Fellow, Brookings Institution, Washington, D.C.

China in the Current Global Economic Crisis

Testimony before the U.S.-China Economic and Security Commission
in Panel II: China's Short Term and Long Term Economic Goals and Prospects
at Hearing on "China's Role in the Origins of and Response to the Global Recession"
Tuesday, February 17, 2009, Room 562, Dirksen Senate Office Building

Wing Thye Woo
Brookings Institution & University of California, Davis
wtwoo@ucdavis.edu

Video of Testimony on C-Span:
http://www.c-span.org/cspanFLVPop.aspx?src=project/economy/econ021709_china1 flv&s=7359.425&e=0&live=N&popup=Y

The unexpected depth and global nature of the current recession

China's economic situation in 2009 does not look good. The 9.0 % GDP growth rate in 2008 was not representative of the annualized quarter-to-quarter (q-oq) growth rate of 2.6 % in 2008:4Q.[1] Despite Premier Wen Jiabao's prediction in Davos at the end of January 2009 that China's growth would be 8 % in 2009, the IMF's January 2009 projection was 6.7 %, which was down from its November 2008 projection of 8.5 %. The February 2009 estimate of the number of jobs lost by migrant workers was 20 million, which was double the estimate of December 2008; and an additional 6 to 7 million rural residents were expected to join the migrant work force. The factory-gate price index fell 3.3 % in January 2009 and is expected to fall 6.3 % in February 2009. The pace of China's growth slowdown has consistently exceeded the expectations of the Chinese government and most outside analysts.

The dramatic drop in level of economic activity in China is also seen across the world; the q-o-q growth rate in 2009:4Q was -12.7 % in Japan, -3.8 % in US, -2.1 % in Germany, 1.8 % in Italy, -1.5 % in UK, and -1.5 % in the Euro Zone. The overall growth in 2009 has been forecasted to be -2.3 % for US, -3.4 % for Japan, -2.7 % for the Euro Zone (Citigroup, January 22, 2009); and 0.5 % for the World Output (IMF, January 28, 2009). The unanticipated nature of the decline in China is also shared by other countries, as evidenced in Table 1 by the IMF's continual downward revision of its projected 2009 growth rates for different countries, e.g. the Euro Zone growth rate in 2009 was expected to be 1.2 % in the July 2008 projection but -2.2 % in the January 2009 projection.

What caused the output decline in China and elsewhere?

A sizzling growth of 13 percent was produced for the 17th congress of the Communist Party of China (CPC) held in October 2007, easing the consolidation of the political leadership by Hu

[1] The 2.6 % estimate is from Goldman-Sachs (January 22, 2009). Deustche Bank put it at -2.3 % on January 16, 2009, and then revised it to 1.5 % on February 16, 2009.

Jintao. It was therefore to be expected that fighting inflation became the primary policy focus after the meeting, and economic technocrats switched from accommodative enforcement to rigid enforcement of the credit quotas that every bank was subject to, and initiated a faster rate of yuan appreciation. The q-o-q GDP growth rate went from 10.8 % in 2007:4Q to 7.3 % in 2008:1Q, 11.8 in 2008:2Q and 6.2 % in 2008:3Q. The slowdown in the first three quarters of 2009 is attributable primarily to macroeconomic and exchange rate policies and other domestic factors because there was no sign of a slowdown in export growth in the first three quarters of 2008, and the y-o-y export growth rate in October was 19 % which was consistent with the monthly growth rates in 2008:2Q and 2008:3Q.

Then export growth (year-over-year, y-o-y) plunged to -2.2 % in 2008:11M, -2.8 % in 2008:12M, and -17.5 % in 2009:1M (while the yuan-dollar exchange rate was unchanged). The precipitous drop (y-o-y) in industrial production from the double digit level in January-September (11.4 % in 2008:9M) to 8.2 % in 2008:10M, 5.4 % in 2008:11M, and 5.7 % in 2008:12M, and the large jump in unemployment of migrant workers were the consequences of the negative shock from China's export markets. In short, China's present economic crisis resulted from a policy-induced slowdown that has been greatly exacerbated by an unexpectedly deep economic collapse in US, EU, and Japan.

The deepening US recession is caused by the generalised credit crunch generated by the implosion of the US financial system that was initiated by the bursting of the housing bubble in 2006 which led to the subprime mortgage market melting down in 2007. The housing bubble was only the most prominent feature of a more generalized overvaluation of financial assets. The "irrational exuberance" displayed by investors was produced by a number of interacting factors: the choice of CPI (and not a price index that included asset prices) as the paramount target to guide monetary policymaking, the Panglossian attitude of the economics profession that asset markets are most rational in its use of information (the "efficient markets" hypothesis), negligence by the financial regulatory bodies (e.g. turning a blind eye toward reports about Bernard Madoff's Ponzi scheme), inadequate supervision of new financial instruments (e.g. subprime mortgage bonds), and the complicity of the rating agencies in understating risks.

The front page report in the New York Times of December 26, 2008, "Dollar Shift: Chinese Pockets Filled as Americans' Emptied", reported the claim by some analysts that the US housing bubble was able to continue only because China prevented the long term interest rate from rising by continually investing its large trade surpluses into Freddie Mac and Fannie Mae bonds. I reject this claim that the flow of Chinese financial opiate through its chronic trade surpluses is a cause of the US financial crisis that is significant enough to be ranked together with erroneous money target, faulty bond rating, incompetent financial oversight, and complacency toward financial innovations. Pogo's verdict of "We Have Met The Enemy and He Is Us" is a more convincing explanation.

For someone who believes that the US financial crisis cannot be solved without staunching the intravenous flow of Chinese financial opiate through the trade channel, he will have to insist that the $787 billion stimulus package of the US Treasury, the expanded financial lifelines of the Federal Reserve, and the reorganization of the Securities and Exchange Commission will not work until the Obama administration also implements one of the following two proposals that have floating around in Washington for some a number of years: impose a 27.5 percent tariff on all imports from China, and force China to appreciate the yuan by 40 percent. (A first step to implementing either measure is to declare China guilty of currency manipulation.)

However, even if Pogo is wrong (i.e. I am wrong in rejecting Chinese trade imbalances as a necessary factor in causing the US financial crisis), I believe that starting a trade war in the middle of a global recession will worsen, not improve, the prospects for economic recovery in the US.

<u>China's dilemma: short-run political expediency versus long-term economic efficiency</u>

In November 2008, China announced a two-year stimulus package of 4 trillion yuan ($586 billion), which is about 7 % of GDP per year. It is clear that China will increase the dosage of stimulus if that is necessary to ensure social stability. My opinion is that, unless the global economy weakens significantly, China's growth in 2009 is likely to lie closer to Premier Wen's 8 % target than to the IMF's projection of 6.7 %, say, 7.5 % in 2009 and 2010. The state-owned banks (SOBs) will be happy to obey the command to increase lending because they cannot now be held responsible for future nonperforming loans. The local governments and the state-owned enterprises (SOEs) can now satisfy more of their voracious hunger for investment motivated by the soft-budget constraint situation where the profits would be privatized and the losses socialized. The stimulus package will work well because of the collusion between the managers of the SOBs and SOEs to transfer public assets to themselves. In January 2009, the banks extended 1,620 billion yuan in new loans, more than double the 806 billion yuan extended in January 2008, and the 772 billion extended in December 2009.

Also, under the cover of economic emergency, the local governments will now ignore the recently-strengthened laws on environmental protection, worker safety, and medical insurance in order to encourage investment. The price of the 7.5 % growth in the midst of a global recession will be paid later by the recapitalization of the SOBs and a more depleted natural environment.

<u>The challenges to generating high sustainable growth in China</u>

China's economy has been like a speeding car for almost thirty years. The high-probability failures that could cause the car to crash in the near future could be classified under three categories (1) hardware failure, (2) software failure, and (3) power supply failure; see Woo (2007).

A hardware failure refers to the breakdown of an <u>economic mechanism</u>, a development that is analogous to the collapse of the chassis of the car. Probable hardware failures are (1) a banking crisis that causes a credit crunch that, in turn, dislocates production economy-wide, and (2) a budget crisis that necessitates reductions in important infrastructure and social expenditure (and also possibly generates high inflation, and balance of payments difficulties as well).

A *software failure* refers to a flaw in governance that creates frequent widespread social disorders that disrupt production economy-wide and discourage private investment. This situation is similar to a car crash that resulted from a fight among the people inside the speeding car. Software failures could come from (1) the present high-growth strategy creating so much inequality, and corruption that, in turn, generates severe social unrest which dislocates economic activities; and (2) the state not being responsive enough to meet rising social expectations, hence causing social disorder.

A *power supply failure* refers to the economy being stopped because it hits either a natural limit or an externally-imposed limit, a situation that is akin to the car running out of gas or having its ignition key pulled out by an outsider. Examples of power supply failures are (1) an environmental collapse, e.g. climate change; and (2) a collapse in China's exports because of a trade war

The Chinese leadership is moderately confident that it could prevent and respond appropriately to most hardware failures because it knows that the technical solutions can be learned quite quickly from previous hardware failures in other countries. As long the technocrats are well-educated and the politicians are relatively non-ideological, stealing with one's eyes is an effective strategy to handling hardware failures. The present stimulus package is the latest application of this management strategy.

A good clue as to the priority ranking of these three types of failure is found in the resolution passed at the CPC Plenum in October 2006. The Plenum committed the CPC to establishing a Harmonious Society by 2020. The proposed harmonious socialist society would encompass a democratic society under the rule of law; a society based on equality and justice; and a society in which humans live in harmony with nature. The obvious implication from this commitment is that the present major social, economic and political trends within China might not lead to a harmonious society or, at least, not lead to a harmonious society fast enough. Software failure and power supply failure are the revealed highest priority concerns. The difficulty is that software failures and power supply failures are harder to handle than hardware failures because their solutions are politically more difficult, often rely on the cooperation of other countries, and require scientific knowledge that is not yet developed.

The need to improve governance to prevent software failures in China

China's strategy of incremental reform combined with the fact that institution building is a time-consuming process mean that many of its regulatory institutions are either absent or ineffective. The most well-known recent regulatory failures occur in the food and pharmaceutical sectors, e.g. misuse of chemicals to lower production costs has resulted in the addition of poisonous substitutes into toothpaste, cough medicine, and animal feed; the application of lead paint to children toys; and the over-employment of antifungals and antibacterials in fish farming. There have also been significant regulatory failures in the protection of labor, e.g. wage arrears and forced labor of kidnapped children in the brick kilns of Shanxi and Henan provinces.

Inadequate institutions of governance are not the only cause of social tensions in China, however. The present economic development strategy, despite its ability to generate high growth, also generates high social tensions because, in the last ten years, it has had great difficulties in reducing extreme poverty further and in improving significantly the rural-urban income distribution and the regional income distribution. In the 1999-2005 period, the proportion of rural population receiving an income of $0.50 a day actually increased from 1.9 percent in 1998 to 2.8 percent in 2005. In a recent study, the Asian Development Bank found that China is probably the most unequal country in Asia today, with a Gini coefficient of 0.473 in 2004 and the combined income of the richest 20 % being 11.4 times the combined income of the poorest 20 %.

Doing more of the same economic policies today will not produce the same salubrious results generated in the early phases of economic reform because China's development problems have changed. In the first phase of economic development, the provision of more jobs was enough to lower poverty significantly. At the present, many of the poor people need an infusion of assistance (e.g. empowering them with human capital through education and health interventions) first in order to be able to take up the job opportunities. The weakening of China's trickling-down mechanism does not bode well for future social stability.

The incidence of public disorder, labeled "social incidents", has risen steadily from 8,700 in 1993 to 32,500 in 1999 and then to 74,000 in 2004; with the average number of persons in a mass incident rising from 8 in 1993 to 50 in 2004. Obviously, the number of mass incidents would have been lower if China had better governance. If the government's actions had been monitored closely by an independent mechanism, and it had also been held more accountable for its performance, it would have made more pre-emptive efforts at conflict mediation, instituted more effective programs to increase human capital formation in the rural areas, and reduce abuse of power by government officials.

The experiences from the developed countries show that three elements are important in improving governance: free and fair elections, a free press, and an independent judiciary. The challenge to preventing a software failure in China is whether the CPC could rise to the demands of the Harmonious Society objectives by transforming itself into a social democratic party.

<u>China's present development strategy is environmentally unsustainable</u>

The present mode of economic development has given China the dirtiest air in the world, is polluting more and more of the water resources, and, is, possibly, changing the climate pattern within China. The reality is that CPC's new objective of living in harmony with nature is not a choice because the Maoist adage of "man conquering nature" is just as unrealistic as creating prosperity through central planning.

Water shortage appears to pose the most immediate environmental threat to China's continued high growth. Presently, China uses 67 to 75 percent of the 800 to 900 billion cubic meters of water available annually, and present trends in water consumption would project the usage rate in 2030 to be 78 to 100 percent. The present water situation is actually already fairly critical because of the uneven distribution of water and the lower than normal rainfall in the past fifteen years. Right now, "[about] 400 of China's 660 cities face water shortages, with 110 of them severely short."[2] The extended period of semi-drought in northern China combined with the economic and population growth have caused more and more water to be pumped from the aquifers, leading the water table to drop three to six meters a year.

The desert is expanding (possibly, at an accelerating pace), and man appears to be the chief culprit through over-cultivation, overgrazing, deforestation and poor irrigation practices. One direct upshot is a great increase in the frequency of major sandstorms that play "havoc with aviation in northern China for weeks, cripples high-tech manufacturing and worsens respiratory problems as far downstream as Japan, the Korean peninsula and even the western United States."[3]

While northern China has been getting drier and experiencing desertification, nature as if in compensation (or in mockery) has been blasting southern China with heavier rains, causing heavy floods which have brought considerable deaths and property damage almost every summer since 1998.[4] The sad possibility is that the northern droughts and southern floods may not be independent events but a combination caused by pollution that originates in China. I will have more to say about this possibility later.

Clearly, without water, growth cannot endure. And in response, the government begun implementation in 2002 of Mao Zedong's 1952 proposal that three canals be built to bring water from the south to the north: an eastern coastal canal from Jiangsu to Shandong and Tianjin, a central canal from Hubei to Beijing and Tianjin, and a western route from Tibet to the northwestern provinces, and each canal will be over a thousand miles long. Construction of the eastern canal (which would be built upon a part of the existing Grand Canal) started in 2002, and the central canal in 2003. Work on the western canal is scheduled to begin in 2010 upon completion of the first stage of the central canal.

This massive construction project will not only be technically challenging but also extremely sensitive politically and fraught with environmental risks. The central canal will have to tunnel through the foot of the huge dyke that contains the elevated Yellow River, and the western canal will have to transport water through regions susceptible to freezing. The western canal has generated a lively controversy. Some scientists are contending that it "would cause more ecological damage than good"[5] because it "could

[2] "China may be left high and dry," The Straits Times, January 3, 2004.
[3] "Billion of Trees Planted, and Nary a Dent in the Desert," New York Times, April 11, 2004
[4] The National Development and Reform Commission (2007) reported: "The regional distribution of precipitation shows that the decrease in annual precipitation was significant in most of northern China, eastern part of the northwest, and northeastern China, averaging 20~40 mm/10a, with decrease in northern China being most severe; while precipitation significantly increased in southern China and southwestern China, averaging 20~60 mm/10a ... The frequency and intensity of extreme climate/weather events throughout China have experienced obvious changes during the last 50 years. Drought in northern and northeastern China, and flood in the middle and lower reaches of the Yangtze River and southeastern China have become more severe."
[5] "China Water Plan Sows Discord," Wall Street Journal, October 20, 2006.

cause dramatic climate changes ... [and] the changed flow and water temperature would lead to a rapid decline in fish and other aquatic species."[6]

The truth is that water conservation could go a long way toward addressing the water shortage problem because currently a tremendous amount of the water is just wasted, e.g. only 50 percent of China's industrial water is recycled compared to 80 percent in the industrialized countries, and China consumes 3,860 cubic meters of water to produce $10,000 of GDP compared to the world average of 965 cubic meters. The most important reason for this inefficient use of water is that "China's farmers, factories and householders enjoy some of the cheapest water in the world"[7] even though China's per capita endowment of water is a quarter of the world average.

There is, however, the unhappy possibility that neither the price mechanism nor the three canals can solve China's water problem and make its growth sustainable unless the present mode of economic development is drastically amended. There is now persuasive evidence that China's voluminous emission of black carbon (particles of incompletely combusted carbon) has contributed significantly to the shift to a climate pattern that produces northern droughts and southern floods of increasing intensity.[8] So, until China reduces its emission of black carbon significantly, it means that (a) China's massive reforestation program will not succeed in reducing sandstorms in the north because trees cannot survive if the amount of rainfall is declining over time; and (b) the number of south-north canals will have to be increased over time in order to meet the demand for water in northern China;

<u>Pre-empting a power supply failure: reducing the tension over the exchange rate and trade imbalances</u>

China has been accused of exchange rate manipulation that has caused large U.S. trade deficits, which have reduced U.S. welfare by increasing unemployment and reducing wages. In addition, the strong claims by some observers that the prolonged large trade imbalances would sooner or later cause a rocketing of inflation in China almost make it a moral imperative for the US to use tariffs to force a 40 % yuan appreciation for China's own good. The facts are however contrary to the above claims, and the do-gooder instinct is misguided; see Woo (2008).

The alleged negative effects on U.S. labor from the trade imbalances are greatly exaggerated. The average unemployment rate in 1999-06 was 5 percent compared to 6 percent in 1991-1998; and the total compensation (including benefits) for blue-collar workers rose in the 1991-2006 period. In order for the take-home pay of the blue-collar to increase substantially, it is important that the cost of healthcare be brought under control. Beside accelerated globalization, accelerated technological innovation was another important trend in this period. The latter produced large productivity gains that enabled labor income to rise despite the greater competition from imports and immigrant labor. The negative consequence of quickened technological progress is that it has caused more frequent job turnovers, and this has increased the anxiety of US worker greatly because US social safety nets are the least adequate within the OECD. The real source for the

[6] "Chinese water plan opens rift between science, state," <u>American-Statesman</u>, September 10, 2006.
[7] "Water wastage will soon leave China high and dry," <u>South China Morning Post</u>, March 8, 2006.
[8] Menon, Hansen, Nazarenko, and Luo (2002).

anxieties that have given rise to the present U.S. obsession with yuan appreciation is not the large trade imbalances but the large amount of structural adjustment necessitated by the acceleration of economic globalization and of labor-saving technological progress. Dollar depreciation and trade barriers will slow down the process of structural adjustment but will not stop it because the other main driver (quite possibly, the bigger driver) of structural adjustment in the United States is technological progress.

The claim that China's swelling balance of payments surplus had caused the People's Bank of China (PBC) to lose some control of credit growth is wrong. Chinese banks face credit quotas, and credit growth could not have stayed high in 2003-2007 without continual upward adjustments of the credit quotas by the PBC. The reason is not technical inability to control money growth but the political patronage required in ensuring factional loyalty before the CPC congress in October 2007. In other words, even if the Chinese balance of payments surplus had not increased secularly during the 2003-07 period, the PBC would have engineered the observed money growth in this period.

The claim that a 40 percent appreciation of the Renminbi (RMB) against the US$ would reduce the U.S. global trade deficit represents the triumph of hope over experience. When the average Yen-US$ exchange rate fell from 239 in 1985 to 128 in 1988, the U.S. global current account deficit only fell from 2.1 percent to 1.7 percent of GDP because Japanese companies started investing abroad and exported to the U.S. from there. For similar reasons, a large yuan appreciation would succeed in reducing the bilateral US-China trade imbalance but it would not reduce the U.S global trade deficits significantly because the US would now switch its import supplier from China toward other Asian and Latin American countries. The outcome would be a disgruntled China and a US that is not any happier than before. It is instructive to recall that when the U.S. global trade deficit fell only slightly despite the huge Yen appreciation, Japan-bashing continued under a new guise: the additional demand that Japan must remove its "structural impediments" to import.

China's current account surplus exists because its dysfunctional financial system cannot intermediate the growing savings into investments. The private savings rate is high because China does not have the variety of financial institutions that would, one, pool risks by providing medical insurance, pension insurance, and unemployment insurance; and, two, transform savings into education loans, housing loans, and other types of investment loans. The backward financial system in China has made the private savings rate in China 7.0 to 12.2 percentage points higher than in the U.S.

The optimum solution to reducing the friction in U.S.-China trade relations is a policy package that emphasizes multilateral actions to achieve several important objectives. It is bad economics and bad politics to dwell on adjustment by only one region (China), induce the adjustment by employing only one policy instrument (RMB appreciation), and focus on only one policy target (external imbalance).

What should the United States do? Congress should strengthen social safety nets and programs that upgrade the skills of younger workers; make healthcare insurance coverage independent of individual employers; and accelerate the reduction in structural fiscal imbalance after the present recession. In addition to improving the TAA program, the establishment of wage insurance is an excellent way to bring U.S. social safety nets more in line with the type of structural adjustments driven by globalization and technological changes. Occupational obsolescence created by the latter should be addressed by establishing extensive skill-upgrading programs (e.g. training loans, apprentice stipends) and improving the formal education system especially at the grade school and high school levels.

What should China do? The obvious short-run policy package has three components. First, the appreciation of the yuan appreciation begun in July 2005 should be resumed after the current global crisis is over. Second, state expenditure (e.g. rural infrastructure investments, and rural health programs) should be accentuated to soak up the excess savings, with an emphasis on import-intensive investments (e.g. buying airplanes and sending students abroad).

It is now common to hear calls for China to rebalance its growth path by reducing investment and increasing consumption. This notion of consumption-led growth is an oxymoron because growth requires expansion of productive capacity and this cannot be achieved by lowering investment. The correct rebalancing is to increase consumption at the expense of the trade surplus and not at the expense of domestic capital accumulation. A government-induced increase in consumption that lowers investment will maintain full usage of the existing output capacity but it will diminish the expansion of output capacity, causing a lower GDP growth rate and, hence, a slower absorption of China's surplus labor. Furthermore, China still has a long way to go before its technological level reaches that of the G-7; and technological upgrading requires investing in more modern capital equipment. So a policy that increases consumption and decreases investment is not only a slow-growth policy, it is also a slow technological upgrading policy.

Consumption could be increased without lowering investment by, one, the state providing an integrated health insurance system, a comprehensive pension system, and an extensive scholarship program; and, two, the financial system providing more sophisticated financial products like education and housing loans, and various types of insurance schemes, and stopping its discrimination against private investors. The establishment of a modern financial system requires the appearance and growth of competitive *domestic* private banks. As China is required by its WTO accession agreement to allow foreign banks to compete against its SOBs on an equal basis, it is akin to self-loathing not to allow the formation of truly private banks of domestic origin.

What should the United States and China do collaboratively? A recent survey by the Pew Research Center found that there has been a dramatic decline in support for free trade within the United States and the major developed countries. With the United States weakening in its resolve to protect the multilateral free trade system, it is the time for China to show that it is a responsible stakeholder by joining in the stewardship of the multilateral free trade system, from which it had received immense benefits. With China so far playing a passive role in pushing the Doha Round forward; by default, Brazil and India have assumed the leadership of the developing economies camp in the trade negotiations. According to Susan Schwab, the U.S. Trade Representative, at the G-4 (the United States, the EU, Brazil, and India) meeting in Potsdam in

June 2007, Brazil and India retreated from their earlier offers to reduce their manufacturing tariffs in return for cuts in agricultural subsides by the developed economies because of "their fear of growing Chinese imports."[9] The failure of the Potsdam talks hurt the many developing economies that were agricultural exporters.

The reality is that Brazil is now attempting to bypass multilateral trade liberalization by entering into FTA negotiations with the EU. A growing number of nations like Brazil "are increasingly wary of a multilateral deal because it would mandate tariff cuts, exposing them more deeply to low-cost competition from China. Instead, they are seeking bilateral deals with rich countries that are tailored to the two parties' needs."[10] China and the United States must now work together to provide leadership to prevent the unraveling of multilateral free trade. It is not possible for China to become harmonious society in a non-harmonious world. For its own sake as well as for the world's, China must help to build a harmonious world, and the existing world powers should not misinterpret this as a power grab by China.

<u>The US and China at the G-20 meeting in London: hanging together or hanging separately?</u>

The present global recession requires that large countries like the US and China focus not just on stabilizing themselves but also on stabilizing the global economic system in order to produce rapid national recovery. At the same time that China and the US use fiscal stimulus to stabilize themselves directly (and hence stabilize the rest of the world indirectly), China should also use its large foreign exchange reserves and the US should also use its dollar-creation power to help stabilize other regions directly in order to stabilize themselves indirectly. Both two sets of stabilizing actions should be enacted because they are mutually-reinforcing not mutually exclusive.

At the G-20 meeting in London on April 2, 2009, China and the U.S. should focus the discussion on the global coordination of fiscal stimulus and monetary loosening, global avoidance of beggar-thy-neighbor policies of export promotion and import restrictions, global harmonization of regulation governing financial institutions and accounting practices, and the feasibility of the U.S. Federal Reserve broadening its temporary network of bilateral swap lines to other well-managed emerging economies. An *ad hoc* Global Financial Crisis Secretariat (GFCS) should be established to undertake global coordination on these matters, and be temporarily housed as an autonomous unit (in the manner of the World Bank) within the office of the UN Secretary-General. Simultaneity in expansionary macroeconomic policies is GFCS's most important objective because it prevents deterioration in the trade balances from rendering each country's expansionary policies unsustainable.

China and US should also support the establishment of a GFCS working group on the reform of the IMF: how much to increase its resources to allow it to fight global financial fires, how wide to increase its jurisdiction to authorize it to improve regulation of financial markets, and how radically to restructure its ownership to give it the legitimacy to impose its will on prostrate

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[9] "Schwab surprised by stance of India and Brazil," *Financial Times*, 22 June 2007; and "China's shadow looms over Doha failure," *Financial Times*, 22 June 2007.
[10] "Brazil, Others Push Outside Doha For Trade Pacts," *The Wall Street Journal*, 5 July 2007.

economies. While an improved IMF is highly desirable, both the US and China should recognize that the better first line of Asian defense against financial contagion would be a greatly enhanced swap facility, the Asian Financial Facility (AFF), because Asia collectively now has enough reserves to fend off unwarranted speculative attacks on a subset of its members. It must be emphasized that the core mission of the AFF is to combat financial contagion and not to finance balance of payments adjustment caused by economic mismanagement.

An AFF is necessary because it is simply impossible to increase the size of the IMF enough to enable it to have in-depth expertise on most of the countries to be able to respond optimally in a timely manner to each national crisis. Even if the improved technical competence of the IMF is not doomed to disappoint the emerging economies, the emerging economies would be disappointed by the long time required for an improved IMF to appear. The negotiations on meaningful IMF reforms would inevitably be cantankerous and hence protracted.

Right now, East Asia has a thin network of swap lines to defend their currencies. It would be desirable to hasten the evolution of the existing swap facility into the AFF by two actions. First, the existing swap facility specifies that a cumulative drawing that exceeds 20 percent of a country's quota would require the country to accept IMF supervision. This "flight-to-IMF" clause should be removed because painful memories of 1997-98 make it politically suicidal for any East Asian leader to do so. Second, because the primary purpose of the AFF is to reduce the cost of bad luck and not of bad economic policies, the removal of the "flight-to-IMF" clause requires that the swap facility establish a surveillance mechanism to pre-qualify its members for emergency loans. Without this surveillance mechanism, the Asian Financial Facility would not attain a meaningful size because no member would be willing to risk committing a large part of its reserves to the facility.

Why should the G-20 support a GFCS? The IMF simply lacks legitimacy and credibility in the eyes of East Asia. If need be, the assignment of global financial regulation to an expanded BIS would be a better alternative. The IMF should forgo its dream of jurisdiction-expansion and become instead a more specialized agency that undertakes macroeconomic surveillance for the world, and balance of payments assistance for the emerging economies. The UN is the global organization with the most legitimacy, and its temporary custody of the GFCS would, one, be a good signal by the G-20 of their genuine desire to make multilateralism work; and, two, be a collective statement that it is time for the national allocation of global responsibilities to be reconfigured.

Why should the US support an AFF? The US and the rest of the interested world would be members of the AFF just as they are now influential members of the Asian Development Bank. In dealing with Asia, the US should rely less on the hard power of a formal dominant role in global leadership, and more on the soft power of US example, like helping Asia do what's best for Asia (which is an excellent start to the US re-engagement with Asia). The AFF would expand over time to be an APEC-level institution; and be a good partner to the IMF because "two heads are better than one" in analyzing unexpected quickly-evolving crises and in preventing their contagion.

The bottom line for the April 2 meeting is that the focus should be on fighting global recession and not on reforming the international financial architecture; and the bottom line for beyond April 2 is that the better way to improve the supply of global public goods is not to simply increase the size of the existing providers but to increase the number of providers while seeking to improve the performance of existing ones. The establishment of the GFSC will enable simultaneous implementation of macroeconomic stimulus, and harmonized regulation of financial markets. The US support for AFF will be a much-needed change toward an inclusive US approach that is diversified in modality to handle each specific multilateral issue. If the G-20 can act decisively on April 2 on these well-defined economic tasks, the world can then have more faith that enlightened self interests will also accomplish the much more arduous task of containing environmental contagion from global climate change.

