U.S. DEBT TO CHINA: IMPLICATIONS AND REPERCUSSIONS

HEARING

BEFORE THE

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

ONE HUNDRED ELEVENTH CONGRESS
SECOND SESSION

February 25, 2010

Printed for use of the
United States-China Economic and Security Review Commission
Available via the World Wide Web: www.uscc.gov
April 07, 2010

The Honorable ROBERT C. BYRD
President Pro Tempore of the Senate, Washington, D.C. 20510

The Honorable NANCY PELOSI
Speaker of the House of Representatives, Washington, D.C. 20515

DEAR SENATOR BYRD AND SPEAKER PELOSI:

We are pleased to transmit the record of our February 25, 2010 public hearing on *U.S. Debt to China: Implications and Repercussions*. The Floyd D. Spence National Defense Authorization Act (amended by Pub. L. No. 109-108, section 635(a)) provides the basis for this hearing, as it requires the Commission to report to the U.S. Congress on “the national security implications and impact of the bilateral trade and economic relationship between the United States and the People’s Republic of China.”

Expert witnesses provided the Commission with perspectives on the implication of America’s rising debt to China. The fact that China is the largest foreign purchaser of U.S. Treasury securities has raised the question of whether Beijing will be able to influence or dictate policy to Washington by either threatening to withhold lending or threatening to sell the Chinese central bank’s existing stock of dollar-denominated debt. In their testimony before the Commission, the broad cross-section of invited witnesses rejected this notion. They argued that China’s purchases of U.S. Treasury securities are mainly driven by China’s need to seek a return on its $2.4 trillion worth of foreign exchange reserves, most of which are estimated to be in dollars. Moreover, China’s policy of suppressing the value of its currency, the renminbi, depends upon China accumulating and holding U.S. dollars or dollar-denominated debt.

China’s methodology of maintaining a pegged currency requires China’s banks to swap the dollars flowing into the country for renminbi. This system of strict capital controls discourages Chinese citizens and businesses from holding, investing or spending dollars. This policy also keeps the renminbi from appreciating relative to the dollar. The artificially low value of the renminbi has the intended effect of granting an advantage to Chinese exports by making them cheaper than they would otherwise be.

Witnesses pointed out that a decision by China to sell its U.S. Treasury securities would constitute a reversal of China