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Table 1:
The Stream of IMF's Projections of Growth Rate of Output, July 2008 - January 2009

	2006	2007	2008	2009	2010
Growth Rate of World Output					
October 2007	5.4	5.2	4.8		
April 2008	5.0	4.9	3.7	3.8	4.8
July 2008			4.1	3.9	
October 2008	5.1	5.0	3.9	3.0	4.2
November 2008	5.1	5.0	3.7	2.2	3.8
January 2009		5.2	3.4	0.5	3.4
Growth Rate of U.S. Output					
October 2007	2.9	1.9	1.9		
April 2008	2.9	2.2	0.5	0.6	2.9
July 2008			1.3	0.8	
October 2008	2.8	2.0	1.6	0.1	2.0
November 2008	2.8	2.0	1.4	-0.7	1.5
January 2009		2.0	1.1	-1.6	1.6
Growth Rate of Euro Zone Output					
October 2007	2.8	2.5	2.1		
April 2008	2.8	1.6	1.4	1.2	1.2
July 2008			1.7	1.2	
October 2008	2.8	2.6	1.3	0.2	1.3
November 2008	2.8	2.6	1.2	-0.5	0.9
January 2009		2.6	1.0	-2.0	0.2
Growth Rate of China's Output					
October 2007	11.1	11.5	10.0		
April 2008	11.1	11.4	9.3	9.5	10.5
July 2008			9.7	9.8	
October 2008	11.6	11.9	9.7	9.3	9.8
November 2008	11.6	11.9	9.7	8.5	9.5
January 2009		13.0	9.0	6.7	8.0

Data compiled from updates by IMF of World Economic Outlook

HEARING COCHAIR SLANE: Thank you, Dr. Woo.
Mr. Chang.

STATEMENT OF MR. GORDON CHANG, AUTHOR OF "THE COMING COLLAPSE OF CHINA," BEDMINSTER, NEW JERSEY

MR. CHANG: Thank you, Commissioner Slane, Commissioner Wessel and distinguished members of the Commission. It's a privilege to appear before you today, and I thank you for this opportunity.

China has the world's fastest slowing economy. In 2007, growth of gross domestic product was over 13.0 percent, Beijing's official number. In December, in all probability, it was less than zero. China's economy is contracting at this moment largely because exports are falling and Chinese consumers are cutting back.

To pick up the slack and to prevent this slide in growth, Chinese leaders announced a stimulus package in November, but even with subsequent modifications, the package is inadequate and unlikely to help much this year, which is a crucial one for the Chinese economy.

The State Council's National Development and Reform Commission estimates that the stimulus package will add only one percent to growth of gross domestic product over this year and the next.

There are many criticisms that we can make of this plan. The plan's heavy emphasis on infrastructure spending will marginalize the private sector, which really has been the engine of growth for China over the last three decades.

The plan could trigger the biggest surge of corruption in Chinese history, and the plan will do little to engineer what is really needed to get China going again, and that is increasing consumer spending.

The country's economic model is particularly ill-suited to the global downturn. The stimulus effort, however, shows that Beijing's leaders are merely trying to reinforce this unsustainable model. Chinese leaders have announced measures to increase consumption, but at the same time they're creating structural impediments to consumption. The bulk of their effort is really to increase spending and also to increase exports.

There are two parts of this plan that are of special interest to the United States. First, Beijing seems to be restricting imports so as to keep a positive trade balance as exports decline. In January, when exports fell 17.5 percent, imports on the other hand collapsed, falling 43.1 percent, and we also saw this pattern in November and December.

Eventually, China's trading partners are going to notice this disturbing trend, and they will retaliate. Of course, many people fear a trade war and everyone wants to prevent it, but it seems the Chinese are already waging one.

Second, to support exports, China actively trades its currency to set its value. Beijing evidently feels little pressure to stop what is after all a predatory trade practice. When Timothy Geithner said during his confirmation proceedings that China manipulates its currency, well, he was the one, not Beijing, which received all the criticism.

Yet I think Geithner was right to raise the issue because China is indeed manipulating its currency. Asian nations are already depressing the value of their currencies so as to stimulate exports so they'll be more competitive with China's.

In the 1930s, of course, we saw tariff barriers go up, and that only deepened the Depression and made it longer. Today, we're seeing more subtle and I think, just as destructive measures. And I think essentially they're going to have the same effect.

You will hear many commentators say, well, changing China's currency practices are not going to solve America's trade deficit. Well, of course they're right because currency manipulation is not the sole reason for the plight of American manufacturing; yet Chinese currency manipulation is an important factor.

As a lawyer, I represented parties who were involved in trade between China and the United States, and during negotiations, I would see them haggle over pennies when it came to unit prices. Just a difference of a few cents' swing either way would make a very big difference to my clients' businesses, whether they'd be successful or not.

So it's counterintuitive to say that Chinese currency manipulation, which can change the price of a product 30 or 40 percent, is not going to have an effect on our trade deficit.

One final point. The Chinese economic model appeared successful during a period of almost two decades of prosperity and globalization, but now, however, even just the initial stages of the downturn are exposing the inherent weaknesses in the Chinese economy.

Chinese leaders understand what should be done, but they're not implementing sensible policies fast enough due to the rigidity of the political system. When they had the opportunity to change the basis of their economy, Beijing's leaders squandered it. Instead, technocrats promoted fast growth and fast growth has resulted in dislocations such as bad bank loans and the environment that Dr. Woo talked about.

These problems have not posed serious threats to China in a period of a growing economy, but when the economy begins to contract, as we're starting to see now, I think these dislocations are going to be too big to ignore and perhaps they're going to be too big to solve.

Now, today, you're going to hear a lot of talk, a lot of it from economists and from others, about the Chinese economy, but I think the best thing to do is look at what Chinese citizens and businesses are doing. I think that they see the end of the Chinese miracle. In October through December of last year, Chinese people and enterprises smuggled out of the country, despite the country's strict currency controls, they smuggled out $126 billion. Another estimate which uses a broader definition of hot money put the figure at an absolutely staggering $240 billion.

I think the Chinese people are sending a message by sending out their currency and their money to other parts of the world, and of course we should be aware of it.

Thank you.

[The statement follows:]

Prepared Statement of Mr. Gordon Chang, author of "The Coming Collapse of China," Bedminster, New Jersey

Statement of
Gordon G. Chang
U.S.-China Economic & Security Review Commission
Washington, D. C.
February 17, 2009

Chairman Wessel, Chairman Slane, and distinguished members of the Commission:

It is a privilege to appear before you today, and I thank you for this opportunity.

My name is Gordon Guthrie Chang. I am a writer and live in Bedminster, New Jersey. I worked as a lawyer in Hong Kong from 1981-1991 and Shanghai from 1996-2001. Between these two periods, I frequently traveled to Hong Kong and China from California.

I am the author of *The Coming Collapse of China* (Random House, 2001) and *Nuclear Showdown: North Korea Takes On the World* (Random House, 2006). I am a Forbes.com columnist and blog at *Commentary* magazine's site.

Summary

China has the world's fastest slowing economy. To arrest the alarming slide in growth, Chinese leaders announced a stimulus package last November. Even with subsequent modifications, the package is inadequate and is unlikely to help much this year, a crucial one. The country's economic model is particularly ill-suited for the global downturn, but the stimulus effort is evidence that Beijing does not intend to change it.

Within the next half decade, Chinese leaders cannot engineer the one thing necessary to create sustainable growth: an increase in consumption. Their plan contemplates stimulating exports, closing off the domestic market to foreign producers, and spending government cash quickly. Beijing's course of action, unfortunately, will increase trade tensions and destabilize the global economy.

China actively trades its currency to set its value, and it does so to obtain a trade advantage. Beijing, however, feels little need to change this predatory policy and will not do so until Washington brings pressure to bear on China.

Chinese leaders will not undertake any major reforms to either the country's capital controls or currency rules in the near future.

Fall in Growth

Beijing reported 6.8 percent growth in gross domestic product for the last quarter of 2008. In reality, growth was no more one percent, at least if calculated according to how most countries report their results,[1] and the economy may even have contracted. Moreover, it is almost certain GDP shrank in December (as compared to November).

Yet whatever growth was, it is in a steep decline. According to official statistics, GDP skyrocketed a staggering 13.0 percent in 2007, and it was, in all probability, higher than that due to poor sampling procedures that did not properly take into account the output of small manufacturers, then the most productive part of the economy. Now, however, small manufacturers are suffering more than other producers, so current statistics do not reflect the real drop-off. When other distortions in the statistics—some the result of fakery—are taken into account, it's clear no economy is falling faster than China's at this moment.

At the World Economic Forum in Davos last month, an apparently confident Wen Jiabao predicted the Chinese economy will grow eight percent this year. Taking into account trends, it's apparent the premier is about as wrong as he could be. If the fall-off in growth continues—and there is every reason to believe it will—this year the Chinese economy will contract.

Stimulus Package

Beijing's technocrats, to their credit, saw problems coming by the middle of last year. In late July, the Politburo officially reversed course from fighting persistent inflation to lifting growth. Since then, China's technocrats have, among other things, provided tax rebates, handed out incentives for home purchases, and cut interest rates. Nothing, however, seemed to work.

Pessimistic forecasts apparently unnerved China's policymakers, and in November China's State Council announced its stimulus package. The body, the central government's cabinet, said it would spend an "estimated" four trillion yuan, about $586 billion, over nine calendar quarters on ten major areas. In addition, Beijing promised to loosen credit and reduce taxation.

The plan, at least as announced, disclosed few details and, therefore, had a made-up-on-the-spot quality to it. From what we can tell at this point, the stimulus program is deficient in important respects. First, as big as it is, the contemplated spending is not sufficiently large. Second, the stimulus program does not look as if it will work fast enough. Third, the spending plan is pushing the country in the wrong direction. All of these deficiencies stem from the plan's apparent bias toward large-scale infrastructure projects.

First, with regard to the size of the stimulus plan, it is not clear how much of the announced spending was already contemplated in the current five-year plan. Probably only a quarter of the announced outlays are actually new. Moreover, even if all the contemplated spending is new—extremely unlikely—we should remember that the Chinese central government has been pumping massive amounts of cash into highways, ports, and railroads since 1998, and pump-priming loses its effectiveness over time. Governments are notoriously inefficient investors, and this plan comes ten years into Beijing's fiscal stimulus program.

This means China's spending must be overly large to have an appreciable effect on economic performance at this moment. The country, however, is already overbuilt and therefore running out of places in which to profitably construct things. When I returned to my dad's hometown in Jiangsu province last June, I could see the dusty backwater—it's technically a "city" but has the look and feel of a town—was scarred by too many projects. There was a virtually vacant 18-story hotel built to world-class standards and towering over its surroundings. The hotel was near to an expensively appointed opera house set to open and in sight of a deserted park dedicated to long-life and dominated by a ten-story statue of a mythical Chinese figure, the biggest bronze longevity monument in the world.

Overbuilding has also plagued the country's great cities. I stayed at a brand-new hotel in the central Wangfujiang section of Beijing. The place was almost empty as were the others next to it even though I was there at a high season for tourists. I was certainly impressed—even astounded—by the ambition of Chinese officials but wondered about the economic viability of their grandiose plans. In a country with too much of most everything, the government's concept now is to simply build more. Eventually—and inevitably—inefficient investment is counterproductive and catches up with an economy.

The State Council's NDRC, the National Development and Reform Commission, estimates the November stimulus plan will add one percent to GDP over its existence.[2] This assessment indicates the program, despite its apparent size, is insufficient.

Second, the plan's emphasis on infrastructure means it will take time to have an effect on economic output. Apart from already-announced projects, the government does not appear to have an inventory of shovel-ready programs for quick funding, especially because the stimulus plan was hastily prepared from all we can tell. As powerful as China's leaders are, they cannot just push a button and churn out eight-lane roads. It takes time to conceive projects, move peasants, survey land, flatten mountains, and pour cement.

Another factor slowing down the speed of the plan is that the government has yet to work out its funding. Soon after the initial announcement in November, central leaders revealed they would contribute only 1.18 trillion yuan of the four trillion funding needed.[3] The rest of the money, they said, would come from lower-tier governments, state enterprises, and banks. Yet many local governments are already dangerously overextended, enterprises now respond to market conditions as much as to central dictates, and bank lending is constrained by loan-quality concerns.

Undoubtedly, the central government will eventually decide to spend likes there's no tomorrow, but the effect of its spending will not be felt until long after that. The additional infrastructure projects contemplated by the plan—whatever they are—will, for the most part, not help until 2010, if then.

Third, Beijing's new spending is pushing the country in the wrong direction. China already invests 45 percent of its income with much of that on infrastructure.[4] Increasing the government's share of the economy, which is what its stimulus plan is all about, will only lead to sluggish economic performance later. The NDRC has estimated that most stimulus spending will go into government cement-type projects.[5] This means the November plan will surely end up favoring large state enterprises over small and medium-sized private firms. Beijing's political leaders will undoubtedly allocate funds for political reasons, and financial institutions will divert credit to government-sponsored infrastructure. China has averaged an exceptional 9.8 percent growth in the thirty years of the reform period largely because of the creation and expansion of the private sector, both in the countryside and the city. In short, Beijing is relentlessly pursuing a counterproductive solution.

Of course, the stimulus plan is a work in progress, changing all the time as tens of thousands of officials at all levels of government interact. Since the November roll-out of the plan, Beijing has issued announcement after announcement on stimulus projects. For example, this month the central government revealed spending plans to support the textile and heavy machinery sectors.[6] These were just the last of a series of industry-specific stimulus initiatives, which covered, for instance, vehicle and steel companies. At present, there are nine plans, both announced and to be announced, for specific industries. Analysts expect the release of future plans for the electronics, communication, light industry, petrochemicals, shipping, and non-ferrous metals sectors.

The provinces, predictably, have also gotten into the act. This month, for instance, hard-hit Guangdong announced 150 industrial and infrastructure projects.[7] Of Mainland China's 31 provinces, autonomous regions, and provincial-level cities, 28 have so far released stimulus plans, and those plans call for a fantastic 29.23 trillion yuan of spending.[8] Now, every town, city, and county in the country is trying to get additional monies from Beijing as is every enterprise and government unit, and the NDRC is now rubberstamping "beauty-show projects" it had rejected earlier. As a result of the rush to spend, one analyst expects the plan to create the greatest surge in corruption in Chinese history.[9]

Of course, not all those plans can be funded, especially because the Central government in 2008 ran a deficit due to a spending extravaganza in December. Beijing entered the last month of the year with a 1.22 trillion yuan surplus and emerged from it with a 111.01 billion yuan deficit.[10] The deficit is widely reported to be a mere 0.4 percent of GDP, but this ratio was probably larger due to various factors, including the overstatement of GDP. This year, the central government's provisional deficit is estimated to be 800 billion yuan,[11] but it will probably end up larger. Beijing has room to spend more—the Ministry of Finance has signaled it will issue almost twice as much debt this year than it did in 2008[12] to pay for the spendathon—but it has only limited ability to tap its enormous foreign exchange reserves. We have to remember that those reserves, on the books of the central government, have been largely accumulated by issuing debt in one form or another. While the "greatest fortune ever assembled" gives Beijing some flexibility, the government understands that at some point it has to pay most of this money back.

The worst thing about the stimulus plan is not that it weakens Beijing's finances, that it cannot work as quickly as needed, or that China does not need much of the infrastructure it will build. If there is any significance to the stimulus package, it is that, three decades after the beginning of the country's reform period, China's leaders have shown they remain wedded to the old ways of doing things, namely stimulating their economy with large infrastructure projects. In what may be a once-in-a-lifetime global downturn, they face two urgent and related tasks. They must, at the same time, create growth and put their economy on a sounder basis. The November stimulus plan looks like it will help only with the first goal—if it helps at all.

Structural Problems of the Economy

Chinese officials, like their counterparts around the world, must know that their infrastructure-heavy plans make sense only as stopgap measures. Yet economic problems for China are potentially more serious than they are for almost any other country. The steep downturn in the Chinese economy is an indication that Beijing's economic model, which received near-universal praise in recent years, is particularly ill-suited to the global economic crisis. China appeared strong during a benign period of almost two decades of uninterrupted prosperity and globalization. Now, however, even just the initial stages of the downturn are exposing the inherent weaknesses of its economy.

As we saw in the Great Depression, it was the current-account-surplus countries that had the hardest time adjusting to deteriorating economic conditions and, consequently, suffered the most. That is proving to be the case now as well. China, a surplus country, is extraordinarily dependent on foreign markets for its manufactured goods and agricultural products. About 38 percent of its economy is attributable to exports—but global demand is either flat or slumping.

According to the World Bank, global trade will fall this year, which will be the first time since 1982, and the International Monetary Fund says that global growth will be the lowest since the end of the Second World War. Globalization, which looked like an inevitable trend just a few months ago, is now obviously going into reverse. So the Chinese could end up as the biggest victims of recent events. Yet whatever happens, it is apparent that their country, for all its apparent strength, does not have it within its power to solve its own problems (current-account-deficit countries, on the other hand, can import less and save more and thereby achieve recovery on their own). Export incentives announced at the end of December—value-added-tax rebates for certain goods[13]—seem inadequate to keep exports at 2008 levels. In fact, China's exports are now falling precipitously, declining a greater-than-expected 17.5 percent last month (on a year-on-year basis).[14]

Many observers unthinkingly say that Beijing can solve economic problems by engineering increased domestic consumption to take up the slack. Yes, that is true as a theoretical proposition. And it is true Chinese technocrats understand that this is what China must do. Optimists can point out that the list of ten areas in the original announcement of the stimulus plan include some—such as affordable housing, health, and education—that look like they could boost consumption. And Chinese state media called the plan "a wide-ranging effort to offset adverse global economic conditions by boosting domestic demand."[15]

Yet, as we have seen, the plan overemphasizes government investment instead. Only one percent of the $586 billion spending plan will go to desperately needed social services according to a *Wall Street Journal* assessment,[16] and although this estimate may prove to be too low, it nonetheless gives an indication that Chinese leaders are still stuck in the mindset of a state-dominated economy.

As a practical matter, it is unlikely that China will have a consumer economy either this decade or next. For one thing, China is moving in the opposite direction: consumption's role in the economy has been sliding, dropping from its historical average of about 60 percent to 35 percent today. That's undoubtedly the lowest rate in the world, and while some may say it cannot get lower, it definitely can. As an initial matter, Chinese consumers, reacting to grim economic news from home and abroad, have been pulling back recently, especially as coastal property values collapse and stock markets slide. Moreover, the government's love affair with investment spending is, of course, decreasing the shares of economic output attributable to the two other legs of the Chinese economy, consumption and exports. Finally, Beijing's steps to stimulate exports—like holding down the value of renminbi—inevitably discourage consumption. In any event, it will take years for Chinese technocrats to reorient their economy once they make the decision to do so.

And the best that can be said is that they are only beginning to decide to do so. The most important recent move to promote consumption came in January when the central government said it would spend $123 billion to create a universal health care system in two years.[17] This welcome announcement, however, had a typical nonspecific quality to it, and it could end up as just another soon-to-be-forgotten pronouncement. This month, Beijing has unveiled a series of measures to boost consumption, such as last week's Ministry of Commerce initiative to improve the distribution of goods in the countryside.[18]
The central government is also increasing social welfare spending, especially in the form of direct payments to poor households, but these measures are not in fact preventing consumption's share of the economy from falling behind.

The fact that Beijing had not done more to encourage consumer demand during the sweet spot of the last few years is certainly an indication that it will find it hard to do so in the exceedingly difficult period we are now entering. China's leaders may understand what should be done, but they do not implement sensible policies fast enough because they are constrained by their rigid political system, which inhibits their ability to adapt to changing circumstances.

There is, consequently, little at this moment the central government will do to prevent economic failure. China's grand experiment of grafting a free-market sector onto its socialist economy has just about reached the limit of what it can achieve. Beijing's spending plan reveals that Chinese leaders, despite the seriousness of the situation they face, do not have the tools to implement necessary change. Yet we should not be surprised that they seem unable to break from old patterns. In the last three years, they have shunned further structural economic reform. The changes we have seen in recent times have been minor, and many of them have not been advances. China's economy has progressed about as far as it can within its existing political framework.

When they had the opportunity to change the basis of the economy, Beijing officials squandered it. Instead, technocrats promoted fast growth and fast growth has created dislocations, such as bad bank loans, unfunded social welfare obligations, a degraded environment, and rampant corruption. These problems have not posed serious threats because increases in economic output in past years have masked them. But as growth slows and the economy begins to contract, the dislocations are becoming too big to ignore—and probably too big to solve.

Chinese citizens and businesses sense the end of the so-called "Chinese miracle": they evaded Beijing's strict currency controls and smuggled out $126 billion from China from last October through December.[19] Another estimate, using the broadest definition of "hot money," put the figure as high as $240 billion for the same period.[20]

What does this mean for the United States? The two most important imbalances at this moment are the Chinese current account surplus and the American current account deficit. The fastest path to global prosperity is for American manufacturers to sell to Chinese consumers, thereby reducing in one stroke both imbalances. Given the size of the American and Chinese economies—together they account for about 31 percent of global output—there is little prospect for worldwide recovery until these two countries establish a more sustainable trading relationship.

Unfortunately, Beijing seems to be restricting imports to maintain a positive trade balance as exports fall. For the last several months imports have fallen substantially in excess of exports. In January, for example, when exports were down 17.5 percent, imports collapsed, falling by 43.1 percent.[21] We saw the same pattern in both November and December.[22] Eventually, China's trading partners will notice this disturbing trend and will retaliate. Many people fear a trade war and want to prevent it. Unfortunately, the Chinese are already waging one.

Currency

Until July 2005, the renminbi was tightly pegged to the dollar. From that month to last July, Beijing permitted a managed float. As a result, the renminbi appreciated 9.4 percent against the dollar in this three-year period. In July, however, the ruling Politburo switched gears and began exercising tighter control over the value of the renminbi to give the country's exporters important price advantages. In December, the People's Bank of China, the country's central bank, engineered a one-day fall of almost one percent of the value of the renminbi, apparently a warning to the United States that Beijing would resume its efforts to cheapen its currency.[23] Throughout all these periods, the renminbi has apparently been kept at an artificially low level. Today, Beijing continues to intervene in its market so that the currency hits a target in the middle of a tight band, and it does so to give an advantage to its now-ailing exporters.

Due to Beijing's active intervention, no one knows the true value of the renminbi, but the discount to market value is thought to be somewhere in the vicinity of 35 percent.[24] The United States and other countries, naturally, want the Chinese currency to trade more freely. To persuade Beijing to loosen its policy, former Treasury Secretary Henry Paulson had worked behind the scenes. The Bush administration, therefore, never cited China as a currency manipulator in any of its twice-yearly reports to Congress mandated by the Trade Act of 1988. Doing so would have required Treasury to open formal negotiations with China on the issue. Paulson was not especially successful for all his efforts.

Will China allow the renminbi to float or at least loosen the tight trading band? That's unlikely for two reasons. First, Beijing wants to help Chinese exporters and its major tool for accomplishing this goal was—and remains—intervention in its domestic market to fix the value of the renminbi.

Second, Beijing evidently feels little pressure to change its policies. When Timothy Geithner stated last month during his confirmation proceedings that "China is manipulating its currency," he—not Beijing—received criticism. Moreover, the market for Treasuries momentarily reacted negatively to his comments on manipulation.

Yet Geithner did the right thing to raise the issue. As an initial matter, China is indeed manipulating its currency. The Bush administration's failure to confront Beijing surely emboldened Chinese officials and made it harder to persuade them to take steps in everyone's interest. Virtually everybody seemed to worry about the "prickly" Chinese and how they would react to Geithner's words. Yet Beijing's leaders are not little children. On the contrary, they are ruthlessly pragmatic. And despite what some in Washington may think, they respond to pressure just like Americans—and like everyone else on the planet.

It is a mystery to me why complaining about protectionism is itself considered protectionism. In my view, the United States should do all it can to bring Chinese currency practices in line with those of China's trading partners. The real risk for us—the United States and the rest of the global community—is that Beijing will take too long to do so. Asian nations are already depressing the value of their currencies to make their exports more competitive with China's.[25] In the 1930s, tariff walls deepened the Great Depression and prolonged it. This time, more subtle—but probably as destructive—measures look like they will produce the same effect.

You will hear many commentators say that changing China's currency practices will not solve America's trade deficit. Of course that's true, because currency manipulation is not the *sole* reason for the plight of American manufacturers. Yet Chinese manipulation is an important factor. I practiced law for more than two decades, much of it in Asia. I represented parties involved in trade between China and the United States and often saw them haggling over pennies when negotiating unit prices. A swing either way of a few cents had a disproportionate effect on the success of the business of my clients. So it is counterintuitive to think that currency manipulation, which can change the price of a product by thirty or forty percent, would have no affect on our country's trade deficit.

Capital Controls and Currency Restrictions

Beijing still maintains an elaborate set of capital controls and generally discourages the use of the renminbi outside the Mainland. Clearly, Beijing would like to liberalize restrictions so that it can eventually play an even more important role in Asia.

Recently, the Chinese government has taken some steps in this direction. For example, at the beginning of last month, the People's Bank of China announced it would allow companies in Hong Kong and Macau, special administrative regions of China that are outside the renminbi zone, to use renminbi to settle transactions in goods with parties in Guangdong province and the Yangtze River Delta. The Bank also said it would allow renminbi for trade between parties in Guangxi and Yunnan provinces and the ten Asean nations.[26] Moreover, this month Beijing joined with Japan and South Korea in extending swap lines to Indonesia[27] and entered into a similar deal with Hong Kong in January.[28] Both arrangements contemplate the use of renminbi. And some think Beijing will expand the issuance of "panda bonds" as a way of popularizing the renminbi.[29] Most analysts believe the Chinese are viewing the global crisis as an opportunity to make progress in making their presence felt in the region. Some Asian analysts even think that, given China's heft, in time the renminbi will displace the dollar to become the world's reserve currency.[30]

That sounds unrealistic for many reasons, even if we adopt a long horizon. Yet whatever happens in the indefinite future, I believe there will be only a few liberalization experiments in the short-term, while the global crisis lasts. Chinese leaders appear to be extremely concerned by the trends in the economy, and during periods such as these they will remain conservative and shy away from grand experiments. Until the economy stabilizes itself—and the smuggling of money out of China ends—Chinese officials are unlikely to authorize any major changes in their capital controls and currency rules.

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[4] Kenneth Rogoff, “Growing Pains,” *South China Morning Post* (Hong Kong), February 6, 2009, http://www.scmp.com/portal/site/SCMP/menuitem.2af62ecb329d3d7733492d9253a0a0a0/?vgnextoid=3a233c179564f110VgnVCM100000360a0a0aRCRD&ss=China&s=News.

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HEARING COCHAIR SLANE: Thank you.
Ms. Harney.

STATEMENT OF MS. ALEXANDRA HARNEY, AUTHOR OF "THE CHINA PRICE," HONG KONG

MS. HARNEY: Good morning. Thank you so much for the opportunity to appear before you today. I believe that too often the voices of ordinary people get lost in the debate about China and America. So I'm particularly glad that you asked me here to share with you what I've been seeing on the ground in China.

I have spent the last five years researching the Chinese economy, first, as a reporter for the Financial Times, and then more recently as an author. My book, The China Price, is an investigation into China's competitiveness as the world's leading manufacturer of consumer goods. To research my book, I spent a lot of time in Shenzhen, the heart of China's export machine, as well as talking to factory managers, workers, labor activists, and the businessmen who enable American consumers to buy their goods so cheaply.

I've just returned from a trip to the Chinese countryside where Beijing is focusing many of its economic stimulus efforts. Today, I'd like to share with you some of the insights I gained on that trip as well as a recent trip to Beijing.

I'd like to make three main points. First, China's primary focus this year is to create jobs to avoid the social instability that it fears unemployment would cause.

Second, despite the concerns that have been expressed in the Chinese and international media, I believe that Chinese workers are not going to be the source of massive social unrest in China this year.

And third, and most importantly, China appears to be taking advantage of this global slowdown to strengthen its competitiveness and to address some of the imbalances that have developed over the last two decades.

Let me start with China's concerns. Over the past several months, Chinese officials have stepped up their statements to the media about the likelihood of unrest. In January, Outlook Weekly quoted Huang Huo, a bureau chief at state news agency Xinhua, as saying: "We are entering a peak period for mass incidents."

Earlier this month, Chen Xiwen, a senior rural planning official, warned that perhaps 20 million workers had already lost their jobs as a result of the economic downturn.

Privately, when I speak to Chinese businessmen, they tell me that government officials have been urging them to avoid layoffs. One senior government official told me that he'd been instructed to watch for and report any signs of social unrest. The whole country is on high alert, he told me.

This year, as you know, is politically significant in China because it's the 20th anniversary of the protests centered on Tiananmen Square and the 60th anniversary of the founding of the People's Republic of China.

There are also fresh demands for political reform. Recently, thousands of Chinese, including some well-known intellectuals and government officials, signed a petition calling for, among other things, a new constitution, democratic elections, and the freedoms of assembly, expression and religion.

Beijing believes the economy and social stability are closely linked. As we all know, in the fourth quarter of 2008, economic growth slowed to 6.8 percent, the lowest pace since 2001. Decreased American and European consumption has lowered China's export volumes, which has, in turn, contributed to the failure of thousands of factories.

As we heard, export volumes shrank 17.5 percent in January. If you look at export figures on a provincial basis, the slowdown is even more severe. In Guangdong Province, exports were down in January by 23.6 percent. Zhejiang Province down 10.7 percent. Of course these numbers are affected by the fact the Chinese New Year came earlier this year, and so there were fewer working days, but we can see that the worst hit sectors so far are machinery and electronics, which were two of the fastest-growing categories of exports to the United States.

No one, not even the Chinese government, knows exactly how many factories have shut down so far or how many workers have really been laid off. What is clear, though, is that the manufacturing sector employs many of the country's 150 million migrant workers. The wages that those workers send home to their families in the countryside represent as much as 40 percent of rural incomes in some areas.

Beijing, as we've heard, has responded with a multi-pronged approach: create jobs and economic growth through public expenditure, stimulate domestic consumption, and reassure the most vulnerable workers. It has also cleverly managed the discussion of the impact of the global economic downturn by warning of hard times ahead and launching stimulus measures with big price tags early on.

In addition to the package of stimulus measures, we've also heard about a measure to offer rural residents rebates on purchases of home appliances and computers and motorcycles. Beijing has announced plans to set up 150,000 stores in the countryside this year alone.

In the cities of Hangzhou and Chengdu, the city is handing out coupons to low-income residents for use at the supermarket. There are countless areas that Beijing could choose from to employ people and generate economic growth--countless roads to be paved, sewage projects and sewage treatment plants to be built, low-cost homes to be constructed.

And in China, these projects tend to be more labor intensive than they are in wealthier countries.

Almost as important as what Beijing has done is what it has not done, and crucially, since this crisis began, it has not tried to devalue the currency to make its exports more competitive, and it has not introduced major subsidies to try to help exporters survive this crisis.

This time of year is a very difficult time to asses the unemployment situation, particularly in the export manufacturing sector, because many Chinese orders are tied to the American Christmas season. It's not yet clear to anyone how severe these job losses will ultimately be. Many American companies have not yet placed their orders for this year, and that process is just starting.

Nonetheless, I believe that unemployed migrant workers may not pose as much a threat to stability as people fear for three reasons:

First, despite the fact that many of these workers have no unemployment insurance and little safety net beyond their plot of farmland in the countryside, they're very optimistic. Workers I spoke to who had been laid off didn't blame the Chinese government for their fate. The uncertainty of their daily lives in good times has prepared them to cope with the recession more calmly than their low income levels might suggest.

Secondly, the migrants in Chinese factories today are very different from workers even only ten years ago. Many were born after China introduced a one-child policy in 1979. They come from smaller families. Their ambitions are more economic than political. They want to buy an apartment, move to the cities, start their own businesses.

If they're unable to achieve this dream as quickly as they'd expected a year ago, they're not likely to hold the government accountable for that.

Third, and finally, there is no charismatic leader to rally migrant workers around the country together. Workers are certainly more likely to strike or sue their employer than even five years ago, and they're much better connected through mobile phones and the Internet, but most of their protests so far have been very specific and local and tied to specific injustices.

The only union that China allows is the All-China Federation of Trade Unions. Independent labor activists are closely monitored, and their activities are curtailed.

China may well see more labor unrest this year than last year as factories skimp on wages and close their doors without paying their staff. And there certainly may be leaders who emerge to unify the migrant workers or other disadvantaged groups. But I believe for all the reasons I've just explained, the risk of migrants causing instability on a national scale is relatively low.

When I was in the Chinese countryside earlier this month, I met a migrant worker who has for the last 13 years been making shoes for export in factories near the coast. His earnings had put one daughter through high school and through college and were putting another daughter through high school. But recently, he saw the writing on the wall. He saw that factories around his were closing and he knew that it was only a matter of time before he lost his job.

When we met, he was putting together a plan to start his own business. He told me this crisis is an opportunity. Speaking to businessmen in China, I heard this refrain again and again. The CEO of an Internet company in Shanghai said he had taken advantage of the downturn to lay off his least productive employees.

The head of a large American company's Chinese operations told me that as his smaller rivals went bankrupt this year, he planned to acquire them.

Factory closures in China will certainly cause short-term pain. Beijing's long-term strategy is to shift the focus of the economy away from reliance on low value-added labor and resource-intensive exports towards one that relies more on domestic consumption and higher value-added exports.

I believe the economic downturn will accelerate this inevitable adjustment. Just as American textile companies began to move away from Massachusetts a century ago, Chinese shoe, toy and textile factories are now moving off the coast into inland provinces where labor and land costs are lower.

As it has in other countries, the slowdown has certainly exposed the imbalances that have developed as a result of China's extraordinary growth over the past two decades. As we've discussed this morning, China's safety net is too weak to catch many of its most vulnerable citizens: rural residents and migrant workers.

That encourages these citizens to save more and consume less and contributes to some of the imbalances we've seen in the global economy. I'd like to add one note on the Chinese consumer since we've spoken about this Chinese consumer many times this morning and that is to say that there is no one Chinese consumer. Spending patterns differ dramatically on who you are, where you live, and what your income level is.

An Internet executive in Shanghai in his 20s might spend just like an American, but a rural resident in the countryside in his 50s might save a significantly higher portion of his income. At the same time, this year we'll see wage increases of the last couple of years slow down as more factories close and as jobs become more scarce.

And so, if you are a worker in the countryside, if you are a rural resident, you are facing very real costs for education of your children, for health care, for your own retirement, and maybe even to build yourself a house without borrowing money from the bank.

I think that China has noted this fact that consumers in rural areas, in particular, need to be encouraged to spend more and that's why we've seen Beijing introduce programs targeting rural areas in particular. As we've talked about, China is trying to accelerate its plan to offer universal health care. It's promised to reform its pension system. These reforms in theory should help people feel more comfortable about spending, but they will undoubtedly take years to implement.

I believe that China has wisely, though, moved these up their list of priorities during this crisis. So as China uses this as a chance to become more competitive to address some of the imbalances and structural issues in its economy, I believe we in America might focus our efforts on the same. We might too see this crisis as an opportunity.

Thank you.

[The statement follows:]

Prepared Statement of Ms. Alexandra Harney, author of "The China Price," Hong Kong

Good morning. Chairmen Wessel and Slane, commissioners, thank you for the opportunity to appear before you today.

I believe that too often, the voices of ordinary people both here and in China get lost in the debate about our two countries. So I am particularly glad that you have invited me to share with you what I am seeing on the ground in China.

I have spent the last five years researching the Chinese economy, first as a reporter for the *Financial Times*, and then as an author. My book, *The China Price*, is an investigation into the sources of China's competitiveness as the world's leading manufacturer of consumer goods. To research my book, I spent time in Shenzhen, one of China's largest industrial cities, and spent two years talking to the factory managers, workers, labor activists and businessmen who enable American consumers to buy goods as cheaply as we do. I've just returned from a trip to the Chinese countryside, where Beijing is focusing many of its economic stimulus efforts. Today, I'd like to share with you some of the insights I've gained in my research. I'd like to make three main points.

First, China's primary focus this year will be creating jobs to avoid the social instability it fears unemployment would cause. Second, despite concerns expressed by Chinese officials and reported in the press, I believe that Chinese workers are not going to cause massive social unrest this year. And third and most importantly, China appears to be taking advantage of this crisis to strengthen its competitiveness and to address some of the imbalances that have developed during its rapid growth over the past two decades.

China's concerns

Let me start with China's concerns. Over the past several months, Chinese officials have stepped up their statements to the state-controlled media about the likelihood of unrest this year. In January, *Outlook Weekly* quoted Huang Huo, a bureau chief at state news agency Xinhua, as saying: "we are entering a peak period for mass incidents. In 2009, Chinese society may face even more conflicts and clashes that will test even more the governing abilities of all levels of the party and government." Earlier this month, Chen Xiwen, a senior rural planning official, warned that 20 million workers had already lost their jobs as a result of the economic downturn.

Privately, officials have been urging businesses to avoid large-scale layoffs. One senior government official told me that he had been instructed to watch for and report any signs of protests or other instability. "The whole country is on high alert," he said.

This year is politically significant because it is the 20th anniversary of the protests centered on Tiananmen Square and the 60th anniversary of the founding of the People's Republic of China. There are also fresh demands for political reform: thousands of Chinese, including well-known intellectuals and government officials, recently signed a petition calling for, among other things, a new constitution, democratic elections, and the freedoms of assembly, expression and religion.

Beijing believes the economy and social stability are closely linked. In the fourth quarter of 2008, economic growth slowed to 6.8 percent, the slowest pace since 2001. Decreased American and European consumption has lowered China's export volumes, which has in turn contributed to the failure of thousands of factories. Export volumes shrank 2.8 percent in December.

No one, not even the Chinese government, knows exactly how many factories have closed, or how many workers have been laid off so far. What is clear is that the manufacturing sector employs many of the country's 150 million migrant workers. The wages they send home to their families in the countryside represent as much as 40 percent of household income in rural areas.

China's response

Beijing has responded to the crisis with a multi-pronged approach: create jobs and economic growth through public expenditure, stimulate domestic consumption, and reassure the most vulnerable workers. It has also cleverly managed the discussion of the impact of the global economic downturn by warning of hard times ahead and launching stimulus measures with big price tags early.

In addition to the $585 billion package of stimulus measures announced in November, Beijing has introduced other initiatives targeted at boosting domestic consumption, easing the burden on rural residents, and retraining migrant workers. It has expanded a scheme to offer rural residents rebates on home appliances, computers and motorcycles and announced plans to set up 150,000 stores in the countryside this year alone. The cities of Hangzhou and Chengdu are handing out coupons for low-income residents to use at supermarkets.

There are countless projects Beijing could choose from to employ people and generate productive economic growth – countless roads to be paved, sewage treatment plants to be built, low-cost homes to be constructed. And in China, these projects are much more labor-intensive and cost-effective than similar projects would be in wealthier countries.

Almost as important as what Beijing has done is what it has not done. Since this crisis began, it has not tried to devalue the renminbi to make its exports more competitive. It has not introduced major subsidies to help exporters survive this crisis.

Likelihood of worker unrest

This time of year is a difficult time to measure unemployment in China. In the export manufacturing sector, because most Chinese factories' orders are heavily geared toward the Christmas season, it is not clear yet to anybody how severe the job losses will ultimately be. Many American companies are only now starting to place their orders for this year.

Nonetheless, I believe that unemployed migrant workers may not pose as much of a threat to social stability as some fear for three reasons. First, despite the fact that most Chinese migrant workers have no unemployment insurance and little safety net beyond their plot of farmland in the countryside, many are still optimistic. Workers I spoke to who have been laid off don't blame the Chinese government for their fate. The uncertainty of their daily lives in good times has prepared them to cope with a recession more calmly than their annual incomes would suggest.

Second, the migrants in Chinese factories today are very different from their parents. Many were born after China introduced its one-child policy in 1979, and therefore come from smaller families. Their ambitions are more economic than political. They want to buy an apartment, move to the cities, start their own businesses. If they're unable to achieve this dream as quickly as they had hoped a year ago, they're not going to hold the government accountable for it.

Third, there is no charismatic leader to rally migrants around the country together. Workers are much more likely to strike or sue their employer than even five years ago, and they are far better connected through mobile phones and the internet. But most of their protests so far have been specific and local – in response to unpaid wages or poor treatment, for example. The only labor union China allows is the state-controlled All-China Federation of Trade Unions. Independent labor activists are closely monitored and their activities curtailed.

China may well see more labor disputes this year than last, as factories skimp on wages and close their doors without paying their staff. And there may still be leaders who emerge to unify migrant workers, or other disadvantaged groups. But I believe, for all the reasons I have just explained, the risks of migrants causing instability on a national scale are relatively low.

Crisis as opportunity

While I was in the Chinese countryside earlier this month, I met a migrant worker who has for the last 13 years made shoes for export in factories near the coast. His earnings were putting one daughter through college and another through high school. Now, he saw the writing on the wall – factories were closing. It was only a matter of time before he lost his job. When we met, he was putting together a plan to start his own business. He told me: this crisis is an opportunity.

Speaking to businessmen in China, I heard this refrain again and again. The CEO of a small internet company in Shanghai told me that he had taken advantage of the economic downturn to lay off his least productive employees. The head of a large American company's Chinese operations said that as his smaller rivals went bankrupt this year, he planned to acquire them.

Factory closures in China will undoubtedly cause short-term pain. But Beijing's long-term strategy is still to shift the focus of its economy away from reliance on low value-added, labor- and resource-intensive exports towards one that relies more on domestic consumption and higher value-added exports.

I believe the economic downturn will accelerate this inevitable adjustment. Just as American textile companies began to move away from Massachusetts a century ago, Chinese shoe, toy and textile factories are now moving off the coasts to inland provinces, where land and labor costs are lower.

As it has in other countries, this slowdown has exposed the imbalances that have developed as a result of China's extraordinary growth over the past two decades. China's safety net is too weak to catch most of its most vulnerable citizens – rural residents and migrant workers. That encourages those citizens to save more and consume less, and contributes to some of the imbalances we have seen in the global economy.

Beijing has pledged to spend $124 billion to offer universal health care to all citizens. It has also promised to reform its pension system. These reforms, in theory at least, should help people feel more confident about spending money in the long run. These plans will undoubtedly take many years to implement, but in this downturn, China has wisely moved them up its list of priorities.

As China is using this as an chance to become more competitive, I believe that we in America might focus our efforts on the same. Like the Chinese, we too might see this crisis as an opportunity.

Thank you.

Panel II: Discussion, Questions and Answers

HEARING COCHAIR SLANE: Thank you, Ms. Harney.

Our first question will come from Commissioner Wessel.

HEARING COCHAIR WESSEL: Thank you to all our witnesses and our apologies, Ms. Harney, to you to having to interrupt your recent honeymoon with e-mails to arrange your participation here, but thank you for appearing today. So much appreciated and enjoyed your most recent book.

I'd like to ask a couple of broad questions or maybe one broad question because--and going back to your line that this is potentially an opportunity. I know that you were here for the last panel when Dr. Roach talked about our consumption binge.

In part, we have a unique problem here now that clearly we need to save more at a time when incomes have dropped precipitously or have disappeared for too many Americans. At the same time, as you just pointed out, China's looking at this as an opportunity to go higher up the food chain, if you will, in terms of products, in terms of value addition, in terms of efficiency.

I think at one point you indicated there were 20,000 or so factories in Guangdong that had closed. I don't remember exactly. And many of that migrating to the hinterland or to Vietnam or elsewhere.

What is the China challenge we're going to face two years from now? The nonperforming loans you talked about, Dr. Woo, operate as a subsidy. The environmental degradation vis-à-vis the U.S. and how we subscribe to environmental protection can act as a subsidy. We've seen that in a number of industries.

What is the challenge? How is the relationship if at all going to change over the next couple of years? How do we build confidence here that China is going to be a responsible stakeholder going forward understanding that we need to solve this global crisis together?

MS. HARNEY: Well, no worries about the honeymoon. I'm glad to be here. What I observe in China's manufacturing sector is a consolidation, one that began well before this financial crisis started. This was the result, in fact, of Beijing's efforts to encourage the exit of a lot of low-end, labor-intensive, resource-intensive manufacturers that were ultimately dragging down the profitability of entire industries. Chronic overcapacity has meant that Chinese manufacturers have not been competing with ten companies; they have been competing with a hundred or a thousand.

That process of consolidation started when Beijing began to introduce a string of policies, starting with the July 2005 removal of the peg to the U.S. dollar and the subsequent appreciation of the renminbi. It continued with tax changes that essentially made it less profitable to be a Chinese exporter, as well as the new labor law which was introduced in the beginning of 2008.

These policies introduced pressures that Chinese manufacturers had never faced before. It exposed the fact that many manufacturers were not, in fact, paying the full legal wages and all the benefits that they should have been paying. Many of them found their costs had increased substantially, and they began to go out of business in the thousands, as you indicated, and as I indicated in my testimony.

I believe what we see now is a continuation of the process. The situation has been exacerbated by the fact that there are fewer orders, and so now the biggest crisis that these factories are facing is that there are no orders. There is no demand for their products.

Secondly, that they cannot get financing. It's very difficult to tell exactly how much of their financing was from retained earnings and how much was from bank lending, but it is fair to say that any factory in China will tell you today it's much harder to borrow money than it used to be, much more expensive.

These factors are basically winnowing down the number of factories. We can expect to see several outcomes:

One, that more factories will move inland. Labor-intensive activities will move inland and more high-tech design, development-oriented activities will stay on the coast. So you'll have a geographic redistribution of manufacturing capacity. At the same time, you would expect to see some factories get larger and more vertically integrated. Other factories might end up shrinking to produce more tailored, smaller orders as American orders get smaller or factories decide to focus on other markets.

Another theme I hear from manufacturers is that they are diversifying the markets they supply. If the U.S. and Europe aren't buying, these factory managers tell me, we'll try to shift our focus to other more developing countries. So I think we'll see a more competitive, more streamlined Chinese manufacturing export sector in two, three, four years' time, and I think that's something that the United States needs to prepare for.

HEARING COCHAIR WESSEL: Mr. Chang.

MR. CHANG: I agree with Ms. Harney that there just aren't export orders, and I think it's going to be very difficult because Chinese manufacturers can become the most efficient in the world, and indeed they will, but if there aren't orders, they just are not going to be able to be profitable or economic, and I think that's the overriding reality right now, the global environment.

China has an economy that maybe 38 percent of GDP is attributable to exports. And that's extremely high by world standards. Consumption is maybe 35 percent, the lowest in the world. This is an economy which is really geared to selling to the rest of the world, and the problem is, yes, China will make adjustments, but it won't make the adjustments fast enough because of a deteriorating global environment.

One could take a look and then make assumptions about where we're going. I assume it could be three or four, maybe five, years before we see a recovery, and if that is indeed the case, then Chinese manufacturing is going to be crippled, especially because they are making investments and they're not going to have consumers in order to buy those products.

HEARING COCHAIR WESSEL: Dr. Woo.

DR. WOO: I think the biggest challenge in China's economic management is China's inability to look at the bigger global picture. As you could see, China in 2006 identified its most important task is to create a harmonious society. The implication is that existing trends in China will not create a harmonious society or at least not create one fast enough to ensure stability.

While it is understandable (given what we have heard about the social tensions, the embezzlements and the political difficulties) that China's focus is internal, it is terrible for the world that China does not seem to get the point that it cannot achieve a harmonious society on its soil if there is not harmonious world outside its borders.

China needs to widen its mental horizon. You could see this need very clearly by China's reaction to the global economic crisis. China says, "We will keep ourselves strong so that the rest of the world could benefit indirectly." Whereas, what China should have been saying is, "We will keep ourselves strong through fiscal stimulus so that the rest of the world can benefit indirectly; but, at the same time we will use our foreign exchange (forex) reserves to stabilize our neighborhood so that China can benefit indirectly from its neighbors."

This is not an either/or situation because these are not mutually exclusive actions. These actions are mutually reinforcing. The Chinese need to get rid of the free rider mentality and the mentality of the small country. As I said before, its passiveness in the WTO negotiations is another instance of its insular mindset.

In the short run, we have to get China to work with us on coordinating fiscal stimulus on the global level. In the medium-term, work with us on strengthening the WTO. And in the long-term, work with us on climate change and the development of alternative energy.

China is building a coal-powered plant every week. This is a chance to build all kinds of prototypes to burn coal cleanly. But China has no incentive to do so because using present green technology will raise the cost by one-third. We have to work with China on this very important issue of burning coal cleanly.

Hence, I think that the pressing challenge for the U.S. is that the U.S. alone can no longer pull the rest of the world along. Furthermore, with the end of the Cold War, our international economic agenda is no longer identical to that of Western Europe, which is why when Sarkozy suggested that we convene a G-7 meeting to deal with the global financial crisis, Bush responded with “let's do a G-20 instead”. Our national interests are now wider and different because of the end of the Cold War.

HEARING COCHAIR WESSEL: Thank you.

HEARING COCHAIR SLANE: Thank you.

Chairman Wortzel.

VICE CHAIRMAN WORTZEL: I'm not going to ignore you, Gordon, but I--

MR. CHANG: I'm always ignored so--

VICE CHAIRMAN WORTZEL: I see a little bit of a contradiction between the statements of Dr. Woo and Ms. Harney in a major area. I want to invite both of you to maybe address it.

If any infrastructure spending is not going to address unemployment problems in China, which I copied down from your oral statement, Dr. Woo, then what does that say for social stability? From my time out there in China, that means that the forces of repression and the public security organs and the Party have to get a little tougher if unemployment increases.

But Ms. Harney says; "Aah, don't worry about it; it's going to work out. Everybody is going to suck it up. New industries will start.”

I take from you, Dr. Woo, that infrastructure spending not only won't employ all these people but won't create new service or tertiary industries that might employ a lot of laborers. From what we as a Commission saw in Shenyang two years ago that’s true. We saw billions going into plants and no service industries or local industry was created from the spending.

If that's the case, how is unemployment going to be addressed and then why won't there be a certain amount of serious unrest?

I have a second and separate question for you, Dr. Woo. If it is true that infrastructure spending won't create employment in China, what about in the United States? Do population differences make a difference there? That's a separate question that has to do with our financial market.

MS. HARNEY: Do you want to go first?

DR. WOO: Ladies first.

MS. HARNEY: Well, what I said was that infrastructure spending tends to be more labor intensive in China than in wealthier countries, which I think we can agree is the case. Having been to the Chinese countryside relatively recently, I believe that infrastructure spending, while it may not create an immediate bump of jobs the way a burst of spending by American consumers might create, certainly paves the way for long-term growth in areas that hadn't seen that much growth before.

Certainly if you go to the Chinese countryside, you'll see a single highway or railway is enough to start the economic transformation of a region.

I think one of the crucial questions that China faces is the same question that we in America face, which is this question of the skills that the workforce has. Long term, china needs to expand its service sector to absorb some of the people that will inevitably lose their jobs as a result of this consolidation in the manufacturing sector.

If Chinese consumers begin to spend a significantly greater portion of their income, we'll see more factories set up to serve domestic consumers, but long term, China needs to address this question of reskilling its workforce in the same way that we in America do.

Some of the programs that Beijing has initiated to retrain migrant workers . But they have to make sure that it's easy for these workers to enter the service sector and that there is significant growth in the service sector to support that.

DR. WOO: My point was that infrastructure construction is usually less employment--intensive than the production of manufactured exports. However, there are other kinds of investment that are more employment-intensive than bridge building and dam building. An example of these more labor-intensive investments is low-cost housing, which is something that is long overdue in China.

China says that it is committed to raising the education and health levels in the countryside, but these are very difficult things to do. It is easier to achieve them by bringing the rural people to the cities and providing the services there. You could educate them better in urban centers and you could also supply them with medical care better.

Public housing is affordable in China unlike in many other countries. Public housing is affordable in China for the same reason it was affordable in Hong Kong and Singapore. On key reason why public housing is very difficult to undertake in the U.S. is that the U.S. agency has to buy the land in addition to putting up the structure. Whereas, in Hong Kong and Singapore, the governments own the land, and so their governments pay only for the construction of the structure. Because the Chinese state also owns most of the land, China could certainly afford to undertake the low-cost public housing projects to accelerate urbanization. Right now, the low-cost housing projects would also be a timely economic stimulus.

China's investment plan ought to stress not only the employment-intensive sort of investments but also import-intensive sort of investments. Specifically, the building of the high-speed train network would require China to import a large amount of high quality steel which China is incapable of producing at the moment (It is true that China has excess capacity in steel, but this excess capacity is in low-quality steel.)

Another type of import-intensive investments that China should undertake is based on my observation that most of the Chinese graduate students in the U.S. are supported by fellowships from the U.S. universities. China should be using its large forex reserves to invest in its own people by sending more of them for a quality education in the United States. This would certainly not only improve the research atmosphere in the U.S. and China, it would also reduce the trade imbalances.

To sum up, even with the domestic economic stimulus, China will still have an unemployment problem, a fairly severe unemployment problem. China is still very dependent on the recovery in the rest of the world to pull more of its people out of unemployment.

HEARING COCHAIR SLANE: Thank you.

Commissioner Bartholomew.

CHAIRMAN BARTHOLOMEW: Thank you and thank you to all of our witnesses today. We really appreciate it. Ms. Harney, congratulations. I didn't realize that Commissioner Wessel was harassing you during your honeymoon. Otherwise, I might have stepped in and done something.

HEARING COCHAIR WESSEL: For the record, it was Paul, but that's--

CHAIRMAN BARTHOLOMEW: There are a couple of different directions my questions are going to go. Dr. Woo, earlier, we had a discussion with Dr. Lardy about the issue of the state of China's banking system because I was quite intrigued by the fact that he said that they don't have toxic assets anymore, which is quite a turnaround, and maybe there are things that our system could learn from that.

But I'm very interested that you note in your testimony that because of the pressure to increase lending, China's state-owned banks will not be held accountable for nonperforming loans. Can you elaborate on that a little bit?

And Mr. Chang, I know you've had some views on this over the years, too. But let's look out a little bit. If indeed, lending can go forward not based on some sort of strict credit, creditworthy standards, what does that mean? Is the Chinese banking system heading into another crisis at some point? How long do you think that takes if that's the case? And finally, what does that mean for U.S. investments in the Chinese banking system?

DR. WOO: Well, it was very common to predict a bank run in China at the end of the 1990s. That prediction never came about for the simple reason that while the banks were insolvent, the government that owned them was not insolvent, and as long as the government could bail the banks out, there was no need to run on the banks.

The other thing that has been often said is: “Look at the large amount of nonperforming loans (NPLs) in China. This means that China must have been investing in a lot of garbage. So there will be a coming collapse of the Chinese economy because of the nonproductive investments have made growth unsustainable.”

We have waited, and the predicted output collapse hasn't come. The reason is that the bank loans turned bad,-- not because they were invested in garbage that yielded zero rate of return. The borrowers chose not to repay the loans because they knew that the government would bail out the banks and forgive the loans. Most borrowers who defaulted did invest in projects that earned a good rate of return because most econometric estimates show that the rate of return on investment in China is over 20 percent.

Let me now identify what the big failure of the Chinese banking system really is. It is not the generation of nonperforming loans (NPLs); the loans were just stolen, they were not wasted. This embezzlement has negative implications for social stability--

CHAIRMAN BARTHOLOMEW: Right.

DR. WOO: --but not for economic stability. Economic stability is not directly threatened by the embezzlement, but political stability is. The big failure of the Chinese banking system is its failure to turn all of China’s savings into investments. This inability to turn all savings into investment is the reason why China has a chronic trade surplus. The unused savings is stored in foreign assets acquired by China from exporting more goods than it imports.

China is sick in the economic sense in that the domestic rate of return of investment is 20 percent, and borrowing money from abroad is only around five percent. China should be borrowing from abroad to invest more at home rather than lending its savings to the rest of the world.

The main reason is why China's state banking system does not work efficiently is because it has been kept as an instrument of political patronage by the government. That is an instrument to buy political support by transferring assets to co-opt potential opposition, and to benefit friends and future business partners.

So we need not fear a banking crisis in China unless the fiscal base of the government collapses for other reasons. As long as the government has the money, it will bail out the banking system. The NPLs are not unproductive investments but asset transfers to the friends and future business partners of the leadership.

CHAIRMAN BARTHOLOMEW: Gordon.

MR. CHANG: I think that if you look at the Chinese banking system, it's really very interesting for the reasons that Dr. Woo mentions. What the central government did do was it kept the banks afloat. They had, even by the Chinese official statistics, something like a 30 percent nonperforming loan ratio which was really probably a little bit over 50, but what happened, though, in a period of about two-and-a-half years is that the NPL ratio went down to eight percent according to Chinese statistics and is probably about seven percent now.

That's a little bit too fast because no government can really manufacture such a solution to a crisis in such a short period of time. So I'm not so sure that the statistics are really correct, but one of the things that the Chinese government did do, of course, was it blew up the balance sheets of the Big Four banks and some of the others as well.

If you look at some of the offering statements for the Big Four banks or the Big Three or three of the largest banks that did go public, you will see that what they did was they increased their lending and their nontraditional forms of lending at very substantial rates like 18 percent a year. And I think by doing that, what they did was they made their NPLs smaller just because in relation to everything else their balance sheets became so much bigger.

Now, you can do that in a period of prosperity and China certainly had a boom. It's had basically five years of double-digit growth, ten years of expansion until the last couple months. And so, yes, of course, the Chinese government could prevent banks from failing in such a benign environment.

But what we're seeing now is a complete reversal of the trends that led to the China boom, and the boom that we saw around the world, as well, and because of its severity and I think because of its length, the Chinese government is going to have problems ensuring that banks stay afloat.

In any event, what we're seeing right now is the central government trying to fund its stimulus plan not from its own sources. It said that out of the four trillion of the November stimulus plan, only 1.18 trillion was going to come from central government money. The rest of it was supposed to come from state banks as well as from state enterprises, and that means, as Dr. Woo has indicated, that the banks are going to again go on this lending spree.

That can certainly tide them over in a period if prosperity returns quickly, but I don't think prosperity will for the global environment, and China is very, very dependent on the global environment.

Dr. Lardy did say that the banks, the Chinese banks, didn't have toxic assets, which he really meant the derivatives and the fancy sort of instruments that we had seen in our country. And yes, the Chinese banks have written off a substantial portion of the, quote-unquote, "toxic assets." But what they haven't done and what Dr. Lardy did mention was that there are a lot of bad loans.

When I went back to my dad's hometown in June, which is really sort of a dusty village, we saw an 18-story hotel which just towered over everything else and which was built really to world-class standards, and it was completely empty except for my wife and me. And that just shows what the central government has been doing in trying to keep the Chinese economy going.

Now, I'm sure they can build another two or three 18-story hotels in my dad's hometown, but after awhile, this game has got to run out.

DR. WOO: Commissioner Bartholomew, I forgot to answer your question about the implications for U.S. investors.

CHAIRMAN BARTHOLOMEW: Yes.

VICE CHAIRMAN WORTZEL: Oh, yes.

DR. WOO: One major reason why the NPLs went from 30 percent to seven percent is because the government just took over the nonperforming loans and gave the banks new capital. What's the implication? Can the government keep on doing it? My calculations show that the last recapitalization is basically the last one that the Chinese government could afford to do. And in the next round of NPL removal, I expect the recapitalization to be done by selling a much larger proportion of the shares of the state banks to foreigners. This explains why so many U.S. investors bought Chinese bank stocks a few years ago despite knowing that there will be this loss in the future. This purchase was quite rational because it put these U.S. investors at the front of the line to buy bank shares when the second recapitalization is needed.

I think that these U.S. investors expected NPLs to reappear, expected the government being less able to afford another bailout, and expected to buy a larger proportion of the bank shares at a lower price. So it might seem like a waste of money when the U.S. investors went in the first time, but that put them the first in line to buy in the second round; perhaps, even buy a controlling share.

CHAIRMAN BARTHOLOMEW: Dr. Woo, it's interesting and it's an interesting response, and I think from my question this morning to one of the issues that I am struggling to understand is that the U.S. taxpayer ends up bailing out U.S. financial institutions and those U.S. financial institutions are invested in financial institutions in China. Where does that all go and what does that all mean?

So thank you very much.

HEARING COCHAIR SLANE: Commissioner Fiedler.

COMMISSIONER FIEDLER: Let me first make a comment. The question of stability. Your observations, one thing we've heard today, we have a Chinese government that quite clearly disagrees with you and is frightened every night before the leaders go to bed about what's going to happen tomorrow and state so publicly.

We may even have a United States government that is more concerned with stability in China than it is with some other considerations. There are some of us who might argue that United States policy has always been an unarticulated one of we must keep a stable China at all costs. Politically, we're in a very interesting dilemma where the U.S. government may still believe that, but the American people have quite a different notion of the cost that they're willing to bear in order to maintain a stable China.

I would submit to you that we're coming to the end of that string from the average American. When I asked the question, what was the net effect of the WTO accession on the average American, was it positive or negative, I got only general answers I think Mr. Cassidy said no, and everybody else sort of avoided that question.

Stability here seems to me to be what drives the Chinese economic stimulus. Everybody is nodding their heads, but in the United States, it is not stability that is driving this. We don't expect the revolution to occur out of this recession, but we do in China.

Therefore, how much of this relationship that we have with China, i.e., not mentioning currency--God forbid--not mentioning subsidies--God forbid--not mentioning unfair trading practices--God forbid--is actually generated for foreign policy reasons by the United States government and not for economic reasons?

Question? Answer? Comment?

MS. HARNEY: I'd like to address this question of social stability because I think it's very much on the minds of Chinese policymakers and people who are watching China from here.

I think it's important to examine why Chinese government officials would come forward with numbers like 20 million workers unemployed and to continue to stress this issue of social instability. There may be domestic reasons.

For example, if you are communicating with a local official in China, you'd want to make sure that as the central government that you were communicating that this issue of social stability is of prime importance, and that all programs that you are looking at should be directed at that issue.

I'm not downplaying the size of the potential risk here, but I do think that there is also a question of whether the Chinese government is communicating perhaps with those rural residents themselves to say, listen, there are already 20 million people out of work in the cities; perhaps you might want to stay home and find a job there.

COMMISSIONER FIEDLER: And don't get out of line. Yes. I understand that.

MS. HARNEY: I'm not sure whether we're talking about getting out of line. That's a separate question of public security, and those are different kinds of communications. But speaking about the economy, I am speaking specifically about worker unrest, and we've seen a huge increase in the number of labor disputes in China.

Last year labor disputes were up about 50 percent nationally, 300 percent in Guangdong Province. So there is certainly a lot more worker awareness of the ability to strike and to protest, and that has changed. But whether that becomes a coordinated national strike or coordinated national unrest is what I'm addressing, and that is where I say the risk is relatively low.

COMMISSIONER FIEDLER: And why is that?

MS. HARNEY: For the reasons that I talked about. One, workers are not organized on a national scale independent from the government.

COMMISSIONER FIEDLER: No, no. They're not allowed to be organized on a national scale.

MS. HARNEY: Correct.

COMMISSIONER FIEDLER: And your characterization I think was a gross understatement that worker activists are curtailed. They are jailed, they are repressed. Okay. They are unable to organize. No natural leader has evolved because if he or she did, they would be put in the laogai.

MS. HARNEY: That's correct. There are labor leaders on local levels. There are independent labor activists all across China. It's just, as I said in my statement, their activities are curtailed, and absolutely, yes, there are cases where they are jailed.

MR. CHANG: I think that it's really interesting because I can agree with Ms. Harney that labor migrants might not pose the greatest risk to the Chinese state because they don't want to bring down the central government. I'm sure they don't, but that's not the way revolutions work, especially these days. What we have seen in a number of countries, especially the Philippines, is leaderless revolution.

People get upset; there's a time of great stress in society, which is what we're seeing right now. People strike over something. And the last thing they might want to do is to kill Hu Jintao, but, on the other hand, what they are doing is they are destabilizing an unstable situation, and things can just spread from one province to the next, as we've seen in a number of times in the last five years.

There's been certainly great labor unrest since October. Who knows? The Chinese government has been lucky. It's been lucky for quite some time, but that doesn't mean it's going to be lucky forever especially when you have a contracting economy. China's economy right now is contracting. It might do so for another one or two years, maybe even longer than that, and in a situation where nobody really likes the Communist Party, what we have seen is no revolution, but that's because of the repressive nature of the state.

The interesting thing right now, and I think it's much more dangerous than migrant workers on the loose, is the increase in ridicule of the central government, which you see not only among the poor but also the wealthy and middle class.

The most popular person in China a month ago was a jobless drifter who entered a police compound in Shanghai and killed six police officers while wounding four others, and you had middle class Chinese demonstrating in the street with banners which said "Long Live the Killer" and "Down with the Communist Party."

I don't know if this is going to happen this year or whatever, but certainly there are the elements of social instability, and in a time of great stress, migrants might do something that does something else that does something else that leads to a situation which the central government cannot control.

And certainly in a period of declining economic environment, which is what we have right now, anything can happen.

DR. WOO: Commissioner Fiedler, you made a very interesting point. Why does the Communist Party of China (CPC) sound like it's afraid of its own shadow, constantly talking about possible instability and so forth? It is instructive to note that the same thing is said by the Malaysian government. Why do these governments all say the same thing?

They say this to justify the repressive authoritarian practices of the state: We have to save you from yourself, your natural untamed instinct, which is why we have to disallow a free press, which is why we have to disallow free trade unions, and which is why we need to disallow an independent judiciary system." These public expressions about chaos being just around the corner serve as a convenient excuse for political repression.

But more importantly, you asked about whether our concern for stability in China has meant that we have unintentionally ended up propping up the Chinese state. Looking at the U.S. administrations over time, I don't think that there have been any serious efforts to prop up the Chinese state, and there has been no need for us to do so because CPC has shown its resoluteness on June 4, 1989 about propping itself up.

Our concern about instability in China comes largely from that it could motivate the Chinese leaders to resort to nationalism to distract its population from the domestic problems. For example, China could distract its population by having a more aggressive policy on Taiwan, and by opposing human rights interventions by the United Nations.

I think that is the primary reason why we should be concerned about political stability in China because it affects CPC's policies on Korea and on nuclear proliferation. Only a China that sees itself growing has a stake to think long term about issues like global climate change, something that affects us, whether CPC stays in power or not.

You raised the important question of China's WTO membership, whether it has had been a positive or a negative impact on the U.S. I think that the anxiety of the U.S. worker has come from two sources. One is, no doubt, globalization, with WTO allowing more imports to come in. If one believes that globalization is cause for anxiety, then one would expect to see the following developments: higher imports leading to higher U.S. unemployment, in turn, leading to lower U.S. wages. However, the facts show exactly the opposite. During the time of rising U.S. trade deficits, 2001 to 2007--that's the period when the deficit increased most dramatically--that is the time when the average U.S. unemployment rate is lower than in the seven years before that, which in turn is lower than the seven years before that. The real wage of the blue collar worker, defined to include fringe benefits, health insurance and pension, rose the fastest between 2004 to 2007 compared to equivalent-length periods before then.

It is my opinion that the increase in worker anxiety in the U.S. has been created more by accelerated technological innovations than by greater trade competition. The reason why the U.S. blue collar worker has been paid more in the most recent period is because productivity had come from technological innovations.

The interesting question is whether the expansion of WTO, the globalization process, and the technological innovations are linked? The history of the world suggests to me that openness promotes innovation.

COMMISSIONER FIEDLER: Thank you.

HEARING COCHAIR SLANE: Thank you.

Commissioner Mulloy.

COMMISSIONER MULLOY: Thank you, Mr. Chairman. Thank you for being here and for your excellent testimony, which we had a chance to read most of it before you came in.

This is directed to Mr. Chang and then the others can comment. In his testimony, Dr. Roach from Morgan Stanley, who is based in Hong Kong, says:

"The bottom line for China: its unbalanced economy must be rebalanced. The export-led growth formula, which served the nation well for three decades, must now give way to the internal impetus of consumer-led growth."

I think it's important for Americans to understand what's happened here. China has been pursuing an export-led growth strategy. That means you grow your economy, the key part of it is you export to others. That's us. We're buying it; they're exporting it. They're getting the dollars.

Dr. Woo said why is the Chinese government lending to us when it could get a higher rate of return lending in its own society?

With that question in mind, and think about this, I ask you three questions. Did China have an export-led growth strategy? And does it still? Two, was the under pricing of its currency a key part of China's export-led growth strategy? Three, did the under pricing of its currency act as an incentive to attract U.S. and other companies to shift jobs, R&D and technology and know-how from this country to China?

MR. CHANG: Certainly, to answer your first question, China did have an export-led strategy. Just looking at the composition of the Chinese economy, it was clear that approximately 40 percent of growth or that 40 percent of the economy is attributable to exports, and if you look at countries around the world, that is extraordinarily high.

Judging from the statements that the Chinese government has made all the time about trying to encourage its export sector, it's clear that it had an export-led economy. Certainly currency was a key part of this strategy. China devoted substantial efforts to keeping its currency low just for the simple reason that I mentioned in my oral testimony, and that was to make its products cheaper across the world.

I don't think ... that really is beyond question. The terrible thing on our part is that we're not willing to admit that. We may decide, for instance, to say, well, China is manipulating its currency, but for other policy reasons, we may not do anything, but the terrible thing for us is not to admit the truth.

COMMISSIONER MULLOY: Right.

MR. CHANG: And the Chinese government sees this, and they say, oh, those foreigners they're so afraid of us they won't even say black is black or white is white.

COMMISSIONER MULLOY: They won't even tell the truth to their own Congress.

MR. CHANG: They won't tell the truth to their own Congress, and I think that poisons our political system, and certainly the other thing that it does longer term is delegitimizes free trade in the United States because people see that the U.S. government is really not enforcing its WTO rights. It is letting China off the hook on a number of important issues, and certainly it's not telling the truth.

And so people then say, well, why do we have free trade? Well, there are, of course, very important reasons why we have free trade, but the delegitimization of free trade long term is going to be bad not only for the United States but for the rest of the world. So I think that the important thing is for the United States to say, yes, China is setting the value of its currency to obtain an advantage in export markets.

Clearly, the Chinese government wants to attract money and technology. That's been a program almost 25 years old. And clearly they've been very successful at doing it because foreign direct investment has gone up almost year after year, though we saw last month that it plunged 33 percent, and it's probably going to continue to fall because, going back to Ms. Harney's point, the orders are not coming in.

What we've seen over the last three months is a precipitous fall in orders. I suspect that's going to continue for quite some time.

COMMISSIONER MULLOY: The customer is broke.

MR. CHANG: The customer is broke. People say that China is an engine for the world economy. Well, that's not true. It's the American and the European consumers who have been the engines of the world economy, and now Americans are doing the economically rational thing which is to buy less.

So the world goes into the tank, and I think that you can see that it is the United States, for all of our problems, it still is the engine of the world economy. You heard all this talk about decoupling for two or three years in Asia. It was just garbage really when you think about it, when you look at the events of the last year or so.

Clearly these economies are linked to the United States. China's was especially linked to the United States, and clearly China is going to go through severe problems because we are readjusting in our own economy.

COMMISSIONER MULLOY: Thank you.

I don't want to go over my time, but if anybody--Dr. Woo.

DR. WOO: The growth of East Asia is historically much faster than the growth of other industrial revolutions. The main reason is because they were export-led growth. The reason export-led growth leads to faster growth rates is because exporting allows a country to import new technology.

COMMISSIONER MULLOY: Right.

DR. WOO: And it is imported new technology that allows a country to grow faster. So what's wrong with China is not that it's export-led growth, but its failure to import new technology by the amount it should have. This failure comes from the fact that the savings (the export earnings) were not rechanneled into investment because of the dysfunctional financial system I had talked about.

When people talk about consumption-led growth, they are stating an oxymoron. What is growth? Growth is the expansion of production capacity. Without investment, you cannot possibly increase production capacity. There can only be investment-led growth. There is no such thing as consumption-led growth. An increase in consumption can guarantee full utilization of existing production capacity, but it does not increase existing capacity directly.

COMMISSIONER MULLOY: Thank you.

DR. WOO: There is a fundamental misunderstanding when people talk about consumption-led growth. You will get one-and-a-half percent growth as in the first Industrial Revolution in the United Kingdom when the final demand for goods is almost entirely internal in origin.

MS. HARNEY: Just to add briefly. If you talk to manufacturers in China or you talk to businessmen in China, or American buyers of Chinese-made goods, they'll tell you that the currency is only one factor in their decision; that, in fact, when you're moving your manufacturing to China, other factors include low land costs: the ability to get a large supply of workers and, also uneven law enforcement in terms of laws on labor and the environment.

Not to mention the fact that many of these export areas have developed as clusters, which are one of China’s genuine competitive strengths. China’s competitiveness is not just about its currency.

Another point I would make is that manufacturing is sticky. If you talk to people who have moved their manufacturing to China, they tell you that they would rather not move their manufacturing across the street, much less to another country.

So as China's competitiveness is enhanced in manufacturing, it only brings more orders to China and further enhances its advantages.

Those jobs, these orders, will not come back to America. I believe that we need to look more closely at what American companies are doing overseas and whether they are behaving in ways that are sustainable and responsible and promoting better environmental practices, better labor practices on the ground in China.

COMMISSIONER MULLOY: Thank you very much. Very helpful.

HEARING COCHAIR SLANE: Thank you, panel. It has been fabulous, and we appreciate your time, and we are going to adjourn for lunch. We're going to return at 2:15.

[Whereupon, at 1:15 p.m., the hearing was recessed, to reconvene at 2:15 p.m., this same day.]

AFTERNOON SESSION

PANEL III: THE EFFECT OF THE CRISIS ON THE U.S.-CHINA ECONOMIC RELATIONSHIP

HEARING COCHAIR WESSEL: Welcome back. Our third and final panel will look into the impact of the global recession on the U.S.-China relationship.

If the global financial crisis was the result in part of a U.S-China trade imbalance, we'd like to know if the solution can also be found within the U.S.-China relationship.

Derek Scissors is a Research Fellow for Asia Economic Policy at the Heritage Foundation's Asian Studies Center.

At Heritage, Mr. Scissors focuses on the Chinese economy as well as broader Asian economic trends and challenges facing the United States. In addition to his duties with the think tank, Mr. Scissors is an Adjunct Professor at George Washington University where he teaches a course on the economy of the People's Republic of China.

Michael Pettis is a Professor at Peking University's Guanghua School of Management--hope I pronounced that correctly--where he specializes in Chinese financial markets.

He is a member of the Board of Directors of ABC-CA Fund Management Company, a Sino-French joint venture based in Shanghai.

Besides trading in capital markets, Professor Pettis has been involved in sovereign advisory work including for the South Korean Ministry of Finance on the restructuring of the country's commercial bank debt.

Eswar Prasad is the Tolani Senior Professor of Trade Policy at Cornell University and a Senior Fellow at the Brookings Institution. He is also a Research Associate at the National Bureau of Economic Research.

His research has spanned a number of areas including labor economics, business cycles and open economy macroeconomics. His current research interests include the macroeconomics of financial globalization, monetary and exchange rate policies in emerging markets, and the Chinese and Indian economies.

In light of the fact that we recessed for an hour, I'll just restate the goals of the Commission, which is hopefully to have oral comments of roughly seven minutes in length. Your full prepared testimony, will be inserted in the record. And then we will have questions and hopefully time for two rounds if possible.

Dr. Scissors, if you could begin.

STATEMENT OF DEREK SCISSORS, PH.D., RESEARCH FELLOW, THE HERITAGE FOUNDATION, WASHINGTON, DC

DR. SCISSORS: Thanks for having me. I appreciate the invitation to speak before the Commission.

I'm actually going to dispense with the crisis-- the causes of the crisis-- fairly quickly, not because they aren't interesting, but because that's not what I have the most to say about.

I'm going to assume that the core of the crisis is American monetary policy. That ties in with the Commission's interest because there is this- question of whether Chinese bond purchases have contributed to excessively loose American monetary policy. I'm going to dispense with that quickly as well and say there has been a contribution. It's a numerical fact. However, the contribution has not forced U.S. interest rates down.

In a period in June from June 2007 to June 2008, Chinese purchases stalled and U.S. interest rates plummeted. So we still control our interest rates certainly Also, in this case Chinese behavior is entirely transparent. We see them purchasing our bonds, but the responsibility is still ours.

That is not the main focus of my testimony. It may be the focus of my colleagues' testimony. Some implications of that are the main focus of my testimony.

One implication has not been picked up widely and is certainly debatable. But I think is worth it for the Commission to hear given how much material that you have to go through on this issue. The Chinese growth spurt from late 2002 to late 2007, where they moved from basically eight percent growth to 11 percent growth, that spurt coincides perfectly with very loose American monetary policy. My arguments--not very well established but something for everyone to think about before we get into the details--is that this was not some innovation on China's part to discover a new path for economic development.

Rather it was the same money illusion that we suffered here and that has been suffered around the world. The extra growth that China enjoyed in the previous five or six years is the same phenomenon that we saw here, which is rapid growth, and it's stimulated by American monetary policy.

In addition, and I don't want to tread on my colleague Michael Pettis' remarks because he's going to emphasize this, but balance of payment surplus countries such as China, Japan, Germany, are going to have a more difficult time adjusting in this crisis than balance of payment deficit countries such as the U.S.

The basic idea is that, in the U.S., the response to the crisis is for citizens to save more, which is what we need to do to rectify our side of the imbalances with China and with the world.

In China, the basic response to the crisis is also for citizens to save more, but that is not what they need to do. They need their citizens to spend more. So there's a natural adjustment, and Michael at least, possibly Eswar, will talk about it at length.

There is a natural adjustment process that makes it easier for deficit countries such as the U.S. to adjust and harder for surplus countries such as China to adjust.

Therefore, I give a completely different picture of the Chinese economy than is commonly presented. It's an economy that grew at extra-speed. Not that it would not have grown quickly in any case; it still would have grown at closer to its baseline rate. But it grew more quickly in the last five years largely because of American monetary policy and is going to have more difficulty adjusting to this crisis than the United States.

In terms of U.S.-China economic relations, we don't have good information yet on how the trade deficit is going to evolve. So far it's gone flat. It shrunk a little bit in November. It rose a little bit in December. It's not clear that the imbalances will be resolved by the crisis, which is a common viewpoint, but empirically that doesn't seem necessarily to be the case.

The most powerful information we have on that is that China, as some of you may be familiar, in the last six months, has run the six-largest monthly trade surpluses in world history.

Their trade surplus with the entire world is not shrinking as you would expect in light of falling global demand. Chinese goods are historically very competitive in difficult times, and our own evidence in the bilateral relationship is mixed. That we may not see this imbalance be corrected by the crisis is another important fact that I would like to bring to the Commission's attention.

On renminbi valuation as a solution to the imbalance. It's certainly true that the renminbi is undervalued. From the end of 2004 to the end of 2008, it climbed between 17 and 21 percent against the dollar depending on how you count and about 14 percent against the euro, but in that same period, China's aggregate trade surplus with the world increased 800 percent.

So we have a currency movement of 15 to 20percent, and we have a trade surplus increase of 800 percent. We know, regardless of the discussion and regardless of the labels, that the renminbi has not adjusted significantly in that time. Does that mean that the solution to our trade imbalance with China is found in renminbi movement?

Almost certainly not. For one thing, as a policy stance, we supported China's obsession with currency stability through the Asian financial crisis. Their policy hasn't changed; it's our goals that have changed. So the use of the word "manipulation" is a little difficult in that context.

Perhaps more important, we're starting to get information from China's own attempt to stimulate their economy of extremely large financial transfers out of the banking system to firms, and that includes exporting firms.

Now, at a micro level, say somehow the U.S. were to persuade China to revalue the renminbi 15, 20 percent upward. If lending is increasing even faster than that, and it's essentially free lending, there's essentially no cost of capital in these transfers--it won't make any difference.

And we've seen that recently. During the period that the renminbi has appreciated against the dollar, the trade deficit has increased. Arguably the trade deficit would have increased more in any case, but I should emphasize to the Commission that changing the value of the renminbi in the current context will not have the results of correcting the imbalances.

We have evidence of that in the past; we have very powerful evidence of it coming now from China's own stimulus.

So what does that leave us with? I'm afraid I don't have much of a happy answer where we can snap our fingers and pick an easy solution, sit down with the Chinese and strike a grand bargain, as Fred Bergsten says. We need to change our fiscal and monetary policies. One of the imbalances is we save too little. One of the reasons we save too little is the government dissaves, and it would encourage our savings rate if the government would at least dissave less.

That's all we can hope for right now. We can't actually hope for the government to run a surplus, but if they would just run a smaller deficit, that would be helpful.

Another thing that would be helpful would be to have interest rates with proper yields so that it costs the U.S. money to sell Treasury bonds to people, and that's a natural constraint on government spending. So the ideal for us is to fix our fiscal and monetary policies. We should do that in any case, but that would be particularly helpful with regard to the China relationship.

The ideal for the Chinese is actually going to be a much harder sell. We need to push on them financial reform at a time where they consider reform to be discredited. They have no strong grounds to stand on this. China missed the opportunity to reform in the period of high growth.

Now, they claim they're too fragile to reform and that reform is a bad idea because it's led the U.S. down this terrible path. It's leading

China down this path as well.

I don't want to go into the technical details, but I would actually argue that China did not grow at all in the fourth quarter. It will not grow at all in the first quarter. In on-quarter terms, which are the terms that are announced in most other countries, the economy is shrinking. There is a good argument to make, that I'll leave to my colleagues, that they're going to have trouble resuscitating sustained growth, not a temporary blip in growth, for years to come.

So as this crisis unfortunately unfolds, we're going to have more credibility with the Chinese talking about reform, not a lot of credibility but more than we talk about now. The key reform that China should undertake is clearly financial system reform. It's lending on the basis of commercial return instead of at the government's direction, which we are seeing in colossal amounts at the current time.

And it's liberalizing the capital accounts so that the huge quantity of reserves China has built up can actually be used in China instead of dumped in U.S. Treasuries.

Now, there's an obvious risk, which is: we want them, because of our not-so-responsible fiscal policy, to continue buying Treasuries and at the same time I'm advocating that they should liberalize the capital account and find other uses for their money besides buying Treasuries.

That suggests immediately that there is room for co-movement, that the U.S. and China need to move together, that if only one country moves, it's going to be destabilizing for both and harm both and perhaps not correct the imbalances. So we have negotiations to undertake with the Chinese. They are negotiations that are not from a position of Chinese strength, which they may or may not be inclined to boast of, but a position of rather stark Chinese weakness. That complicates the matter, but that's the only way in which the imbalances can be unwound.

Otherwise, any recovery we have is just going to return us to 2006-2007; both economies are growing nicely, but we're accumulating a huge trade deficit with the Chinese and they're stockpiling huge amounts of U.S. dollars that they cannot invest, which would be in neither country's interest.

[The statement follows:]

Prepared Statement of Derek Scissors, Ph.D., Research Fellow, The Heritage Foundation, Washington, DC

The Financial Crisis and the Sino-American Economic Link

Addressing the effect of the current economic crisis on the U.S.-China economic relationship presumes an understanding of the crisis and the relationship. This is plainly a matter for debate but, for the purposes of my testimony, the single biggest contributor to the crisis is an overly loose American monetary policy which began in late 2002. This policy was exacerbated by federal government-sponsored distortion in housing and flawed regulation of the credit system.

As is well-known to the commission, there has been a Chinese contribution to loose American monetary policy. The nonconvertibility of the yuan and the singular global stature of our bond market combine to effectively force the recycling of the surplus dollars the PRC earns through trade with the U.S.

This, however, is not a particularly good explanation of the time pattern of American interest rates. Most striking, Chinese purchases of U.S. Treasury bonds barely budged (and their purchases of agency debt slowed sharply) from June 2007 to June 2008 but the federal funds rate plunged. While the data are too limited to be conclusive, it is in any case the responsibility of U.S. monetary and fiscal decision-makers to adopt correct policies, especially when Chinese contributions to liquidity are entirely transparent. That conclusion leaves the understanding of the bilateral economic relationship itself.

The Chinese Side of the Relationship

Whatever its sources, loose American monetary policy has had global repercussions. One effect that has been largely missed and is germane to this hearing is our underwriting of China's economic acceleration from late 2002 to late 2007. In late 2002, the then-new administration of Hu Jintao and Wen Jiabao embarked upon a traditional pattern for incoming Chinese leaders: buying political loyalty through faster economic growth. Credit was greatly loosened, triggering a surge in investment, production, and export.

Had this loosening of credit occurred two years earlier, when domestic retail prices were falling outright and foreign demand was unsteady, the result for the PRC would have been crushing deflation. Loose U.S. monetary policy, though, stimulated not only American but global demand. This permitted China to export excess production and accumulate foreign exchange to more easily acquire mineral resources to sustain the excess production. Money earned from exports enabled skyrocketing deposits by firms, joining those by individuals, and bolstered the financial system against the outpouring of loaned funds (see Table 1).

And so a virtuous, if temporary, cycle was created. Apparently believing that they had found a new economic approach, Chinese decision-makers eschewed further market reform beginning around 2004.[1] Many observers implicitly endorsed that decision, finding the "Chinese way" to be superior. China's baseline growth had stemmed from demographics, intense resource exploitation, and the efficiency gains from market reform introduced voluntarily for much of the 1990s, then introduced through the concessions made to win WTO membership. The additional gains seen from 2003-2007 were due to artificial stimulus made temporarily more powerful by money illusion originating in the U.S.

That is to say, the recent phase of the Chinese economic miracle suffered from the same conceit plaguing many workers, investors, and policy-makers around the globe. The world was not necessarily working harder or investing smarter or making better choices; instead, loose credit merely made it seem so, just as tight credit now makes everyone seem foolish. The PRC's complaint against the U.S. for causing the financial crisis is partly accurate. Among the things left unsaid is that, in the same way, we are also significantly responsible for China's boom prior to the crunch.

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[1] See, Derek Scissors, Ph.D., "U.S.–China Economic Dialogue: In Need of Tough Love," Heritage Foundation WebMemo No. 2200, October 21, 2008, at *http://www.heritage.org/Research/AsiaandthePacific/bg2200.cfm*.

This clarification of the sources of China's recent expansion understates the challenge Beijing now faces. It is likely to be considerably more difficult for the balance of payment surplus countries, such as the PRC, to adjust to the financial crunch than it will be for deficit countries such as the U.S. The simplified logic is that extravagant spenders will save when times are difficult but extravagant savers are unlikely to spend, which is necessary for their national economies.[2] The Commission should not be fooled by the wonderful economic statistics Beijing will continue to announce. China's success earlier this decade was somewhat over-interpreted and the obstacles before it are being widely understated.

The American Side of the Relationship

One area of concern in the U.S. is Chinese financial influence. As noted, Chinese investment is largely involuntary, a function of having a great deal of money and no place else to put it. This refines the usual analogy of banker and customer to one where the banker has a choice of "lending" to one particular customer for the better part of her business, or crafting an exceptionally large mattress. The influence is mutual.

Who needs the other more varies with American and international financial conditions. The more money the U.S. borrows, the more the American economy needs the PRC. The more desirable Treasury bonds are, the more China needs us. The U.S. is planning to run a federal deficit of over $1 trillion but there has been a flight to quality and American Treasury bonds are highly desired. There is balance on this score. The PRC can exercise little or no leverage over American policy by virtue of its purchase of our bonds.

There is future danger in the possibility that we will run sustained, gigantic deficits. The longer these last, the more likely it is that U.S. treasuries will become relatively less attractive, thereby tipping the balance of influence toward China. The U.S. could come to need Chinese purchases more than the PRC needs American bonds, yet another argument to control the federal budget.

Beyond bonds, Chinese investment in the short term will be minor. Failed investments by SAFE and others—for example SAFE's losses in its fund with TPG and CIC's painful investment in Blackstone—have made Beijing naturally cautious. Even when asset prices begin to recover, there are multiple reasons why Chinese investment will remain guarded, including the fact that, as long as it runs large trade surpluses, the PRC has no pressing need to generate additional foreign currency through investment.

The same motives will push China's non-bond investment away from the financial sector where it was concentrated prior to the crisis.[3] If permitted, SAFE, CIC, and Chinese state financials and corporates will likely seek control of various kinds of assets plentiful in the U.S. but in short supply in the PRC. Such assets range from physical resources such as farmland to equity stakes in business accounting firms.

Another area of concern frequently raised in Congress is the bilateral deficit. The deficit is often blamed on manipulation of the yuan and sometimes attributed to China's failure to live up to pledges made at WTO accession. These are topics worth discussing but they can obscure important facts.

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[2] I note my colleague Michael Pettis' intellectual leadership on this point without binding him to my version.

[3] This observation is derived from a new and ongoing Heritage Foundation dataset on China's non-bond investment around the world starting in 2005. See, Derek Scissors, Ph.D., "Chinese Foreign Investment: Insist on Transparency," Heritage Foundation *Backgrounder* No. 2237, February 4, 2009, at http://www.heritage.org/research/asiaandthepacific/bg2237.cfm.

From China's WTO accession at the end of 2001 thru 2007, American exports to the PRC more than tripled, slightly outpacing imports from the PRC. The deficit rose because the base established before WTO accession featured much larger American imports from China than exports to the PRC. That base can be traced, in turn, to the Asian financial crisis. Chinese exporters switched away from failing regional markets and there was a third wave of FDI from East Asia, seeking China as a platform to export to the U.S. At that time, Washington praised Beijing for holding the yuan steady when it might have been overvalued. The origins of the deficit lie neither with an undervalued yuan or violation of WTO pledges.

Looking forward, the present crisis is almost surely going to cut into both American exports and imports. However, the effect on the deficit may be limited: In November it fell only 5 percent on-year. It is too early to be confident but a retreat along the path broken over the past 10 years is possible: American exports and imports decline at a similar rate and the deficit falls noticeably because imports are much larger. It is also true, however, that Chinese firms have been competitive in difficult times and could capture additional market share.

The deficit is often said to represent jobs lost due to bilateral trade. Any job loss, of course, must be weighed against the lower prices available to American consumers, the benefits of competition for our economy, and the role an open American market plays with regard to U.S. global leadership. It is worth noting that consumer electronics, clothing, toys, and furniture are the leading American imports from China. Lower prices on these goods may disproportionately benefit those with average or below-average income (see Table 2).

Also, it is fairly clear that it is not truly China we might be losing jobs to. The majority of exports from the PRC are manufactured by foreign-funded ventures. U.S. investment into China has been declining since 2002, while the bilateral surplus has soared, and accounted for only about 7 percent of official FDI through 2008. This compares to the U.S. receiving close to 18 percent of China's exports on official data and 24 percent on American data.

What has happened is foreign investors other than the U.S. have located factories in the PRC to serve the American market. If production in China became less competitive for any reason, these investors would simply relocate to Vietnam, Mexico, and elsewhere.

Solutions

It is not the case that the U.S.-China economic relationship must change for the crisis to be resolved. The Chinese economy is not big enough to have that kind of impact on the American economy. Nonetheless, the ideal solution to the crisis would include more open trans-Pacific trade and investment, so as not to repeat the creation of harmful imbalances on both sides.[4]

The tasks for the U.S. are largely internal: better monetary and fiscal policy. In addition, we must fight the tendency to use trade and investment imbalances and China's ambivalence toward liberalization as excuses for protectionism.

China faces more difficult challenges. The PRC must encourage true consumer spending, not "domestic

[4] I consider the integration of China's response to the crisis with that of other countries and international institutions to be a red herring. No nation with a degree of economic autonomy, including the U.S., gives much weight to international coordination in a tue crisis.

demand" which turns out to be lending for investment, resource use, production, and export. It would be helpful in this regard if the central government would back up words about health insurance and pensions by giving these concerns equal status with economic expansion for job creation. This should occur as demographic pressure eases by the middle of next decade, but is highly unlikely as a crisis response.

The other dimension of the challenge is one China has avoided throughout the reform era and is especially unpopular at the moment: liberalizing the financial system. To make borrowing easier for the government and state firms, interest rates are strictly determined and continually depressed by the People's Bank. This robs savers of wealth. The need to shelter domestic banks is also used to justify the closed capital account, which traps consumer, and some enterprise, savings. This helps state banks lend without regard to commercial return, a colossal subsidy for the state firms to which these banks almost exclusively lend.

Some of these subsidized firms, of course, are exporters. The money they earn overseas cannot be used to create pension funds or otherwise aid Chinese consumers because the yuan is not convertible, another aspect of the controlled financial system. So China saves too much and runs up huge trade surpluses and foreign exchange reserves, which it then cannot use. In this manner, Beijing both contributes to global imbalances and denies its people some fruits of a free market. Financial liberalization in the PRC will certainly not solve the crisis but it will make for a better Chinese, better American, and better global economy.

Table 1: Chronicling The (Official) Boom (% change)

Indicator	2003	2004	2005	2006	2007
Bank loans	+21.1	+14.5	+9.8	+15.7	+16.2
Internal investment	+26.7	+25.8	+25.7	+24.0	+24.8
Trade surplus	-16.1	+25.5	+218	+74.2	+47.4
Corporate Savings	+20.8	+16.8	+13.5	+17.7	+22.5
Outward investment	+41.1	+93.0	+124	+71.5	+25.6

Sources:

China Monthly Statistics,
Statistical Bulletin of China's Outward Foreign Direct Investment

Table 2:

Top 10 Imports From China, January-November 2008 ($ billions)

SITC code	Description	Amount
752,759	Computers and parts	35.8

764	Cell phones and the like	29.8
894	Toys and games	25.6
761	TV's	16.0
821	Furniture	14.1
851	Shoes	13.5
751	Other office machines	7.9
845	General clothing	7.8
842	Some women's clothing	6.9
775	Household equipment	6.2

Source: http://censtats.census.gov/cgi-bin/sitc/sitcCty.pl

HEARING COCHAIR WESSEL: Thank you.

Mr. Pettis.

STATEMENT OF MICHAEL PETTIS, PROFESSOR OF FINANCE PEKING UNIVERSITY, BEIJING, CHINA

MR. PETTIS: Thanks very much for inviting me.

What I want to discuss with you is I think something that may seem a little bit counterintuitive and perhaps a little bit different from what you're hearing, but my reading of this is that China is extremely vulnerable, much more vulnerable to the contraction than many of us realize.

In fact, I think we've only begun to see the brunt of the adjustment, the cost of the adjustment take place, and I would argue that there's a very good opportunity here for the U.S. to work with China in not only helping resolve some of the imbalances that China has to adjust to, but putting in place the institutional framework that's likely to govern relations globally for the next several decades.

Last year and even this year, we saw an awful lot of articles come out with the title "Can China Save the World?" or "Can China Save the U.S.?"

I think that's exactly backwards. The question that we should ask is really can the U.S. save China because the adjustment that China has to go through is going to be brutal. In order to explain why I think that, let me step back a little bit and discuss what I think are the roots of the imbalance over the last decade.

After the 1997 crisis, which profoundly impacted policymakers in Asia, policymakers drew what I think may have been the wrong conclusion from the crisis, which, by the way, the history of financial crises is also the history of drawing the wrong conclusions from financial crises. The conclusion that they drew is that the cause of crisis is a currency mismatch or an external debt crisis, and therefore if you want to protect yourself from a crisis, what you do is make sure you don't have that external debt mismatch. So they constrained the amount of external borrowing and they ran policies systematically to create trade surpluses so as to build reserves.

That was the wrong lesson because the correct lesson, I think, is that balance sheet instability, balance sheet vulnerability, creates the possibility of crisis, and the currency mismatch is simply one way that that can happen.

Another way that that can happen, and if you look at the history of the United States, we had plenty of crises in the 19th century. We never had an external debt crisis or a currency crisis. What we had were overinvestment crises and domestic banking crises. And I think in the determination to protect themselves from 1997, they created what were the conditions for a very American-style, 19th century American style crisis.

And the way it worked is China engaged in a number of policies to run a trade surplus. The currency regime converts the trade surplus into monetary expansion. In other words, in order to determine the level of the renminbi, the Central Bank of China, the PBOC, basically has to guarantee to buy or sell unlimited amounts of dollars at that price.

Given the undervaluation and policies aimed at boosting production and constraining consumption, that meant that China was going to run a trade surplus which was going to be monetized by the PBOC.

Now, in China, the only functioning part of the financial system is the banking system. Basically the stock and bond markets are almost nonexistent. The banking system doesn't create credit to consumers. It creates credit almost exclusively to producers. So as China had a trade surplus which was monetized by the PBOC, which created credit in the banking system, which ended up going primarily to investment, thus boosting production much more rapidly than consumption. That meant since a trade surplus is simply production minus consumption, China's trade surplus was going to continue to grow.

In 2003, 2004, there was a big argument about whether the Chinese trade surplus had peaked out. Economists much smarter than me argued that for structural reasons it had peaked out and it would begin to decline. At the time the trade surplus was around five to $10 billion a month. Those of us who looked at it from a monetary point of view said, no, the trade surplus is going to continue to increase because China has locked itself into this cycle.

Even then, had you told me that the trade surplus would reach $40 billion in a single month, I would have said you're crazy; it's going up, but it's not going up to that level. But it did. And what happened is that in the United States, we had the mirror of that process taking place. The massive recycling of the U.S. trade deficit into the U.S. created a liquidity expansion.

I know it's very unfashionable to say that the crisis was not caused by the stupidity of bankers. Maybe it's because I'm a former banker, but I don't think it was caused by the stupidity of bankers. I think when you have a massive expansion in underlying liquidity, the financial system always accommodates by creating excess credit.

This happened in Japan in the 1980s. It happened in the United States in the 1970s with the petro-dollar recycling, but rather than that occur in the United States where regulatory framework constrained it, it simply moved offshore.

But what ended up happening was that in the U.S., liquidity expansion accommodated massive credit expansion to the consumer section. In China, we had the mirror of that. Liquidity expansion accommodated massive credit expansion to the producer section, and they were both equally foolish in the sense that both of them required for their sustainability that American households had infinite borrowing capacity.

If you assume that they didn't, then it had to end, and if it ended in one place, it would have to end in the other place.

And now we're in the process of the adjustment. Credit is no longer available for households who even if they had credit would probably be more interested in rebuilding the balance sheet.

If you think of a simplified model of the world consisting of the United States and China, the United States provides overconsumption into the world; China provides overproduction into the world. Those two things necessarily require each other.

And U.S. overconsumption is clearly coming down. That means that Chinese or more correctly non-U.S. overproduction must come down. In the case of China, it's not. In the case of China, the trade surplus continues to go up, which means most of the brunt of the adjustment is being born by other countries in Asia and other developing countries as well as the rest of China's trade partners.

Now, is that because China is engaged in predatory trading behavior? No. I don't think it is. China would genuinely like to bring things into balance. I think Chinese policymakers understand how vulnerable they are to a global contraction in demand. Remember that in the 1930s, it was the trade surplus countries that got destroyed by the collapse in trade, not the deficit countries.

The deficit countries did reasonably well, and I think we may see a repeat of that again. If we see a collapse in trade, it's the surplus countries that are must vulnerable to the breakdown in trade, and I think China is very aware of that. China is responding by trying to build demand.

But there's a difference between total demand and net demand, and I think that's where some of the policy mistakes may be being made in China. For example, take the massive expansion in credit in January. The increase in lending in January was equal to one-third of the total increase last year, which was already quite high.

The assumption is that that increase in lending which, by the way, is almost all directed to investments and production--very little of it is directed towards consumption--is aimed at boosting consumption indirectly, and the reasoning is quite straightforward. Every worker that you don't fire is a worker that is able to consume. So by putting money into the productive sector and to investments, you are keeping employment--I shouldn't say you're raising employment. You are raising unemployment at a slower rate, and that has a consumption impact.

But what the world needs from China is not an increase in consumption. What the world needs is an increase in net consumption. And to the extent that investment in infrastructure in manufacturing increases production faster than it increases consumption, what you're getting is that China is contributing not more net investment to the world but less net investment.

But again, I would insist it's not because the Chinese are behaving in a predatory way. It is because the development model they have and the structure of the financial system makes it very, very difficult for them in the short term to add to net demand to the world.

I think that the fact that that's occurring increases tensions around the world, and I think it's no big secret that protection talk is rising very dramatically. I think that could be extremely difficult for China were that to happen, and I think Chinese policymakers are very aware and very worried about the problem. The thing is they lack the tools to boost net demand.

I see that I'm over my time. The only other thing that I wanted to mention is that as part of their weakness--when we think about China, one of the things we keep hearing is that we have to be very careful because if the Chinese decided to stop buying U.S. Treasuries, we would have a very big problem.

I want to say that that argument is almost nonsensical for a bunch of reasons. First of all, they can't decide to stop buying U.S. Treasuries without destroying their economy, and secondly, the only reason they would stop buying U.S. Treasuries is because the U.S. trade deficit was contracting, and a contracting U.S. trade deficit is expansionary for the U.S. economy in the same way that fiscal expenditures would be expansionary.

So these things are not mutually exclusive. There is no tradeoff between Chinese investments in U.S. Treasuries and U.S. policy or Chinese domestic policy.

I'm way over my limit so I'll stop here.

[The statement follows:]

Prepared Statement of Michael Pettis, Professor of Finance, Peking University, Beijing, China

For the past ten years the global balance of payments has been dominated by the trade and investment relationship between China and the US. This relationship is now undergoing a major shift. Most large economies will be affected, and to the extent that their economic policies do not accommodate this shift, they are likely to fail, in much the same way that economic policy failed in the 1930s. The consequence for the world, and especially for China, could be terrible.

The US has an historic opportunity to assert leadership in shaping and influencing the global institutions that will dominate trade and capital flows for the foreseeable future. By ensuring ways to minimize the economic disruption to a China terrified of the potential political consequences of a worse-than-expected economy, it can ensure that Chinese concerns and priorities are embodied in these institutions and that China remains a committed member of the global system.

The process will not be easy. China's trade numbers for January, released last week, could not have been more dismal. After declining by 2.8% year on year in December, China's exports plummeted 17.5% in January. The sharp contraction in export places huge pressure on the country's manufacturing sector, and already unemployment in China is surging. Chinese import numbers are even more dismaying. After declining 21.3% in December, imports dropped a staggering 43.1% in January.

At first glance there seems to be a silver lining in the export numbers: they are not nearly as bad as those reported by other Asian countries. In December, for example, Taiwan's exports fell by 42%, South Korea's by 17%, and Japan's by 35%, capping many months of severe export contraction. Less developed Asian countries also performed in general much worse than did China. From that point of view it seems that China has increased its competitive edge over its trading rivals.

But it is precisely this relative out-performance that indicates the severity of the adjustment yet to take place. China's trade surplus for January was a mind-blowing $39.1 billion, just a smidgen under November's all-time high of $40.1 billion and edging out December's $39.0 billion for second place. In comparison, in the first half of 2008 China's average monthly trade surplus was an already-high $16.7 billion. In the second half it surged to $32.9 billion.

What does this mean? The world's consumers are experiencing a sharp contraction in demand which must be "shared out" among all of the world's producers. The decline in Chinese exports means that Chinese producers are absorbing part of that contraction, but the bigger decline in its imports means that Chinese consumers are contributing an even greater amount to the contraction in demand.

Is China a trade predator?

The net result is that non-Chinese producers must absorb more than 100% of the contraction in demand from non-Chinese consumers. That doesn't mean however that Chinese policymakers are knowingly engaging in predatory behavior. On the contrary, although they seem unable – some might say unwilling – to understand China's role in the global imbalance (much like the US failed to understand its role in 1930), they would nonetheless like nothing more than to see China increase consumption sharply. To that end they have unveiled a major fiscal stimulus package and forced banks to expand lending at a pace so rapid it will almost certainly lead to a future explosion in non-performing loans.

But it will take a long time before their efforts pay off. China's outdated development model, a banking system that has allocated capital very poorly, and its weak consumer base make it very difficult for China's fiscal stimulus to cause a rapid net increase in consumption.

Take the expansion in lending. The Chinese banking system over the past decade has been in some sense the mirror image of that of the US. Whereas American banks accommodated the massive expansion of liquidity of the past decade, whose roots are discussed later in this paper, by making imprudent and foolish loans to the consumer sector, Chinese banks responded to their own surge in liquidity by channeling equally foolish lending into overinvestment.

As part of the US adjustment to the imbalance of the past decade US banks are cutting off consumer lending as they contract, but Chinese banks are actually increasing their lending into the manufacturing and infrastructure sector. Many commentators hail this ability to force countercyclical lending as a good thing, and a huge policy advantage China has over the US, Europe and other economies with independent banking systems. But this may be a very mistaken view. Although the employment effect of this lending will naturally contribute to global demand if it takes workers off the unemployment line, the consequent increase in production may easily overwhelm it, so that China will continue to export huge amounts of overcapacity into a world struggling with collapsing demand.

This can easily lead to trade war. Already Asian countries from India to Indonesia are fending off Chinese exports and western economies from France to the US are veering towards protection. But trade war would be a far greater disaster for China than most realize. Many American policymakers – and, it seems, significant parts of Chinese policymaking establishment – do not fully appreciate the impact of the global crisis on Chinese economic prospects. Although official estimates put urban unemployment in China at just over 4% of the workforce, most unofficial estimates are much higher – closer to 8% – and nearly everyone agrees that the figure is set to rise significantly in the next few months. Some credible estimates suggest that even if China were able to achieve the 7.5% growth projected in 2009 by the World Bank, unemployment would nonetheless double before the end of the year.

Things will get worse. China's huge overcapacity problem has total production exceeding consumption by around 10% of GDP. In the past China has been able to export this excess, but with export markets in the US, Europe and elsewhere contracting so rapidly, it will be all but impossible for rising domestic demand to plug the gap. Trade war would make the problem much, much worse. In addition, collapsing corporate profits will put a sharp dent in new investment, nearly two-thirds of which has been funded, in the past, out of retained earnings. Exports and investment have been two of the biggest sources of Chinese growth, and the outlook for both is pretty poor.

China needs to achieve two major objectives. Domestically it needs to increase employment. Globally it needs to reduce the amount of overcapacity it is exporting into a world struggling with collapsing demand. But these two goals are at loggerheads in the short run. Within China policymakers have so far been unable – some would say unwilling – to recognize China's role in the global imbalance. Policymakers who see the crisis as part of a necessary transition towards a more consumer-led economy are ferociously opposed by policymakers who want to combat unemployment by accelerating the existing, and deeply flawed, development model. They seek to maintain an undervalued currency, repress wages, and shift credit and resources to manufacturers and other producers of additional capacity. All of this has the effect of increasing production and repressing consumption in a world which has too much of the former and not enough of the latter.

The US can help China, and the reformers within China. Rather than demand that China immediately reduce its rising export of overcapacity, the US should work with China to achieve a manageable balance over a four to five year period. Even this will be difficult for China, but it would be much better than a catastrophic adjustment. Threatening China with trade sanctions if it does not rapidly reduce the rising overcapacity it is forcing onto the rest of the world will not work. There is very little Chinese policymakers can do in the short run without causing a collapse in the export sector and a rise in unemployment so rapid that it could quickly lead to social instability.

The world must recognize that China can adjust, but it cannot adjust immediately. It will take several years to do so, and will require significant changes in both its financial system and in its development model. To that end major economies need to work out a plan, in which China is given a reasonable amount of time to make what will inevitably be a difficult transition. In exchange, Europe and other major markets must assure open markets to Chinese exports

The world, under US leadership, has a tremendous opportunity to help China through a difficult adjustment and, in so doing, create a favorable institutional framework that will govern trade and capital relations for decades to come. If not, the advantages trade deficit countries receive from pushing the full burden of adjustment onto trade surplus counties will be overwhelmed by a global environment of deep mistrust and hostility. This is not the time to attack China. China has a serious overcapacity problem that can best be worked out in global cooperation over four to five years. To demand a quick resolution will bring more problems than relief.

The roots of the global imbalance

China runs a massive trade surplus with the US and, in recycling this surplus, a correspondingly large capital account deficit. This recycling has been the main source of the global liquidity that has engulfed the world recently as well as a constraining factor in the global balance of payments. It is impossible for either country to adjust any part of the balance without a major counterbalancing adjustment from the other, but it is far from clear that policy-makers on either side, especially in China, have a clear grasp of the issue.

Other countries have played a role in this imbalance, of course, but with a few important exceptions (OPEC, for example) they have fallen broadly into two camps whose characteristics are typified either by China or the US. One set of countries, like the US, has had booming domestic consumption and high and rising trade deficits. Their highly sophisticated financial systems intermediated the surge in underlying liquidity into the consumer loans that permitted the consumption binge. The second set of countries, like China, have excessively high savings and domestic investment rates, resulting in a huge and rising surplus of production over consumption, the balance of which is exported abroad.

Until recently excess US demand and excess Chinese supply were in a temporarily stable balance. As part of running a trade surplus, China necessarily accumulated dollars, which had to be exported to (invested in) the US. This capital export did not occur in the form of private investment – indeed it was exacerbated by Chinese net imports of private capital – but rather as forced accumulation of foreign currency reserves, which were recycled back to the US largely in the form of purchases of US Treasuries and other US dollar assets by China’s central bank, the People’s Bank of China (PBoC). Since China had effectively pegged its currency, the PBoC had no choice but to accumulate reserves in this manner.

The recycling process also functioned as a great liquidity generator for the world, converting US consumption into Chinese savings, which were then recycled back into the US financial markets through PBoC purchases of highly liquid US securities. There are several self-reinforcing aspects to this system that pushed it to the extremes it ultimately took. In the US the torrent of inward-bound liquidity boosted real estate and stock market prices. As they surged, substantially raising the wealth of US households, these became increasingly willing to divert a rising share of their income to consumption. At the same time rising liquidity always forces financial institutions to adjust their balance sheets to accommodate money growth, and the most common way is to increase outstanding loans. With banks eager to lend, and households eager to monetize their assets in order to fund consumption, it was only a question of time before household borrowing ballooned.

Meanwhile in China, as foreign currency poured into the country via its trade surplus, the PBoC had to create local money with which to purchase the inflow. In China most new money creation ends up in banks, and banks primarily fund investment (consumer lending is a negligible part of bank lending). With investment surging, industrial production grew faster than consumption. A country's trade surplus is the gap between its production and its consumption, and as this gap grew, so did China's trade surplus, which resulted in even more foreign currency pouring into the country, thus reinforcing the cycle.

In this balance, sometimes dubbed Bretton Woods II, Chinese overcapacity was matched with American over-consumption, and Chinese official lending was matched with US household borrowing. This ensured that the current account flows were matched with the capital account flows. Of course any change in one of these accounts required equal and opposite changes elsewhere. This is a fundamental requirement of the global balance of payments – it must balance.

The great imbalance

Many analysts think of the US economy as the engine that drives the rest of the world, but this is not always true. Sometimes changes or distortions in one part of the world can force adjustments elsewhere, and as the world's largest and most open economy, with an astonishingly flexible financial system, it is often the US that absorbs adjustments originating elsewhere.

We see this most obviously in US trade figures. For most of last 60 years, with two exceptions, the US current account surplus or deficit has been within 1% of GDP. The first exception occurred in the mid-1980s when the deficit rose to nearly 3.5% of GDP in 1986-87 before declining sharply and running into a small surplus in 1990. The second began in 1994, around the time of the Mexican crisis, when the US current account deficit climbed to around 1.6% of GDP, declined for two years, and then took off in 1997-98, after which time it raced forward in straight line to peak at around 6% of GDP.

If the US trade deficit were driven simply by a US consumption binge, as is often claimed, it is hard to see why it would have followed a pattern of general stability over many decades marked by two surges – a small one from 1984-1988 and a very large one after 1997. If it was driven by changes in Asian savings and trade policies, this pattern becomes easier to understand. The 1980s surge was driven largely by domestic Japanese policies and conditions and is a fascinating case study in itself, but it is the post-1997 surge that is much more interesting and relevant to the current crisis.

1997 was, of course, the year in which several Asian countries experienced terrifying financial crises and viciously sharp economic contractions, profoundly impressing Asian policy-makers to this day. One of the main lessons policy-makers learned from the crisis was that too much dollar debt and not enough dollar reserves put a country at serious risk of a balance-sheet crisis. To protect themselves from a repeat of the disastrous 1997 crisis many Asian policymakers engineered trade surpluses and began amassing large foreign currency reserves by managing trade policy and the value of their currencies.

This resulted in what some have called a global capital flow "paradox" – the fact that in recent years developing countries have been large and growing net exporters of capital to rich countries. This is a paradox because, historically, capital-poor developing countries have generally been net importers of capital. Accumulating foreign currency reserves involves exporting capital, but for most of the last fifty years official capital exports, in the form of foreign currency reserve accumulation, were significantly less than net private capital imports.

In 1998 official capital exports among developing countries began to take off, and by 1999 exceeded net private capital imports. This is when the "paradox" begins. Since 1998 except for a small decline in 2001 net capital exports from developing countries surged almost in a straight line to around $700 billion annually (combining $1.2 trillion of reserve accumulation versus $0.5 trillion of net private inflows).

But the global balance of payments must balance. As Asian trade surpluses and net capital exports surged, some other part of the world had to equilibrate these adjustments by running large trade deficits and importing capital. The US did exactly this, and the US trade deficit soared after 1997 while at the same time US household savings collapsed.

Rebalancing act

This process was enabled by two related factors. First, the massive recycling of the US trade deficit into the US securities markets set the stage for the surge in real estate and stock market prices which, by raising the market value of accumulated US savings, encouraged households to consume increasingly larger shares of their income. Second, as financial institutions accommodated themselves to the surging liquidity, their response – as it has always been during every liquidity surge – was to expand credit rapidly. This included new lending to home-owners and consumers. As banks made nearly unconditional lending offers to American consumers, inevitably debt-financed consumption rose. US households took advantage of laughably easy lending conditions to engage, much too willingly, in the greatest, gaudiest spending spree in history.

Now, however, the party is over. The old balance of payments has finally broken down, and the world is lurching drunkenly to find a stable new balance. One necessary consequence of the financial crisis must be an increase in US household savings rates. Collapsing real estate and stock markets have caused household wealth to decline sharply, and households must save more than ever out of current income to replenish their wealth. But even if consumers wanted to continue spending, American commercial banks – caught in one of the worst credit crunches in recent history – are no longer willing to lend for consumption. The US household savings rate has nowhere to go but up.

By how much will US household savings increase? For most of the past sixty years until the early 1990s US household savings rates have varied between 6% and 10% of GDP, except for a brief period during the economic crisis of the 1970s when household savings went as high as 13% of GDP. In the early 1990s, the savings rate began declining slowly, and then virtually collapsed after 1997 when household savings fell to well under 2% of GDP.

Although we can't say for sure, it is probably safe to argue that US savings rates will climb back at least to earlier average levels, or even temporarily exceed those levels, as American households rebuild their shattered balance sheets. If they return only to 8%, the mid-point of earlier savings rates, this implies that US household savings must rise by some amount equal to 6% of US GDP, or, to put it another way, that all other things being equal, US household consumption must decline by at least that amount.

But since the balance of payments must balance, something must happen to equilibrate this decline in US household consumption. Either consumption in other sectors of the US economy – i.e. the government, since businesses are also contracting – must expand by that amount, or consumption by foreign countries, with China bearing the brunt, must expand by that amount (and foreign savings decline). To the extent that neither happens, global overproduction – which consists mainly of Chinese overproduction – must decline by that amount. This is just a way of saying that if net American consumption declines, either consumption must rise somewhere else, or production must fall.

In the best possible world Chinese consumption would rise by exactly the same amount as US consumption drops, and we would quickly reach a new stable balance, with one major difference: the US trade deficit would decline, and the amount of capital exported by China to the US would decline by exactly the same amount (the PBoC would accumulate fewer reserves). But if that doesn't happen, total global consumption must decline, and the world economy slow – in fact as it slows global income will decline with it, so that both savings and consumption could decline, trapping the world in a downward spiral of unstable adjustment.

By how much must Chinese consumption rise to prevent a global slowdown? Given that the US economy is about 3.3 times the size of China's, and consumption accounts for less than 50% of China's income, Chinese consumption will have to rise by nearly 40% (or roughly 19% of China's GDP) in order to accommodate an increase in US savings equal to 6% of US GDP. This is clearly unlikely. Of course there is more to the world than simply US household demand and Chinese government demand. There are several other factors that will affect the adjustment. Among the positive ones:

- US fiscal expansion will absorb some of the decline in US household demand.
- The Chinese trade surplus has been equal to about one-half to two-thirds of the US trade deficit, so in principle China should only absorb that share of the global adjustment, while other surplus countries, especially OPEC via lower commodity prices, absorb the balance.

Among the negative factors:

- Assuming a 6% increase in US household savings, to 8% of GDP, is probably conservative. Goldman Sachs predicts that household savings will rise to 10% of GDP.
- It is not just US households and the government that matter. US businesses affect demand too, and they are likely to contract, thereby increasing the total contraction in US demand.
- The world's major economies – Europe, and Japan – as well as many of the smaller economies – Latin America, Russia and Eastern Europe – are more likely to exacerbate global demand contraction, with several of them facing capital outflows (and hence a reversal of their trade deficits into surpluses, which adds to global overcapacity).

It's 1929 again

Although there are great differences between 1929 and 2008 that should not be papered over, the global payments imbalances that led up to the current crisis were nonetheless similar in many ways to the imbalances of the 1920s – with a few countries, dominated by one very large one, running massive current account surpluses and accumulating, in the process, rapidly growing central bank reserves. In the 1920s it was the US that played the role that China is playing today. The U.S. economy had been plagued in the 1920s with overcapacity caused by substantial increases in US labor productivity. This was a consequence of significant investment in the agricultural and industrial sectors and mass migration from the countryside to the city.

Although US capacity surged in the 1920s, domestic demand did not rise nearly as quickly. As a consequence the US ran large annual trade surpluses ranging from 1% to 3% of US GDP during the decade of the 1920s, or 0.4% of global GDP (China, although only 6% of world GDP, has run trade surpluses of roughly the same magnitude). These trade surpluses stayed high as long as domestic production grew more rapidly than domestic consumption. US overcapacity didn't matter when there was sufficient foreign demand. It could be exported, mostly to Europe, while foreign bond issues floated by foreign countries in New York permitted deficit countries to finance their net purchases.

But as the US continued investing in and increasing capacity, without increasing domestic demand quickly enough, it was inevitable that something eventually had to adjust. The financial crisis of 1929-31 was part of that adjustment process. When bond markets collapsed as part of the crash, bonds issued by foreign borrowers were among those that fell the most. This, of course, made it impossible for most foreign borrowers to continue raising money, and by effectively cutting off funding for the trade-deficit countries, it eliminated their ability to absorb excess US capacity.

The drop in foreign demand required a countervailing US adjustment. Either the US had to increase domestic consumption, or it had to cut back domestic production, but there was unfortunately more to the crisis than simply the drop in foreign demand. With the collapse of parts of the domestic US banking system, domestic private consumption also fell. The slack in demand should have been taken up by US fiscal expansion, but instead of expanding aggressively, as John Maynard Keynes demanded, President Roosevelt expanded cautiously. When the credit crunch came and the world was awash in American-made goods that no one was willing or able to buy, it was unreasonable, as Keynes argued bitterly, to expect the rest of the world to continue purchasing US goods, especially since the financing of their consumption had been interrupted.

Since US production exceeded US consumption, the need for demand creation, according to Keynes, most logically resided in the US. But the US had other ideas. In 1927 and 1928 there had already been unemployment pressures in the US, and the 1929 collapse in foreign and domestic demand exacerbated those pressures. This prompted US senators to respond in 1930 with the notorious Smoot-Hawley Tariff Act aimed at boosting demand for domestic production. They attempted, in other words, to create additional demand by diverting demand for foreign goods to US goods – basically attempting to export their overcapacity – and in so doing force the brunt of the adjustment onto their trading partners. Their trading partners, not surprisingly, retaliated by closing their own borders to trade, causing international trade to decline by nearly 70% in three years, thereby shifting the brunt of the adjustment back onto the US.

Without global trade each country had to adjust domestic supply to domestic demand. For countries with excess demand, this meant expanding production, whereas for countries with overcapacity, that could mean slashing production. There is an important lesson in here for us. In an overcapacity crisis, trade-surplus countries are likely to be more vulnerable to trade war than trade-deficit countries, because trade war implies an expansion of production in the latter and a contraction in the former. In the 1930s it was noteworthy that the trade-surplus countries suffered more deeply from the crisis than did trade-deficit countries once barriers to trade were imposed.

What would Keynes say?

The trade tariff made things worse not just because impediments to trade are costly to the global economy but rather because it set off a trade war in which other countries forced the US broadly into balance. In two years US merchandise exports declined 53% to $2.5 billion in 1931, while the trade surplus declined by 63% to under $400 million (US GDP was about $76 billion). US excess production over consumption had to be resolved largely within the US, and since much domestic investment had been aimed at the export sector, the collapse in exports brought a concomitant decline in domestic investment. That meant that either the US engineer a substantial increase in domestic demand by fiscal means, as Keynes demanded, or that it adjust via a drop in production and employment. It did the latter.

China today may be facing a similar problem. Today it is China who is exporting overcapacity and it is the US who is consuming too much, fed by Chinese financing. With the collapse of bank intermediation US households and businesses are cutting consumption and raising savings. This is a necessary adjustment. Most analysts, perhaps thinking they are echoing Keynes' analysis of the problem in the 1930s, call on the US government to engage in massive fiscal expansion to replace lost private demand. But this is not what Keynes would have recommended. If declining US private consumption is met with increasing public consumption, the world will simply continue playing the game that has already led into so much trouble. The only difference would be that instead of having one side of the global imbalance accommodated by *private* US over-consumption and rising debt, it would be accommodated by *public* US over-consumption and rising debt.

But like in the 1930s, if there is a drop in global demand, it is countries with too little demand, the trade-surplus countries, who will need to adjust more than countries with too much demand. Because of the importance of the export sector to domestic growth and employment, and because of the strong positive correlation between exports and domestic investment, if their exports drop quickly there may be significant political pressure for these countries to engineer moves to expand exports.

However since most of them lack large domestic markets, the result isn't likely to be direct import tariffs. What we are more likely to see is direct and indirect export subsidies and competitive devaluations. Already in Asian trade-surplus countries policy-makers are raising export rebates, providing cheaper financing to suffering exporters, restraining wage increases, and even engineering currency depreciation, all to strengthen their share of the declining export market, and all of this is happening even before the real impact of the global slowdown begins to appear.

If Keynes were around today he would probably make the same point he did over 70 years ago. Demand must be created by the trade-surplus countries who have, to date, relied on net exports to protect themselves from their overcapacity. They must force demand up quickly in order to close the gap, and since expecting private consumption to rise quickly enough is unrealistic, it has to be public consumption – a large fiscal deficit.

Smoot-Hawley with Chinese characteristics

But above all they should not try to grow their way out of overcapacity problem by reducing imports or increasing exports. Nor, amounting to the same thing, should they constrain consumption or boost production – by reducing interest rates, constraining wage increases, forcing corporate credit growth, or otherwise subsidizing producers. In 1930 the US foolishly tried to dump capacity abroad by creating import restrictions (which have the effect of expanding domestic production), but the furious, and hardly surprising, reaction of its trading partners caused the strategy to misfire and the US suddenly found itself forced to bear almost all of the adjustment on its own.

Might China and smaller Asian countries repeat the US mistake? Perhaps. China already seems to be in the process of engineering its own efforts to defend its ability to export overcapacity. Although there has been an attempt to boost fiscal spending, most analysts argue that this so far has been too feeble to matter much. On the other hand it has tried to protect and strengthen its export sector by lowering export taxes and reducing interest costs, which lower the financing cost for producers and have little impact on consumers.

This cannot work for long. The world clearly suffers from overcapacity, and as the US reduces demand and increases savings, which it must do, overcapacity will only rise. The proper place for new demand to originate is, as in the 1930s, in trade-surplus countries. They should be engaged in expanding demand, not expanding supply. If they try to export their way out of a slowdown, there will almost certainly be a trade backlash, as there was in the 1930s, in which case the full force of the adjustment will be borne by the trade-surplus countries, again as in the 1930s with the proviso that although China's trade surplus as a share of global GDP is comparable to the US trade surplus in the 1920s, China is a much smaller country, and so its trade surplus represents a much higher share of China's GDP.

The trade-deficit countries know that surplus countries must absorb most of the overcapacity adjustment, and as the world's economy contracts, their domestic tolerance for rising Asian trade surpluses, or even just a continuation of current trade surpluses, is likely to decline. In order to avoid trade friction the world's major economies must engineer a joint program of fiscal expansion, in which the trade-deficit countries expand moderately so as to slow down the adjustment period and to give maximum traction to fiscal expansion on the part of the trade-surplus countries.

But it is the surplus countries that must inevitably bear most of the burden for demand creation. Fiscal expansion on the part of the trade-deficit countries should occur with the clear understanding that it is a temporary measure aimed only at assisting the transition away from an over-reliance on exports to absorb capacity. The world will not support indefinitely continued debt-fueled overconsumption on the part of the US, whether this consumption takes place at the private or public level, and it cannot support continued growth in Chinese capacity without more rapid growth in Chinese consumption. To continue in this way almost certainly means little more than to postpone a larger and more difficult adjustment on the part of both countries, and will probably eventually lead to a collapse in international trade.

Given the relatively small size of its economy and the huge relative size of its trade sector, it is almost impossible for China to absorb its share of US demand adjustment without enormous and probably unacceptable social and political costs. In order to make the transition workable, it is necessary that China be given at least three or four years during which time it makes concerted efforts to boost domestic demand to the point where global imbalances are more manageable. But US (and European) demand contraction will not occur over a three or four year periods. It is occurring much more quickly at a shockingly rapid pace.

There is a real risk that the adjustment process in China will careen out of control. In order to manage this risk, US, European, Japanese and Chinese policy-makers must quickly come to a firm understanding of how significant the global adjustment is and how dangerous the process will be for China, and design a multi-year plan of demand expansion in which China is given time to adjust its overcapacity. If major economies focus only on domestic adjustment, China will almost certainly choose the path of defending its ability to export overcapacity onto the rest of the world, while the trade deficit countries will discover the expansionary impact of trade constraints. In that case it is hard to imagine how China and the world can avoid disaster.

HEARING COCHAIR WESSEL: Thank you.

Dr. Prasad.

STATEMENT OF DR. ESWAR S. PRASAD PROFESSOR OF TRADE POLICY, CORNELL UNIVERSITY, ITHACA, NEW YORK

DR. PRASAD: Chairman Bartholomew, Mr. Wessel and other commissioners, thank you for giving me the opportunity to testify.

My view is that China and the U.S. are locked in an awkward embrace, but one that is likely to tighten over time, much to the displeasure of both parties.

There are different facets to this relationship. One, of course, is trade volumes which have been increasing enormously in the last few years with total trade reaching over $400 billion. Of course, this has resulted in a very large U.S. trade deficit with China.

The financial flows have also increased, but in a very lopsided way. U.S. foreign direct investment to China has fallen to rather low levels, in the few handfuls of billions of dollars, whereas Chinese official purchases of U.S. Treasury bonds have increased a great deal.

China now holds an identified $700 billion worth of U.S. Treasury instruments and another $300 billion or so worth of agency bonds, and almost surely, those are underestimates. These are based on official data from the U.S. Treasury, and we know that these are probably an undercount for a variety of reasons, but even if you look at those official data, just in the last year of the total of about $400 billion of reserves the Chinese accumulated, they put about $200 billion in U.S. Treasuries, and again the reality is probably more, and I concur with my colleagues that it's not obvious where else the Chinese would go for safety and liquidity.

The other issue coloring the relationship between the two countries, of course, relates to the exchange rate, and here I think the focus very often tends to be on the bilateral trade balance and the level of the renminbi, and I think ultimately what we need to think about, and I'll come back to this theme at the end of my discussion, is where the renminbi or the Chinese currency policy fits into Chinese growth both in terms of its sustainability and in terms of its balance, and I think currency flexibility is really the key notion here.

The problem, of course, is that given that much of the debate tends to focus on the bilateral trade deficit and the bilateral exchange rate, it ends up resulting in protectionist actions, not just by the Chinese in implicit and explicit forms, but as we see recently in the U.S. as well, and that is a threat that we need to be very cautious about.

Now much of this action has taken place on the global stage, and although we tend to focus on the bilateral balances, what really matters would be the multilateral balances of the U.S. in terms of its current account deficit, and China in terms of its current account surplus.

But the relationship between these two countries really colors what happens in the global stage. We have seen where global imbalances have led us. There is a vigorous ongoing debate about whether global imbalances were the proximate cause of the crisis or just another thing that added fuel to the flames.

My view is the latter, that there were problems in the U.S. financial system, and these were clearly exacerbated, and rather than there simply being a bubble that would have popped with the internal adjustment mechanisms, the existence of global imbalances and the need for China to use these imbalances to grow essentially created a much more destructive outcome.

Now what is the prognosis and how are the dynamics in each of these countries going to play out in terms of where we will end up in terms of global imbalances? My view, in fact, is that in the short term, if anything, these global imbalances are going to worsen because of conditions in both countries, the U.S. and China.

In the U.S., as Dr. Lardy mentioned this morning, the net national saving rate has fallen and even though the private saving rate is going up, with our stimulus package, it's almost a certainty that the overall saving rate is going to remain low or decline so there will be a large current account deficit to be financed.

On the other side, China is, again, as we've heard from my colleagues, going through its own growth contraction. They have the room, thanks to their virtue in recent years of creating a lot of fiscal space, where they can actually move very aggressively in terms of fiscal policy, and of course, unlike the U.S., although that's changing these days, they do own the banks. That may change in the U.S. fairly soon.

But as of now, what the Chinese can do is get the banks to lend and they are forcing the banks essentially to push money out the door.

The problem is that they are pushing on a string in a variety of ways. They can get the overall economy perhaps to be in not as bad as shape as it would be otherwise in the absence of these measures, but it comes at a very heavy cost.

As Mr. Pettis mentioned, they've been trying very hard to rebalance growth away from an investment-led economy and an export-led economy towards one where private consumption and the welfare of Chinese households is commensurate with the level of economic growth that they have seen.

This stimulus package if anything is going to worsen that imbalance; it's largely being pushed towards investment and in addition they need the exports. Now why do they need the exports if they have so much room on fiscal policy? The problem is that even if they can get investment going, the Chinese face a conundrum in the sense that they do not have employment growth that comes anywhere close to their rate of GDP growth.

In the last decade or so, they've had about ten percent GDP growth on average with about one percent employment growth to boot. And much of that, in fact, has been coming from the export-oriented private sector so they need the exports to keep the jobs going, and this is where one can see tensions clearly arising in terms of why they need the exports in order to maintain social and economic stability.

In addition, they cannot really get the households to consume quite so easily because they do not have a well-developed financial system that allows households to smooth income, borrow against their future income and so on. So in that sense the Chinese do rely on the rest of the world, and at the moment, the rest of the world seems to be largely the U.S.

So, in that sense, the Chinese and U.S. growth prospects are going to feed into much greater global macroeconomic imbalances.

Is there a way out? Although Mr. Scissors dismissed the idea of a grand bargain, I think, in fact, there is a very strong case to be made for a grand bargain, and a grand bargain that actually allows these two countries to do things that are in their own interest but provides a great deal of domestic political cover for them to do so.

And, of course, the Chinese in some sense need this domestic political cover even more than the U.S. does.

So what are the elements here? I would identify three. The first is for both countries to essentially confirm jointly that they will continue to engage in whatever it takes, monetary and fiscal stimulus without relying on exports, in order to boost their economies.

This is nothing new and these economies are doing it already, but I think having them announce it jointly and show that this is not going to be a contentious relationship would be very helpful.

The second is for China to make a movement, a commitment to move towards more currency flexibility. Ultimately, I think currency flexibility is important in terms of China moving forward, in terms of rebalancing growth, and in terms of moving forward with its financial system reforms. Doing it without currency flexibility and an independent monetary policy is making a difficult task that much harder.

And these are priorities that they themselves have. On the flip side, I think the U.S. needs to commit in the medium term towards bringing its deficit under control. In the short term, clearly this is not a priority. We need all the stimulus we can get, but in the medium term I think there needs to be a clear plan because otherwise it's going to create instability in the world economy.

And the third part of the grand bargain is for the U.S. to actively engage China in terms of giving it an expanded leadership role or at least a greater presence in international institutions such as the International Monetary Fund and the Financial Stability Forum.

These are going to happen anyway. China will eventually have a much greater role here, but the U.S. could really show some true leadership by essentially moving that process forward and showing that it can accept China as an equal partner, and this I think will be very important symbolically in terms of the Chinese being able to take home to their constituents, their citizens, that while they may be giving up something in terms of allowing the currency to become more flexible, they will be able to attain their own priorities and in addition get the respect and recognition on the world stage that they deserve.

So ultimately I think this will not only help in terms of the U.S.-

China relations and in terms of improving both the short-term and long-term prospects for these countries, but it could also have the added benefit of providing a certain degree of boost to global confidence that these two economies won't muck it up.

Thanks.

[The statement follows:]

Prepared Statement of Dr. Eswar S. Prasad
Professor of Trade Policy, Cornell University, Ithaca, New York

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

HEARING ON "CHINA'S ROLE IN THE ORIGINS OF AND RESPONSE TO THE GLOBAL RECESSION"

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The Effect of the Crisis on the U.S.-China Economic Relationship

Eswar S. Prasad

Tolani Senior Professor of Trade Policy, Cornell University
Senior Fellow, Brookings Institution

Chairman Bartholomew and honorable members of the Commission, thank you for the opportunity to share with you my views on the timely and important topic of China's role in the international financial crisis and its implications for the U.S.-China economic relationship.

The U.S. and China are two of the dominant economies in the world today and the nature of their relationship has far-reaching implications for the smooth functioning of the global trade and financial systems. These two economies are becoming increasingly integrated with each other through the flows of goods, financial capital and people. These rising linkages of course now stretch far beyond just trade and finance, to a variety of geopolitical and global security issues. Getting this relationship right is therefore of considerable importance.

The global financial crisis has brought this relationship under the spotlight of international attention. Indeed, the U.S. and China together epitomize the sources and dangers of global macroeconomic imbalances. U.S. regulatory and macroeconomic policies may well bear a lion's share of the blame for the current crisis. But there is a deep irony in the fact that Chinese virtue—its high national saving rate—and its policy of tightly managing the external value of its currency abetted U.S. profligacy by providing cheap goods and cheap financing for those goods, setting the stage for a cataclysmic crisis rather than a bubble. The consequences of those policies are now rebounding on the Chinese economy itself.

Paradoxically, the crisis is likely to intensify the embrace between the two economies. In the short run, China needs export growth in order to maintain job growth and preserve social stability. As China continues to run current account surpluses by exporting to the U.S. and other advanced country markets, it has little alternative to buying U.S. treasuries with the reserves it accumulates while managing its exchange rate. The U.S. needs willing buyers for the treasuries issued to finance its budget deficit, which is certain to increase due to bailout and fiscal stimulus operations.

There are certain unhealthy relationship facets of this relationship that have generated tensions between the two economies, with each of the partners seeing the other as benefiting disproportionately. Indeed, these tensions are likely to intensify at this time of worldwide economic distress, with financial markets and economic activity around the world crumbling and economies increasingly hunkering down to protect and insulate themselves as the aftershocks of the crisis reverberate around the globe.

On the economic front, China's exchange rate policy has become a flashpoint for these tensions between the two countries. With the U.S. trade deficit and, in particular, the bilateral trade deficit with China swelling in recent years, China's tightly managed exchange rate regime has come under increasing scrutiny. China's rising overall trade surplus and its rapid accumulation of foreign exchange reserves have revived accusations of currency manipulation. There have been calls by U.S. legislators for imposing large tariffs on U.S. imports from China or taking other retaliatory measures if there isn't rapid progress on exchange rate reform. Meanwhile, the U.S. is falling prey to its own protectionist tendencies. The "Buy American" clause in the stimulus bill, which will impact imports from China and other emerging market countries, will be seen by China as a harbinger of rising trade tensions.

A confrontational approach and a rattling of sabers by both sides will almost certainly be counterproductive. This would poison the U.S-China relationship in a manner that could have deleterious long-term consequences on many fronts. Furthermore, this approach is unlikely to have a large or lasting impact on problems such as the U.S. trade deficit or imbalances in the Chinese economy, and could make matters worse for everyone by creating instability in the global economy.

There is a great deal of commonality of economic interests between the two countries and it is these shared interests that should be the basis for a mutually beneficial economic relationship.

In my testimony, I will lay out the key facets of this complicated bilateral relationship, present my prognosis for how this relationship is likely to evolve, and then discuss how I believe progress could be made in terms of finding common ground between the two economies.

Trade and Financial Linkages between the U.S. and China

Trade between the two economies has continued to increase in volume and the U.S. remains one of China's major export markets. Chinese exports to the U.S. rose from $100 billion in 2000 to $338 billion in 2008, while imports rose from $16 billion to $71 billion. Interestingly, however, the share of China's exports going to the U.S. has actually declined over time, from about 22 percent in 2000 to 19 percent in 2007, roughly the same share as that of the European Union.[5] China's bilateral trade surplus with the U.S. has risen from about $84 billion in 2000 to nearly $266 billion in 2008 (about 1.9 percent of U.S. GDP).

Financial flows between the two economies have increased but also become more lopsided over time, with bilateral foreign direct investment (FDI) flows from the U.S. to China declining from $5.4 billion in 2002 to $2.7 billion in 2007 (this accounts for only about 3 percent of China's gross FDI inflows of $84 billion in 2007). FDI constitutes the principal category of inflows into China as many other types of private capital flows, especially portfolio equity investment, have been restricted until recently (many of these restrictions are now gradually being lifted).

In sharp contrast to declining FDI flows from the U.S. to China, official flows from China to the U.S. have surged in recent years. This largely reflects Chinese central bank purchases of U.S. treasury bonds and, until the middle of 2008, agency bonds (including those of Fannie Mae and Freddie Mac). Although precise numbers are difficult to come by, estimates based on the U.S. Treasury's International Capital System (TIC) data suggest that Chinese holdings of U.S. treasury securities amounted to about $700 billion

[5] These numbers are based on the IMF's Direction of Trade Statistics. When one considers combined trade volumes for Mainland China and Hong Kong, the U.S. accounted for about 23 percent of total exports in 2007, down from about 30 percent in 2000.

at the end of 2008.[6] During 2008, about half of China's total reserve accumulation of $400 billion went towards net purchases of U.S. treasury bills and bonds.

What happens to the size and nature of the linkages between the U.S. and Chinese economies will depend on the depth and length of the downturn. It will also be influenced by the nature of the measures taken by these economies to pull themselves out of the slump. Above all, however, there is one issue that seems to dominate the bilateral relationship and color various aspects of their engagement, and will continue to do so in the near future.

The Exchange Rate Issue

Much of the discussion about the U.S.-China economic relationship tends to get framed in terms of the currency issue and the bilateral trade balance between the two countries. China is accused of using protectionist policies by maintaining an undervalued exchange rate to boost its competitive advantage in international markets. The fact that China has allowed its exchange rate to appreciate by about 21 percent relative to the U.S. dollar since July 2005 takes some of the wind out of this argument. Of course, the fact that China continued to accumulate foreign exchange reserves at a rapid rate even after mid-2005 indicates continued intervention by China's central bank in the foreign exchange market. Senior IMF officials have also recently noted that the renminbi (also known as the yuan) remains substantially undervalued

While the exchange rate is a visible symbol of Chinese policies towards trade, there are in fact more subtle forms of protectionism that remain pervasive. For instance, through its repressed financial system that mainly consists of state-owned banks, China provides cheap capital to many of its enterprises. Subsidies to land and energy have also held down the effective cost of factors of production that are complementary to physical capital. These subsidies clearly give Chinese manufacturers a substantial cost advantage that translates into greater competitiveness in international markets. Here the U.S. is clearly not in a position to take the high road, now just having introduced massive state subsidies into its own financial system and auto industry.

The broader point is that the debate about China's currency is far too often framed in a narrow way that misses the broader context. What is essential for China is to have an independent monetary policy oriented to domestic objectives such as low inflation and

[6] The TIC data probably understate the actual stock of Chinese holdings, particularly since purchases of U.S. financial assets that are routed through financial institutions in third countries are recorded as originating in those countries. Analysts believe that the actual stock of Chinese holdings of U.S. treasury instruments is likely to be about $150-200 billion higher than the reported number. For example, see Brad Setser and Arpana Pandey, 2009, "China's $1.7 Trillion Bet," Council on Foreign Relations Working Paper.

stable growth. Flexibility of the currency is an essential prerequisite for this rather than an objective in itself. Giving the Chinese central bank room to raise or lower interest rates by freeing it from having to target a particular exchange rate would help rein in credit growth and deter reckless investment, reducing the risk of boom-bust cycles. An important point here is that an independent monetary policy requires a flexible exchange rate, not just a one-shot change in the value of the currency or even a managed "crawl" in which the exchange rate is allowed to appreciate gradually.

Independent monetary policy, in turn, is essential for financial sector reforms. Using market instruments such as interest rate policy, rather than government directives, to guide credit expansion is essential to train state-owned banks to respond to market signals and become more robust financial institutions. In the absence of such instruments, the central bank has to revert to its old practice of telling banks how much to lend and to whom, which hardly gives banks the right incentives to assess and price risk carefully in their loan portfolios and to behave like commercial entities. Moreover, maintenance of the fixed exchange rate over a prolonged period has been abetted by financial repression, which is another hidden but substantial cost of the managed exchange rate.[7] Giving state-owned banks little choice but to purchase central bank bonds makes it much easier for the central bank to "sterilize" its intervention in foreign exchange markets and thereby maintain control of the domestic money supply to some extent.

In other words, focusing on the currency's level per se tends to obscure much deeper issues in terms of China's growth model and its consequences for the bilateral relationship. How the trade relationship between these two large economies evolves has the potential to set the tone for broader negotiations on countries' policies towards international trade.

Before considering the bilateral relationship in greater detail, however, it is useful to put this relationship into a global context. To do this, I now turn to the question of whether the U.S.-China relationship may have played a role in fomenting the worldwide financial crisis, as some observers have argued.

Global Macroeconomic Imbalances

There is a vigorous ongoing debate about whether global macroeconomic imbalances were the proximate cause of the global financial crisis. The narrative goes as follows. These imbalances have been characterized by large current account deficits in the U.S. and a few other advanced industrial countries, with these deficits financed by excess savings in China and many other emerging market economies. These excess savings in

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[7] Lardy estimates that the cost of financial repression, as reflected in the low or negative real rates of return on bank deposits, is borne by households and could be as high as 4 percent of GDP. See Nicholas Lardy, 2008, "Financial Repression in China," Peterson Institute Policy Brief 08-8.

Asian and other emerging markets and the bloated revenues of oil-exporting countries were recycled into the U.S. financial markets since the surplus countries did not have well-developed financial markets for intermediating these savings into productive domestic investments. The inflows resulted in a prolonged period of low interest rates in the U.S., creating incentives for aggressive search for yields by U.S. financial institutions and blocking self-correcting mechanisms such as rising interest rates that would normally have resulted from higher government borrowing and a low private saving rate.

Whatever one’s view about the centrality of these imbalances versus problems in the U.S. financial system in triggering the crisis, there is no doubt that global imbalances allowed problems in the U.S. financial system to fester and end in a cataclysm. More importantly, the underlying policies that generated those imbalances were clearly not in the long-term interests of the countries concerned themselves. A looming problem is that these imbalances could actually worsen over the short term, perpetuating macroeconomic problems in the main economies and possibly setting the stage for the global economy to take another tumble in the future.

Indeed, there is a rich set of ironies in the way the crisis has played out. First, the global macro imbalances are not unraveling in the way that most economists had expected. Rather than adjusting via a decline in the external value of the dollar, the U.S. current account deficit may apparently adjust with just a massive contraction in private consumption.[8] Second, the U.S., which has been at the epicenter of the crisis, has become the ultimate financial safe haven, with the flight to quality around the world turning into a flight to U.S. treasury bonds. Third, and most worryingly, the rest of the world still seems to be counting on the U.S. as a demander of last resort. Fourth, all signs are that the global crisis may lead to emerging markets rethinking old notions of reserve adequacy and consider building up even larger stocks of reserves.

In short, as the world economy pulls out of the crisis, the imbalances that created much of the problem could intensify rather than dissipate. This is why the solutions need to be global as well. Moreover, while much has been said about how to redesign financial regulation, this has to be supported by a clear focus on macroeconomic policies.

[8] One cannot be too sanguine about the continued strength of the U.S. dollar, however, especially given the prognosis for the U.S. economy and its high levels of public deficits and debt.

Prognosis

Before peering into the future, it is worth analyzing China's growth model in some detail for clues about how the effects of the global recession and eventual recovery might play out in its case. China's economy has maintained robust GDP growth in the range of 8-10 percent per annum for nearly a decade now, with the pace of growth even picking up by a couple of percentage points on average during 2003-07. The picture for 2009 is of course different as even China is not proving immune to the global crisis. Even before 2009, during the high-growth years, there were certain features of the Chinese growth model that are worth noting.[9] First, investment has accounted for more than half of overall GDP growth, with net exports playing an important role as well since 2005. Private consumption, by contrast, has not been a key driver of growth. Second, even high GDP growth has not translated into much employment growth, with overall employment growth averaging only about 1 percent over the last decade.[10]

Thus, the Chinese government faces the twin challenges of rebalancing growth towards domestic consumption in order to make growth more welfare-enhancing for its citizens and of generating higher employment growth in order to maintain social stability. These challenges have of course taken on added urgency in light of the global recession.

To combat the effects of the slowdown, the Chinese government recently announced an aggressive fiscal stimulus. The net effect of this package in terms of new spending is likely to be on the order of 4-5 percent of GDP, much smaller than the headline number that was announced (about 16 percent of GDP) but still quite impressive. Much of this expenditure will go towards investment projects and partly towards strengthening the social safety net. It is a package that tries to blend together short-term stimulus with longer-term objectives of developing infrastructure in underdeveloped parts of the country (particularly the provinces in the west) and boosting consumption.

However, Chinese household savings have been on a trend increase in recent years and the economic uncertainty is likely to increase saving for precautionary purposes.[11] Thus, the fiscal stimulus could end up actually worsening the balance of growth by tilting it even more towards growth led by investment and exports rather than private consumption. The reliance on exports is, as noted earlier, because it is a key source of job growth.

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[9] For more details, see Eswar Prasad, 2009, "Is China's Growth Miracle Built to Last?" forthcoming in *China Economic Review*. Available at http://prasad.aem.cornell.edu
[10] The annual growth rate of non-agricultural employment has averaged around 2.5 percent during this period, although this has to be set against the growth rate of non-agricultural output, which has been 2-3 percentage points higher than that of overall GDP.
[11] See Marcos Chamon and Eswar Prasad, 2008, "Why Are Saving Rates of Urban Households in China Rising?" Brookings Institution: Global Economy and Development Working Paper No. 31. Forthcoming in *American Economic Journal: Macroeconomics.*

Even if China continues to rely on exports for growth, the recession and the rebuilding of household balance sheets in the U.S. implies that Chinese exports to the U.S. will almost certainly decline during 2009. Thus, the overall volume of trade between the two economies is likely to fall in tandem with the sharp fall in global trade. The U.S. bilateral trade deficit with China could still remain in the range of about $200 billion in 2009, especially if the U.S. fiscal stimulus generates a gradual recovery in U.S. domestic demand. China's overall current account balance, which is estimated to be about $370 billion (roughly 9 percent of GDP) in 2008, could well remain in the $300-350 billion range; the recent collapse in exports has been offset by an even sharper decline in imports.

What are the implications for financial flows between the two countries? This will of course depend on whether capital outflows in 2009 offset part of China's current account surplus and how aggressively China needs to intervene in foreign exchange markets to keep the renminbi from appreciating. Even with modest capital outflows and a significant fall in the current account surplus, it is highly likely that China will continue accumulating foreign exchange reserves in 2009, although at a substantially reduced pace than in previous years.

Ironically, given the turmoil in world financial markets and the dearth of safe and liquid financial instruments, China's reliance on U.S. treasuries to park its accumulation of foreign exchange reserves is likely to intensify. During September to November 2008, the latest three-month period for which data are currently available from the U.S. Treasury, Chinese purchases of U.S. treasury bills and bonds amounted to nearly $123 billion—this at a time when U.S. financial markets were in deep turmoil. The continued flow of Chinese money into U.S. treasuries is of course rather convenient for the U.S. at a time when it faces the prospect of having to finance a massive budget deficit.

Clearly, the bilateral relationship between these two economies is complex and they cannot easily disentangle themselves from the close but awkward embrace that they are locked in. The question is how to make this a more productive relationship that is driven by cooperation rather than conflict.

A Grand Bargain

I have recently proposed a grand bargain between the two countries that would cover two areas--macroeconomic policies and international economic affairs.[12] None of the elements is particularly novel, but rolling them into a package that Chinese and U.S. leaders could jointly sign on to would provide domestic political cover for both sides to implement policies that are ultimately in their own interests. A joint announcement of

[12] See "The U.S. and China: A Grand Bargain?" FT.com, February 2009. http://blogs.ft.com/economistsforum/2009/01/the-us-and-china-a-grand-bargain/

cooperative actions would also give a sorely needed fillip to economic confidence around the world.

The grand bargain would have the following elements:

- *The two countries commit to using fiscal and monetary policy to the best extent possible to stimulate domestic demand in their own economies in the short run.* This is to reaffirm their resolve to follow through and deliver on their stimulus packages, increase the quantum of stimulus measures rapidly if the economic situation deteriorates further, and for China to signal that it will not count on exports to keep its economy and job growth from stalling.

- *The Chinese allow their currency to become more flexible and responsive to market forces while the U.S. articulates a plan that commits it to taming its budget deficit once the economy begins to recover.* This is an opportune time for China to allow more flexibility in its currency, as the pressures are evenly balanced and there is unlikely to be a sharp appreciation in the short run. But greater currency flexibility could have considerable long-term benefits for China by allowing its monetary policy to become more independent, reducing its dependence on exports and rebalancing its economy towards domestic consumption.[13] It would also ease pressure on the Chinese to revalue their currency by a large amount at one step.

  The U.S. will eventually need to tackle its mammoth budget deficit and rising public debt, which have contributed to its current account deficit and dependence on funds flowing in from the rest of the world. A clearer commitment right now to bring the deficit down over a reasonable period after the economy gets back on its feet would reassure financial markets that U.S. government borrowing won't be allowed to get out of control and exacerbate global macroeconomic imbalances in the future.

- *The U.S. supports an expanded role for China in multilateral financial institutions*, including significantly greater voting rights at the IMF and membership in the Financial Stability Forum. These are logical—indeed, necessary—steps to make these institutions more inclusive and effective in dealing with the many global challenges that lie ahead. They are also strongly desired by China, which feels that its role in such institutions is well beneath its true economic stature. While greater Chinese influence in international economic affairs is inevitable, the U.S. has some leverage as its prominent role in

[13] See "Exchange Rate Flexibility in China: Why it Really Matters and How to Make Progress" Eswar Prasad's testimony at the Senate Finance Committee hearing on "The Role of Currency in the U.S.-China Relationship" March 28, 2007. Available at http://prasad.aem.cornell.edu

multilateral institutions means that it is in a position to speed up this realignment. Tying this issue into the grand bargain would allow China to assume its rightful place on the world stage soon.

With these steps, the U.S. could show that it is willing to enter into a genuine economic partnership with China that can benefit both sides and also demonstrate true leadership by accepting China's expanded role on the global stage. The Chinese could reaffirm to their restive citizens their commitment to restoring growth and jobs, and also be seen as getting the respect they deserve as a world power while doing their bit for global economic and financial stability. The political leadership on both sides has to step up to get beyond nationalistic sentiments and convince their people that, in this interconnected world, China and the U.S. will sink or swim together.

The Way Forward

Continued high-level engagement between the two economies on economic affairs should be an important priority for the new U.S. administration. The Strategic Economic Dialogue can be a useful device to nurture this relationship. Maintaining this avenue for high-level dialogues can help in building trust and a deeper awareness of political and other constraints that may be driving economic decisions on both sides. Both countries have complex internal political dynamics that are difficult for outsiders to comprehend. Even in China, there are different locuses of power that are often at odds on matters of economic policy. Influencing the right people in both countries and helping them to influence others is as much a part of changing policy as is the substance of the message.

External pressure can play a helpful role in this reform process, but only if it is placed in the right context. For instance, the debate in the U.S. about the Chinese exchange rate regime has been distorted in some ways and made political rather than substantive by placing it in the narrow context of the U.S.-China trade balance. There is an important strategic (and educational) element related to reframing the exchange rate issue in a broader context, especially by relating it to more independent monetary policy and more effective financial sector reforms. This is where external pressure from the international community can be helpful, not in the form of threats but by reorienting the discussion in a fashion that brings into sharper focus the linkages between currency reform and other core reforms on which there is broad consensus within China.[14]

Ultimately, as far as Chinese reforms are concerned, there is a set of shared interests between policymakers in China and the U.S. For it is deep and enduring reforms that promote sustained and balanced growth in China that are in the best interests not just of China itself but also the U.S. and the world economy.

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[14] Eswar Prasad and Raghuram Rajan, 2006, "Modernizing China's Growth Paradigm," *American Economic Review*, Vol. 96, No. 2, pp. 331-36.

Panel III: Discussion, Questions and Answers

HEARING COCHAIR WESSEL: Thank you. Thank you all.

First question to Vice Chairman Wortzel.

VICE CHAIRMAN WORTZEL: I appreciate all of you being here. I have a question for each of you and I will move through them very quickly.

Dr. Scissors, I looked at your January 2009 Heritage paper, and one of the things you recommend is better access to China's sheltered industries for foreign companies. The simple question is what policy or legislative measures would you recommend here in the U.S. that would help improve that access?

And I'll just move on and then you can answer if that's all right.

DR. SCISSORS: Sure.

VICE CHAIRMAN WORTZEL: Mr. Pettis, I looked at your written testimony submission, and in your last paragraph, it says:

"There is a real risk that the adjustment process in China will careen out of control."

I don't know what that means. Does it spin off the globe and end up in Europe, or does that mean domestic instability? Does that mean a reversion to nationalism? So I'd like to just get a few words out of you on that.

Finally, Dr. Prasad, you argue that China has got to stimulate domestic demand. However, the last two panels said that is not going to happen for three or four years at least. What does this delay mean?

Second, how can you be an equal partner and permit more access to International Monetary Fund or organizations for China when it is still have a country that refuses to permit its currency to be a convertible international currency?

So I guess we can take them in that order.

DR. SCISSORS: I'll go first. Obviously it's a very difficult thing. We've been trying for ten years, in the early WTO accession talks, to open up Chinese industry. This is one of the reasons why Eswar and I disagree on the grand bargain, that our negotiations with China have from the American perspective often been completely fruitless to the point where the SED comes back and says, oh, look, we agreed to keep talking; isn't that a wonderful success?

That makes me very skeptical of actually being able to achieve a grand bargain. A nice step in that direction would be something along the lines of better access for U.S. firms, and I don't have a magical solution. I do think that reciprocity, an offer of reciprocity from United States, has more power than it did because ten years ago when we said, we'll let you invest in our firms, the Chinese would have looked at us and said with what?

Now, they have a lot of money to invest. They've had interest in American firms that we've blocked. I do not at all mean to suggest we can just say we'll offer reciprocal investment access and everything will be fine. There are problems on the Chinese side with state ownership of firms and how that's treated. There are problems on the American side that we haven't actually allowed large Chinese investments in the U.S., and we don't know what the reaction will be politically.

But that's a step in the right direction. The principle of reciprocity, which would not have worked ten years ago, now has more lure for the Chinese because they have money they want to spend. They'd rather not spend it all on Treasuries, as Eswar pointed out, $200 billion in the last year. And they would like to have access to American industry.

So there's a trade that can be struck there, an imperfect trade, that couldn't have been struck ten years ago.

MR. PETTIS: This is an open forum so please forgive me if my answer is a little bit fuzzy. There are some things I'm not that excited about talking about. But let me explain what I mean by "careening out of control." I think it's very interesting to think about China in many ways as having been similar to the United States in the 1920s. In one fundamental way, they were very, very similar.

The United States saw during the 1920s a number of processes including massive migration from the countryside to the cityside and huge investment in productivity which resulted in an explosion in productive capacity.

Consumption wasn't growing nearly as quickly and so the United States ran a trade surplus. It was the largest trade surplus country at the time, possibly in history, during which time, of course, it also generated the largest reserves ever seen before in history.

The trade surplus for the United States at the time was about .4 percent of global GDP, a very significant number, a very large number. In 1929, already we started seeing a contraction in the U.S. economy in rising unemployment. The crisis of 1929 had a very important impact both on domestic financing--it became very difficult for domestic institutions to finance themselves including for consumption--but also external financing.

Foreign countries borrowed money in the New York bond markets in order to finance their trade deficits with the United States and the collapse of the bond markets eliminated the ability of foreign countries to run trade deficits.

So global trade was contracting, and the United States being in a particularly difficult position had to resolve it somehow. The U.S. resolution was very elegant and very simple. One of the things that we can do is to divert domestic demand for foreign products to domestic products. We have an overcapacity problem. The more we boost demand, the better off we are, and they did so by raising tariffs, Smoot-Hawley.

It would have been a great strategy had the rest of the world not cared. Clearly, the rest of the world did care and the consequence was a collapse in world trade. World trade was down by 70 percent over the next three years. Why was that so important? Not for many of the reasons that we think of a reduction in global trade hurts the global economy for a variety of efficiency reasons, but because the U.S. had production that exceeded consumption, and it was able to export that balance.

And with the collapse of internal trade, it could no longer export the balance. It had to bring it back into balance domestically, and there are two ways you can do that. One is you raise consumption, which for either political reasons or good sound economic reasons we weren't able to do quickly enough. The other, of course, is to reduce production, which means closing factories and firing workers. It's what we don't want to do.

China runs a similar position but with some big differences. One difference is that the Chinese trade surplus is roughly around .6 percent of global GDP. So almost 30 to 40 percent higher in those terms than the U.S. trade surplus was.

The other difference, of course, is that the United States at the time was nearly 40 percent of world GDP. China is around seven percent, which means that China, if there were a collapse in trade, would have to make a much bigger adjustment on an economy that was roughly one-fifth the relative size.

That's what I mean by careening out of control. That adjustment is a huge adjustment. Chinese overproduction exceeds consumption. Chinese production exceeds consumption by more than ten percent of GDP.

There is no way they can resolve that domestically. They can only resolve that with foreign demand, at least in the short term. Over five to ten years, perhaps there's a resolution. Over one to two years, there is no resolution.

DR. PRASAD: So the first question, can China stimulate its economy, yes, they can, but in a very limited way. And as we've heard from Mr. Pettis, I think without the foreign demand, it's going to be a very limited kind of growth with very little employment growth.

The bigger problem is that even if they do solve the short-term problem in terms of keeping growth from collapsing, which I think is the best we can hope for right now, it's going to come at a cost of substantially more unbalanced economy led by investment, not all of it very productive. And since there is a great deal of money being funneled through the banking system, which again these days it's a little hard to talk about relative efficiency of the banking system, but it's not that efficient a banking system, and it could set back a lot of the progress they've made on that front.

So worry a little more about the longer-term sustainability, and even in the short term, it's not obvious that they can pull the economy back.

The other question you asked was about whether it makes sense for a country like China which does not have a floating currency or a fully convertible currency to take its place on the world stage?

I think in terms of its sheer size and its importance to the world economy and where it lies in the configuration of these global imbalances, I think China has a much more important role to play. Unless China signs up to the program, in some sense, it's going to be very difficult to resolve some of these tensions in the world economy.

Having said that, the focus has ended up being again on the level of the currency relative to the U.S. dollar, which I think is the real problem. I would rather the focus be in the flexibility of its currency. Once you put it that way, then one needs to think about the capital account opening because to have a fully convertible currency, you not only need a flexible currency but a fully open capital account.

One can't have a flexible currency without a fully open capital account. The capital account has been getting more open over time, but there are still restrictions. So they could have a flexible currency which would give them a much more independent monetary policy, allow them to make progress on financial system reforms, and then move a little more slowly on the capital account liberalization, although again there the capital account is becoming de facto open over time.

I think focusing it that way and trying to work back from the priorities that they care about, and which ultimately the U.S. should care about, which is financial system and other reforms which will deliver more balance and sustainable growth there, I think would be a much more fruitful way of making progress on this issue.

So I think bringing China into the fold in terms of its greater presence at the IMF and other institutions could actually allow us to make progress on that score rather than setting it up as a confrontational relationship in terms of this bilateral exchange rate which ultimately is not the key thing that matters.

HEARING COCHAIR WESSEL: Thank you.

I'd like to ask a question about the adjustment process--and let's take the auto industry as a ripe example. We've seen the incoming administration seeking to tackle this problem, and next month Congress will have to look at whether to deliver the next tranche of aid.

We've talked throughout today about trying to rebalance our accounts and trying to save more, consume more in China, but it's unlikely, Mr. Pettis, as you've just said, that they're going to be able to soak up all the excess capacity they have.

We are looking here at our own auto industry at having to dramatically rationalize production. Congress has provided some aid. There are now concerns that as some of the Big Three seek to address their domestic production patterns that they may be investing more in China and using that as an export platform.

The American people do look at this as a zero sum game in some ways. Certainly as demand reduces, there are going to be winners and losers. What, from a policy perspective do we do about these overcapacity industries as we seek to take capacity out to be more in line with demand?

How do we rationalize U.S. interests versus Chinese interests understanding that there is some shared sacrifice that may have to exist? Whoever wants to start?

DR. SCISSORS: I have to go first?

MR. PETTIS: It's either you or you because I'm in the middle.

DR. SCISSORS: I'm not an expert on the American economy so let's get that straight. I'll start with the Chinese side and I'll try to bring it back to the U.S. side.

Before you asked this question, several days before the Commission hearing, I identified the auto industry in China as something that I thought was going to be a likely target of actual stimulus. Not the announcements which they make which apply to every sector in the economy, but what they're actually going to spend money on.

And the reason being it's a big employer. Sales have dropped. Sales growth has dropped rather precipitously and they overestimate sales because they use transfers to vendors rather than actual sales. When it's shipped to the franchise, that counts as a sale.

So it's possible that sales growth could be negative and export growth has also been dropping. China doesn't have a big car export industry, but that outlet does not seem to be available to them. So it's a high priority, I would think, looking from the Chinese standpoint to stimulate their auto industry.

Now, we don't have a major exposure directly to Chinese cars, but we could, as you pointed out, have an exposure to American investment and exports back here which gets us the cars, might get us the cars cheaper. It doesn't get us the jobs.

Unfortunately, my colleagues have been all too convincing. Any hope I had was vanquished by them. This is a very difficult thing to do, as you would expect in a difficult time, but I think the response is that the imbalances are driven by excess fiscal stimulus on our side and then the Chinese version of that, which is routed through their banks. If we're going to make an agreement, if we're going to cooperate with the Chinese on this, it's going to have to be both of us together stop interfering in our auto industries.

That's the way because otherwise it becomes a battle of subsidies. Forget commercial. Forget free competition. Forget an open market. It's who can more effectively subsidize their auto industry, and we're going to have this kind of battle. That's the danger writ large with competing stimulus packages: to the extent that there are cross purposes--which they have to be, because we have a fixed amount of demand and it's shrinking--that we've completely subverted the market and turned this into our stimulus package is bigger; no, ours is bigger; no, ours is bigger; and so on.

And so again these are partial solutions, as they were with Vice Chairman Wortzel, but that's the deal we can strike. If you don't go down the road that you want to go down of subsidizing your auto industry, we will try to avoid going down the road that we want to go down of subsidizing our auto industry because, just as with Smoot-Hawley and just as with competing subsidies throughout history, everybody gets made worse off.

It's great if we can do it and they won't do it, but they're going to do it, and that's the deal we have to try to strike.

HEARING COCHAIR WESSEL: Mr. Pettis.

MR. PETTIS: I just came back from a lunch meeting in which Derek and I were both speaking. I'm going to ask in the future that Derek and I are never on the same panel because we agree on way too many things so it's not very interesting.

The only thing that I would add to that is that much of the focus on the currency as the fundamental determinant of the trade relationships I think is a little bit misguided because the way I think of it, and I don't want to use such a loaded word as "mercantilist"--I wish there were another more neutral word--but the way I think about it is that anything that stimulates production more than it stimulates consumption is necessarily mercantilist in that sense.

So there are a whole variety of things that affect production in China and in the United States. In the U.S., it's a little bit more difficult to talk about policy because many of these things are set by the market, but, for example, interest rates, setting interest rates has as much impact, especially in a system in which there is quite a bit of leverage, has as much impact on export competitiveness as setting the level of the currency.

Wage rates are also very important. Until a few months ago, there was a lot of talk about raising minimum wages in China. That talk has disappeared. It may seem intuitively correct if we've got a problem with employment and we let wages go up, that's going to increase the cost of workers and so make unemployment worse.

I'm not sure that's true because I think raising wages would have a significant consumption impact. Lowering interest rates, by the way, has a negative impact on consumption in China because the evidence suggests that Chinese save for precautionary motives, and when interest rates go down, they save more, not less.

There are also all sorts of tax and export subsidies that affect overall production relative to consumption, but I would say that that's what the focus needs to be on.

The currency is one of the things that matter, but it's only one of the things that matter. Quite a number of other things matter on the impact of relative production and consumption in the United States and in China.

DR. PRASAD: I don't have a good answer for you, Mr. Wessel, because there will be pain. This is a problem with free trade; there are broad winners, but there are very significant, narrowly defined losers. And there is a process of restructuring in U.S. manufacturing, in particular, which I think is likely to continue for a little while and perhaps worsen because of this crisis.

The issue is whether the notion of free trade really applies given that one of the main trading partners of the U.S. seems to be engaged in practices, not just the currency, but other forms of subsidies, through cheap bank credit and also subsidies of land and energy where it is a level playing field of sorts.

Here again I think we should go back to the point that the Chinese actually recognize--they recognize that they have a model which is heavily oriented towards investment-led growth. Export-led growth is an important component of it, but in terms of sheer numbers, they've got more than 50 percent of their growth in the last five or six years, in fact, almost two-thirds of growth in '05-'06, coming from investment.

They know it's an unbalanced state. China is a developing economy so investment is not necessarily a bad thing. But a lot of it is being financed by inadequate banking system so they're trying to reform that. And this is where I think again the currency flexibility link comes in because they cannot get the financial system reformed until they have their hand no longer tied behind their backs with monetary policy not being independent.

So I think therein lies the hope that essentially the excess capacity that could build up in the Chinese industry and that has built up could start dissipating if China had a more efficient financial system.

But, in the short run, again, things are going to get worse because they are trying very hard to stimulate their economy. We are applauding them for it and rightly so, but it is going to come at a cost of there being even greater capacity being built up in China, and that is a serious risk for the future, which is why again we have to rethink this relationship in terms of where we can rebalance this over the long term once we get out of this short-term mess.

HEARING COCHAIR WESSEL: Thank you.

Commissioner Fiedler.

COMMISSIONER FIEDLER: This morning we heard that the Chinese stimulus was the gold standard of stimuli. You're all shaking your heads no. There wasn't enough time to take that question on this morning, and you certainly have put that to rest this afternoon.

I have a sort of political question, which is in searching for solutions, whether they be alone or together with China, what is your view of the political constraints that exist in China?

We're familiar with the political constraints here. How much of their decision-making is based upon their fear for their own survival?

I would just comment on your comments, Mr. Pettis, that in some ways you were saying that they were making many, many short-sighted decisions and I can only believe that those short-sighted decisions were based on politics, their own politics.

MR. PETTIS: I think that's true. I think some of it may have been based on a development model which perhaps we have too much respect for. I think there were some very serious problems with the development model. This idea that China could be export-led, I think is a great idea if you're Vietnam or a much smaller economy. I think it reaches a point where that model simply doesn't work and it simply doesn't make sense, but the process of moving away from one development to another is very, very difficult.

Looking back on it historically, the United States went through that process, too. Quite a long time ago, we used to be primarily driven by exports, and beginning in the 1798 crisis--I spend a lot of time reading these kind of things. I have sort of a boring private life. But beginning in the 1798 crisis, we started that big transition to being domestic consumption led. It took us about 20 years under very, very difficult circumstances to make that transition.

I would argue that Japan, basically since 1990, has been in the process of making that transition, and I don't need to tell you it's not been an easy process. It is not going to be easy for China either. It's very, very difficult. It involves short-term costs.

And, as we all know, when there's a tradeoff between short-term costs and long-term benefits, we don't always choose the long-term benefits.

The bad news is that very often the adjustment has to be made at the worst possible time. And I think that's what's happening. The adjustment has to be made at the worst possible time because the global demand that was necessary for that old development model is disappearing.

Now what are the political implications? It's very hard to say. I think there's a lot of feverish talk about collapse of the Party. Other people say there's absolutely no way. The Party is well too sophisticated. It will never collapse. I quite honestly don't know one way or the other.

But I do know like any government, there is a great deal of worry about rapidly rising unemployment, and I think part of the problem is that many of the solutions necessary for the transition towards more of a domestic-led economy necessarily imply a rise in unemployment in the short term. And I think it's very difficult under current conditions to make that argument.

We also have pretty significant factional differences within the leadership. And, you don't want to simplify because it's much more complex than that, but broadly speaking the so-called "Shanghai faction" tends to be very macroeconomically sophisticated, very aware of the impact of Chinese policies on the global balance.

They tend to be not terribly concerned with income distribution and much more focused on state-led investment rapid growth.

The other faction, which many people include Hu Jintao in, which tends to be dominated by provincial leaders and members of the Communist Youth League, are to their credit, I believe, much more concerned about income distribution. I think they're very worried about income distribution, especially the rural-urban breakdown.

But I think they tend to be less aware of the impact of Chinese policies on the global balance, and I think there is a higher probability that some of the decisions they make could end up boomeranging if it causes increasing trade tensions.

COMMISSIONER FIEDLER: Thank you.

MR. PETTIS: You notice I very carefully skirted the whole issue of politics.

COMMISSIONER FIEDLER: You came closer to it than anybody else. Thank you.

DR. PRASAD: May I add something to that?

COMMISSIONER FIEDLER: Yes, please.

DR. PRASAD: Mr. Pettis talked about the two factions, and he pointed out that he was oversimplifying, and of course there are multiple factions there. It is a difficult system to understand, but one thing that is clear is that the Chinese Communist Party in recent years has been getting its legitimacy no longer from its ability to deliver political stability but its ability to deliver output and employment growth.

COMMISSIONER FIEDLER: Right.

DR. PRASAD: And that is a critical issue as we think about how they sell policies domestically. Even if these are policies that are in their own interest in the long term, if it is seen as something that does not work towards these objectives, it becomes much harder to sell.

And added to that is the layer of national pride which gets thrown into the mix. This is again not particular to China, but given the orientation of the Chinese Communist Party in earlier years, that is a significant issue, and therefore even if there are policies that are in their own interests, if it's stated to them in a way that does not link it clearly to their own interests--say currency flexibility or exchange rate appreciation that is most often talked about here--it seems to be something that would immediately have an effect on employment growth so it becomes much harder for even the reform-minded wing of the Chinese Communist Party to push it.

So this is where I think the U.S. and other international parties can play a useful role in terms of generating within China the debate that makes this connection between what China wants to achieve, which is balanced growth, more sustainable growth, a better financial system, and what could help not just China but the world economy at large, which is more currency flexibility.

And you made a point that we are familiar with our political constraints, but I think there is this barrier from that side as well, that they don't fully understand our political system, and while we sometimes tend to view the CCP as a monolith that acts and talks with one voice, I think on their side, too, there isn't a full understanding of the complexities of the political dynamics here.

And this is where I think, despite Mr. Scissors' skepticism, avenues like the Strategic Economic Dialogue are useful in terms of conveying the constraints on both sides in finding ways to move forward.

COMMISSIONER FIEDLER: Thank you very much.

HEARING COCHAIR WESSEL: Commissioner Blumenthal.

COMMISSIONER BLUMENTHAL: Thank you very much, all of you.

I'm going to ask you a question that none of you are qualified to answer, but nobody is qualified to answer, and it's along the same lines as Commissioners Fiedler and Wortzel.

It is true that China has been dying from the same heart attack for 20 years. After Tiananmen Square, people said that this would be the end of the CCP, and then during the crisis of banking loans in the late '90s, people said that that might be it. They won't be able to solve that problem, but they've been quite skilled, as everyone said, in solving their economic problems, but what would happen if they didn't this time? And if you could sort of sketch out a plausible scenario. You're not political scientists, but from an economic scenario could the leadership make enough mistakes cumulatively that there would actually be deep economic slowdown and trouble for a number of years. What would those decisions be? What might that look like?

DR. SCISSORS: I'll go first although I'm stealing from Michael, who I think is stealing from me, but he claims he thought of it first.

The Chinese, with the current stimulus package are trying to build a bridge to a global economic recovery. They're trying to say we understand that in 2009, the world's demand for our products is going to be much weaker, led by weaker U.S. demand. We're going to spend money like crazy this year and maybe in 2010, world demand will recover and we'll be able to go right back to where we were in 2006.

I mentioned that in my opening remarks. Now, one way that things could blow up for the CCP, and you're right, I'm not a China politics expert, would be that unfortunately as Dr. Prasad said, we're intertwined if the U.S. economy doesn't recover in 2010. That if we stay in the tank, and this bridge they're trying to build doesn't reach. If you want a reference to infrastructure building, it's really a bridge to nowhere.

The bridge gets halfway across the span and then there is nothing on the other side because there is no recovery in global demand. At that point, the Chinese are faced with they've spent as much as they can. That doesn't mean that they're completely out of options, but they've given their maximum effort, and now they’ve got another year or however long it is, and they've already given it their all.

So their intervention in terms of propping up employment is going to become increasingly less effective. I do not mean to imply that January 1, 2010, the U.S. economy is weak, and everything blows up in China. It means that their returns to what they're doing are going to decline rather quickly over time if we don't get a world demand recovery.

And that's when--and I've been talking about this for some time--one of the end games for the Chinese is to throw up their hands and say the market doesn't work. We know that China can guarantee employment for its people. It was able to guarantee employment for its people as a much poorer country. It did so under a command system.

It was kind of dubious employment in a lot of cases, but nonetheless people weren't starving on the streets and they weren't rioting. So there is this other option. That's my very amateurish answer. That the CCP is making an attempt now to bridge to 2010, and then hopefully go back to the way things were before, from their standpoint.

If that fails, what we get is a movement away, a pronounced movement away from the market toward economic policies that do keep people off the streets, that maintain stability, and whether that will work and for how long, is beyond my area of expertise.

MR. PETTIS: Could be because it's four o'clock in the morning for me, but if I interpret your question correctly, my reading from when I was a grad student, reading political science, in the old days, what we learned was that when you have a small, recently established middle class--middle class is not the right word because they're not the middle group, but you understand what I mean--people with middle class consumption--under conditions in which they feel, generally during an economic slowdown, that they are being threatened it's the poor in the city or the rural poor, they tend typically to respond by forming an alliance with the government and with the military to establish or to ensure order.

That's about as far as I really want to go, but I want to bring up something that Derek mentioned. One of my concerns is the current fiscal stimulus package--and I do not believe it's the gold standard--it really depends what you mean by "gold standard"--but to a certain extent the current fiscal stimulus package involves a bet on the duration of the crisis in the rest of the world.

If the crisis ends at the end of this year, and the U.S. and Europe start growing rapidly, and we're back to the races, it will turn out to have been a very good bet because basically the problems with that stimulus package, the massive expansion in lending, which I suspect will include an increase in nonperforming loans, they will be able to deal with it with the very rapid growth that returns to China.

My fear is that if the global contraction and the U.S. contraction do not recover quickly, and for historical reasons I'm fairly pessimistic that it will recover quickly, then next year, we have the same problem, but we have many fewer weapons to deal with the problem in the short term.

I don't think China's fiscal position is nearly as good as many people say it is. There's a lot of hidden debt in there, and I think if we see a significant increase in nonperforming loans, the banking system is basically guaranteed by the government, and an increase in nonperforming loans means an increase in the total amount of contingent liabilities of the Chinese government, which I suspect are higher than many people think.

So I'm not sure they have two bullets in their gun. I think they have one bullet and they're using it now, and if things don't recover quickly by next year, I think it becomes much more difficult for them.

DR. PRASAD: My view, which is subtly different, is that they may have at least one-and-a-half bullets left. Whether a half bullet is much good is debatable. But although it is true that the level of contingent liabilities in the financial system and in the unfunded part of the pension system is very large, what matters at crunch time is the explicit debt and the explicit level of the fiscal deficit. And there, China has room.

The fiscal stimulus package that we speak about is ultimately going to end up being about four to five percent of GDP over two years in terms of net new spending. It's not going to be a huge increase in the deficit which right now counted correctly is very close to zero.

The level of public debt is below 20 percent. So they have room and again they own the banks so they can use monetary stimulus effectively. So I would agree that if the crisis continues for awhile and if the world economy does not recover in the next three to five years, which at this stage actually doesn't seem that unlikely a possibility, scary as it might sound, then we're in trouble.

But I think they could actually string it out for two to three years at the cost of becoming a significantly more lopsided economy. But the other risk is whether they do this by closing themselves off at some level because they view much of the threat as coming from the outside, and Mr. Scissors pointed out that it's possible that they might go back to a command economy. I don't think they will go back that far.

But it is possible that they could start looking much more inward closing themselves off, and that is a serious risk on a global scale because much of Asia has now tied itself to China in terms of its future. So the repercussions of that could be much greater.

So in terms of the stability of China and in terms of stability of the Chinese Communist Party, I'll wait another few months at least before I really start worrying.

COMMISSIONER BLUMENTHAL: You'll have to come back again.

DR. PRASAD: I will be happy to be back here at that stage although I guess things could be much bleaker. But the bigger issue is what the global ramifications of that could be because China has become much more important in terms of the global supply chains, in terms of where it lies, in terms of the Asian economy overall with economies including Japan having tied themselves to China. So that I see as a much bigger risk.

HEARING COCHAIR WESSEL: Commissioner Mulloy.

COMMISSIONER MULLOY: Thank you, Commissioner Wessel. Mike, I want to thank you and Commissioner Slane and the staff for putting together this hearing. I want to thank the panel also. You folks are terrific. Your testimony is very, very helpful and clear.

In the earlier panel, we had a conversation with Dr. Roach about the consumption boom that is taking place in the United States. And I note that, Mr. Pettis, you wrote an article in the Far Eastern Economic Review on January 9, in which you explain that the fact that the China was recycling its trade surpluses into our Treasuries and Freddies and Fannies caused a torrent of inward bound liquidity, which boosted real estate and stock market prices so people felt wealthier.

And then this raised the wealth of U.S. households, thereby making them willing to divert a rising share of their income to consumption. So it wasn't like the Americans went crazy. They felt wealthier because if their houses and stocks were really worth that much more.

Dr. Prasad, you make the same point. On page four of your testimony, you talk about this. But you go further and you talk about that this also kept U.S. interest rates lower creating incentives for aggressive search for yields by U.S. financial institutions and blocking self-correcting mechanisms in our financial markets that normally would have driven up interest rates and so there would have been some self-correction. And we got by that because of what was happening here.

So I think those pieces of testimony are very, very important for us to make the connection between the mercantilist practices, and that may be a word that we don't like to use, but that's I think essentially what's gone on.

Dr. Roach, in his testimony, makes another point, and I wanted to probe this. He says China has the largest bilateral piece of America's multilateral deficit--trade--not because of the value of its currency, but mainly because of conscious outsourcing decisions of U.S. multinational corporations.

We normally have a panel of congressmen and senators who come in and offer comments as a hearing starts. Congress is out this session, but Senator Webb sent us some testimony, and he says that the reigning corporate ideology in this country has long been on short-term profits and short on the obligations corporations have to the country which has nurtured their growth.

And then again, later in his testimony, he talks about whether there is the need for a convergence of U.S. national and corporate interests?

In other words, I think what may be going on, and we want to probe and ask your guidance on, U.S. corporations are driven by the need to get short term returns for their shareholders, not necessarily for the national interest. And if American corporations can increase returns for their shareholders by moving production to China and other places in Asia, and not have environmental, pensions and health costs and can get the subsidized exports from undervalued currency, it gives that an incentive to invest there and then ship back here because you're getting an export subsidy from that underpriced currency.

Do you think we have a problem here that we should try to think about how to realign our corporate and our national interests? And I would like to start with Mr. Pettis and then go to Dr. Prasad and then Dr. Scissors.

MR. PETTIS: It seems to me that aligning U.S. corporate interests with the national interest may not be the appropriate way to think about it because if, for whatever reason, it is much cheaper to produce a product abroad than domestically, U.S. corporations are not faced with the decision about do we do something that's in the national interests or not in the national interests? They're faced with do we continue in our ability to sell that product or not?

Because the fact is if the U.S. corporations don't do it, they will probably lose market share to foreign corporations that sell in the U.S. markets.

I don't think that's always necessarily a bad thing because I think the strength of the U.S. economy has not been our ability to produce things that compete with China. The fact is we Americans are paranoid, and perhaps that's one of our strengths, and recently I've been seeing a huge amount of concern about technological and scientific innovation in China one day catching up with us and overtaking us.

Let me tell you right now that nobody in this room will live long enough to see that. That's simply not going to happen. The U.S. is extremely creative and extremely good at that. China is not there. There are real problems with the educational system in China.

I think as part of a natural process that certain types of businesses eventually will move out of the U.S. because they're simply not things that we are comparatively good at doing. What we are comparatively good at doing, I know it doesn't sound like it when you read the press--but what we're comparatively good at doing is things that involve innovation, creativity, science, including innovation and creativity in management practices.

It's a difficult process, but it is likely to happen. But I would argue that it's not a question of U.S. companies deciding to outsource.

I don't really think they have a choice. If they don't outsource, they will lose market share and the employment impact on the U.S. will be the same.

The only difference is that the profitability will go to non-U.S. shareholders rather than to U.S. shareholders.

The first thing that you mentioned was consumption, and I'm trying to remember. I just wrote a word down, "consumption." I'm trying to remember what the question was.

COMMISSIONER MULLOY: We peaked at like over 70 percent of our GDP was tied to consumption, and the point was that because people felt wealthier because of the stock and housing prices.

MR. PETTIS: Yes. I agree with Steve on many, many things. I think he's very, very smart. We do disagree, though, on this issue of the global imbalance, whether Asian savings had any role in it or not. Unfortunately, that discussion very quickly degenerates into who do you blame? Is it all America's fault or is it all China's fault? And I think that's totally fruitless. I think that makes absolutely no sense. It was absolutely necessary for both countries basically to mismanage monetary policy to create that problem, and both countries did.

And even that's a little bit glib. I wish I could tell you what the correct monetary policy was, but what I can tell you is that historically when you see these massive increases in liquidity, and very often an important source is major recyclings, whether it's recycling of the U.S. trade deficit in the '80s, or the petro-dollar surplus in the 1970s, or even war reparations payment. Interestingly enough, German war reparations and French war reparations in 1870 had a massive impact on underlying liquidity.

But when liquidity grows, the financial system will accommodate it one way or the other. I guess I'm a disciple of Hyman Minsky there. I think there is no way around that. And with the liquidity growth in the United States and in China, both countries accommodated by making what in retrospect was a foolish credit expansion.

I'm not sure how you get around that problem except maybe by engineering a contraction, but I do agree with you, if one of your statements is to say one explanation of the crisis is that American consumers are basically idiots, I don't think that's an argument that makes sense at all. I think that the system has to accommodate it, and that's one of the ways it does it.

COMMISSIONER MULLOY: I'm not looking for the blame game. I'm trying to understand how, what happened here. Once you understand, then you can craft the correct policies.

MR. PETTIS: Yes. And I think the whole blame issue has been a complete waste of time.

HEARING COCHAIR WESSEL: If we could finish up the panel quickly on this question.

DR. PRASAD: I would agree that the global imbalances get some excessive focus especially in the context of the bilateral relationship, but they clearly did fan the flames, and my concern again is as we look to the future, whether this potential source of problems is going to be exacerbated in the future or not, and in the short term I see all the conditions being right for things worsening a little bit, and whether we're going to get the financial systems under control to prevent another explosive outcome in the future, as Mr. Pettis fears, or whether we can bring it under control or not is a key issue.

But I think there are a couple of facts that are useful to put on the table. When you think about U.S. firms outsourcing to China and so on, if you look at the trade patterns between the U.S. and China, a lot of it actually is related to outsourcing from, not quite outsourcing, but processing trade from the rest of Asia. So if you look at overall the U.S. trade balance with all of Asia, it actually didn't deteriorate that much until about 2005 because a lot of trade had started moving through China after China's WTO accession in 2001 opened up U.S. and other markets.

Of course, in the last three years, it's been a different story with the Chinese trade surplus essentially driving what's been happening to the pan-Asian trade surplus with the U.S. And in fact, a lot of the FDI has also been coming from the Asian countries that are using China as a processing platform.

So, in fact, it is the Asians that are tying again their futures to China and getting products here, but ultimately, and although it's less fun for you if the panelists agree, I think Mr. Pettis has it right that trying to think about using measures to preserve the U.S. manufacturing base through protectionist or other measures, even if it seems like responding proportionately to what other countries are doing, I think it's not in the long-term interests of the U.S., and we need to be thinking about what industries, what aspects the U.S. really has a comparative advantage, and I think there it is knowledge production more than anything else that we really have an advantage in and thinking about putting resources into that I think would be a much better approach.

DR. SCISSORS: Two quick empirical facts, and Eswar and I can argue over the grand bargain if you want more arguing among the panelists, but I agree with him on this.

He said earlier, and I mentioned as well, U.S. FDI has actually been declining. So we get this huge surge in China's trade surplus as U.S. FDI declines. I'm not disagreeing with you, Commissioner Mulloy, that there isn't relocation of U.S. business, U.S. industry, to China--but there doesn't seem to be a very good explanation of these imbalances because U.S. FDI into China is falling as China's surplus is increasing. It's actually shrinking over time. It's a couple billion dollars instead of seven or eight billion. So just an empirical fact which doesn't lead to any necessary conclusions.

The other one is I started this by saying we're responsible for our own monetary policy, and you're implicitly countering that by saying, of course, American consumers felt wealthier, there was a bunch of Chinese money coming in. But the Chinese money is our money; right?

The reason they have all this money to invest is because we're spending all this money on their goods. That answer does not solve the question of what caused the crisis, but I would say one step backwards from where you started with Chinese money coming in is American consumers giving China the dollars in the first place.

And then the question is why are American consumers giving China the dollars?

HEARING COCHAIR WESSEL: Thank you.

COMMISSIONER MULLOY: Thank each of you very much.

HEARING COCHAIR WESSEL: Chairman Bartholomew.

CHAIRMAN BARTHOLOMEW: Thank you. Thank you, gentlemen.

It's interesting. A lot of issues have been raised. Mr. Pettis, I'd like to thank you in particular for pointing out the nonsensical nature of the threat that we can't do anything that the Chinese government might not like because if they do, they're going to stop buying our debt. To me, that fits in the category of if you treat the Chinese like the enemy, they'll become the enemy, and it ends up excusing or providing an excuse for inaction on a lot of different fronts.

As our new Secretary of State has noted, we have a lot of interests in the relationship with China, and we need to make sure that our relationship reflects those.

Dr. Prasad, just a couple of comments, and then I'm going to get to the question. I was really struck as you were talking about free trade--the Chinese haven't exactly been engaging in free trade. They have this 11th Five Year Plan. They have systematically identified pillar industries. Automotive is one of their pillar industries.

They've had plans to build those industries and they have subsidized those. So to me, we say free trade and then they're not an example of the way that free trade is supposed to be working. I think that's some of the crisis that we're now facing.

A second observation is in response to Vice Chairman Wortzel, and the Chinese government's role in global institutions. I think that we need to look at the WTO. When China acceded to the WTO, there are a number of questions of whether the WTO was going to change

China or China was going to change the WTO.

The verdict is not completely in on that one, but what we do know is that the way that China has acted within the WTO has fundamentally changed the nature of disputes and dispute resolution in that it is now perceived that taking a dispute to the WTO is a hostile act. That's not how the WTO was designed.

I think it's changing it. So I think we need to think about that when we talk about encouraging China's participation. Obviously, they have a role, but I think we need to be thinking about the institutions.

To my question, which is different, it's about this concept of global economic recovery. And I find myself wondering--global economic recovery as defined by whose interests? If part of what the Chinese government has been doing over the course of the past 20 years is ensuring that economic growth is a way to deflect attention from their repressive practices and the control of the Chinese Communist Party over the population, why do we believe, how do we believe that what the world needs from China is necessarily what the Chinese government believes it needs to do in order to address this global financial crisis?

What is it? Do we have the same definition of what a global economic recovery is and looks like as the Chinese government does?

DR. SCISSORS: I can be quick so I'll go first. This ties back into something that all of us really have said, but mostly Michael and I, the Chinese really want to go back to 2006. That's what they want to go back to. That's the idea of their strategy, and there's all this talk and there's some action, but there's all this talk about rebalancing their economy.

I'm much more critical than Eswar is. They had the wonderful opportunity to rebalance their economy. They were growing at 11 percent for years and they didn't rebalance their economy. As Eswar pointed out correctly, investment became larger and larger as a proportion of GDP.

So, to me, that was a lot of talk, and when the rubber hit the road, they weren't that interested. What they would like to do is go right back to the great results they had in 2006, 2005, part of 2007, which is we buy a lot of stuff, they invest a lot, all the excess capacity gets shipped overseas, and China becomes the center of Asia economic activity, as all panelists have pointed out.

I'm going to stay away from the CCP part of this, but I do not think it is the right way for the global economy to recover. So there is a disagreement on a purely economic side of this. That we don't see action by the Chinese, and we don't see results in terms of their trade surplus where their notion of global economic recovery is the best notion.

I do not mean to say that our notion of global economic recovery is necessarily the best notion either. So that's a criticism of China because it's out there. I'm cherry picking. It's very easy. There are criticisms that can be turned back on us. Criticisms, obviously fear of what Buy America could turn into more than Buy America itself.

To be more hopeful: if we don't like what they're looking at as the global economic recovery, and they might not like what we're looking at as the global economic recovery, then there's a possibility that we can adjust our policies mutually to reassure the other.

I don't think it will be easy. I think it will be incredibly difficult for the economic and political reasons we discussed. I do think the Chinese have a different notion of global economic recovery than the rest of the world because it involves huge trade surpluses that they extract, from global growth. But I also think that they and other countries have legitimate concerns about what we're doing to stimulate our economy, and that opens the door for negotiations. In this case, two wrongs could actually make a right.

CHAIRMAN BARTHOLOMEW: Mr. Pettis. Dr. Prasad.

MR. PETTIS: I think much of that is really a political discussion more than an economic discussion, and so I don't think there are an awful lot of things I can say very intelligently about it.

The only thing I would say is that in fairness I would disagree with the characterization that Chinese economic growth was driven in the desire to maintain repression on the Chinese people. I think there are a lot of reasons why China wanted growth.

The simplest reason is that China was and still is an extremely poor country. I think there was recognition that the economic policies of the '50s and '60s and '70s were frankly a disaster. I think there was recognition that they had to reverse that, and there's also just a great deal of pride in China.

There really is a sense in China that China should be one of the great nations of the world, and in order to be one of the great nations of the world, it needs economic growth. So there's a very complex set of reasons there, and I think it helps us to be sympathetic to some of those concerns.

DR. PRASAD: Mr. Scissors is partially right that the Chinese would love to be back in 2006. I think we would all love to be back in 2006. Those were the good days.

CHAIRMAN BARTHOLOMEW: That's true.

DR. PRASAD: The problem is that we could be again coming back to 2006-like scenario of imbalances if we continue down this path, and I don't see that much of a way out in the short run, because the options available for the U.S. to stimulate its economy and the options available for China to stimulate its economy, both of which I see as indispensable right now, are going to make things a little worse in the short run.

The issue is how we come together over the medium term. And this is where I think issues become difficult. You pointed out this notion about free trade not really being free, and I have in my written testimony made it very clear that I think there are implicit subsidies for exports that the Chinese have had. The problem is right now the U.S. is going to find it very difficult to take the high road on that given what we've done here with the financial industry and the auto industry.

So there is a risk, in fact, that what is happening in the U.S. could be used by other countries, including China, essentially to take on more explicit measures, and then the whole thing could get ugly and make this rebalancing act even more difficult.

This is why I think ultimately having these two countries come together has to be done because unless we can solve these two sets of problems jointly, the medium term does not look very good at all.

CHAIRMAN BARTHOLOMEW: All right. One clarification. Mr. Pettis, you're absolutely right that China's plan for economic growth and its success bringing over 300 million people out of poverty is multifactorial, and I didn't mean to imply that it wasn't, but I think that some of the opening has been also about maintaining control and power--some of the decisions that have been made.

And it is a really interesting thing. As we go through all of this, for me it is not necessarily a criticism that we're doing here, Dr. Scissors, but more recognition that as cooperation is being developed, that the people who are doing these discussions need to be absolutely clear that our interests and the Chinese government's interests are not necessarily the same in all of this, and I think part of what happens is that there is an expectation that the United States is supposed to make decisions that are to the benefit of everybody in the world, and that other countries are sometimes off the hook on that, and that is some of what we see on the debate over Buy American frankly right now.

Thanks.

HEARING COCHAIR WESSEL: For a short final question.

VICE CHAIRMAN WORTZEL: Dr. Scissors, I know you don't want to answer a political question. So after this I'm going to nail you with another one, privately; but maybe you'll answer this.

All of you referred to the fact that there may be some in China that say the market doesn't work, but there are more than two factions in the Chinese Communist Party. How serious in your view are the reports of a rise of what is characterized in China as a New Leftist faction in the Party that would abandon both export-led growth and domestic-consumption and move back toward really being a Communist Party?

DR. SCISSORS: I have no special insight as to what the likelihood of this is. China, as you just expressed, it's a big, complicated country. I don't know if it's more complicated than the United States, but you can make an argument it's certainly bigger.

There are a lot of things that go on, and if you pick and choose out of the stream what you're going to focus on, you can get a very disturbing picture. One of them is a group Michael probably runs into them all the time--I only run into them on occasion--saying that the U.S. is conspiring to rob China of its wealth, that reserves are forced to be invested in Treasury bonds. We drop yields on Treasury bonds to zero, and our companies go bankrupt, and it's actual conspiracy.

I want to say as a stockholder of several of the companies that have almost gone bankrupt, I was also hurt by this conspiracy, and so I'm equally angry.

You can pick people, you can pick elements in the Chinese political system, and these are government officials--that's who I get to talk to--that say things that are very disturbing. In a time of crisis, you'd expect those voices to become louder.

I found Premier Wen's trip to Europe to be very disturbing, not because he was making wild accusations, but because he at least publicly evidenced the knowledge of the U.S.-China economic relationship that I consider to be woefully unsatisfactory.

So we have ignorance potentially. We have people who are very upset, and naturally, because we're all upset at the economic downturn, and that's a bad combination.

I think Michael, I think both Michael and Eswar mentioned the possibility, as well as I did, that there could be some sort of reversion, move away from the market.

We've had a move away from the market in this country. So I wouldn't paint this as a looming giant threat. I think we have enough economic giant threats to not worry about a political giant threat. It's a factor. Maybe a year from now if the economy hasn't gotten better, we're going to be talking about it more sharply. But from my limited knowledge, it's secondary to the economic concerns.

MR. PETTIS: I think the development of a left in China is actually a very good thing. I think it represents an important widening of the range of debate. There are right-wing critics. That is I hate these right-wing/left-wing labels, but there is certainly a much more free market group of economists including the dean of my school who are ferocious critics of government policy.

There is a group on the left, which frankly in many ways I'm more sympathetic to, who are not the Stalinist left. There is a Stalinist left, but they're very, very small, and they have almost no credibility.

It's really more of a Social Democratic left, whose fundamental argument, and I think it's very hard to dispute, is that all of this rapid growth in China has left China with significant social problems and massive inequality, and that somehow going forward, we need growth, but we also need growth in a way that's more balanced and that addresses some of these problems.

I think that's really the most credible left-wing criticism of current government policies. But, the more dangerous left, I think they're very, very small and I think they have almost no credibility.

DR. PRASAD: There is no going back. I think the benefits that have been delivered to the average Chinese household by the reforms in the last few years and the opening up are going to make it very difficult to reverse that progress.

But there is still a vibrant internal debate in China about what the role of the state should be. How much it should be involved? But in most dimensions, you do see that there is progress, although halting progress, towards a more market-oriented system in the financial system, in terms of restructuring of state enterprises, and so on.

What is happening right now, the financial crisis around the world, is definitely going to make things slower, but in fact what we hear from many Chinese officials is that it makes it even more imperative for them to reform the financial system, but what they mean by reform is something very different from what we might think about it here in terms of financial innovations and so on.

What they're thinking about is a more back to basics approach, getting the banking system working much better, getting even certain plain vanilla derivatives markets like the currency futures working better, and they are doing that.

So I think in that sense we have definitely crossed a threshold beyond which there is no going back.

There will be significant internal debate and fairly vicious internal debates about the direction in particular issues, how much power the provinces should have in terms of pushing their agendas, which gets tied into banking reform, and the role of the state in state enterprises.

But I think all the signs are that so long as the Chinese Communist Party can keep delivering progress, this will go on. And the good thing from their point of view is that even if there are problems being created along the way, if it's a problem divided by GDP, GDP has been rising so fast that eventually the problem divided by GDP becomes less of a problem, and that I think is what they're hanging their hopes on.

This is where I agree with Dr. Pettis, that they take a lot of bets and many of these have worked out. It's still a very fragile system, but so far the bets have worked out. There are enormous vulnerabilities, and these could come home to roost one day, but so far they have held it together and I think they can hold it together in the short term, but beyond that all bets are off.

HEARING COCHAIR WESSEL: Thank you. Thank you to this panel and our previous panels. We will stand adjourned until our next hearing on March 4. Information on that hearing will be posted on our Web site, www.uscc.gov, and we stand adjourned.

Thank you.

[Whereupon, at 3:50 p.m., the hearing was adjourned.]

ADDITIONAL MATERIAL SUPLIED FOR THE RECORD

Statement of Jim Webb, a U.S. Senator from the State of Virginia

Remarks to the U.S.-China Economic and Security Review Commission
February 17, 2009
Senator Jim Webb

I would like to thank Commissioners Wessel and Slane for their invitation to present remarks to the U.S.-China Economic and Security Review Commission. I applaud the decision of the Commission to hold a hearing regarding China's role in the origins of and response to the global recession.

I will initially make general remarks concerning China's response to the global economic crisis. Then I would like to briefly address how China's policy-making will present challenges to U.S. policymakers, from both a domestic and a security perspective. I will conclude by raising issues for follow-up by Congress and the U.S.-China Economic and Security Review Commission.

China has been no exception in feeling the global economic downturn. China sells 48 percent of its exports to the United States, Japan, and Europe. Over the period 2005 to 2007, 32 percent of China's growth in gross domestic product (GDP) was a result of net exports. With the downturn in the United States and elsewhere, China's exports have dropped significantly.

As this commission is aware, hundreds of thousands of migrant workers left the Guangdong Province in 2008 because of lost jobs. To put this in context, Guangdong has been at the center of China's economic expansion, averaging growth of over 13 percent of GDP since the late 1970s, several points ahead of national growth. The vice governor of the province, however, reports that the financial crisis has caused "the most difficult year after the 1998 Asian financial crisis." The Wall Street Journal estimates that 20 million migrant workers have lost their jobs in China.

The decisions made by China's leadership to address a politically and socially explosive situation may have far-reaching consequences. As Dani Rodrik at the Kennedy School noted in his assessment of global economic prospects, "China is a country of enormous tensions and cleavages beneath the surface, and these will find more occasion to erupt into open conflict in difficult economic times."

China has taken steps to stimulate its economy. Although there are some questions as to the effectiveness of China's stimulus spending, particularly as to increasing domestic consumption, it is important to emphasize the significance of a global response to the economic downturn.

At the same, China's policies may threaten the ability of the United States to return to economic growth. China, for example, has adopted new export subsidies, despite having the world's largest trade surplus.

For the time being, China is continuing to buy U.S. Treasury and other government debt instruments. As is well-known, China has spent nearly one-seventh of its economic output purchasing foreign debt, most of which is ours. As of September 2008, China surpassed Japan as the largest foreign holder of U.S. Treasuries. The dangers of continuing to live off borrowed money have been apparent for some time, but have taken on greater significance in the current crisis. China's need to keep more money at home to respond the economic crisis may affect our ability to continue borrowing.

Exchange rate policy presents a particular concern. A depreciation in the Renminbi would help China recapture some lost export opportunities, making their goods more attractive in dollars. Such a development, though, would exacerbate an already unprecedented trade imbalance with the United States. To date, it appears that concerns about financial outflows have kept China from making further downward adjustments to currency value.

Even as we in the United States view our evolving and important economic relationship with China through this new lens of a global downturn, we would be wise to keep in mind that strategically, there remain many serious points of contention between our two nations. China is unlikely to allow the current economic situation to adversely affect its ability to influence an area which is critical to global trade. There is evidence that China is taking steps to expand its naval power and reach, and I would ask the Commission to carefully review all of the aspects of national power that China is bringing to bear along these vital maritime corridors – from trade, to joint military exercises, to infrastructure projects in key nations, to outright military occupation of strategic islands – as it makes its recommendations.

I believe it is important, in this context, to discuss policy-making in the United States and identify the need for a new path to revitalize our economy in a way that puts our workers first. For some time now, the reigning corporate ideology in this country has been long on short-term profits and short on the obligations corporations have to the country which has nurtured their growth. We are witnessing the cost of this ideology every day.

That we live in a globalizing world in which we should be fully engaged is without doubt, but we also live in a nation state with fixed borders and workers in need of good jobs. An answer to the recklessness of short-term profit seeking is recognition of the need for a convergence of U.S. national and corporate interests. As I have stated before, there has been a tremendous transfer of our productive wealth away from the United States, a trend that imperils our economic well-being. It is long past time to reverse this dangerous trend.

In closing, any efforts that the U.S.-China Economic and Security Review Commission can make to further these goals, by collecting relevant information and data, would be helpful to Congress.

I intend to stay engaged on these important issues. Thank you for the opportunity to submit these remarks.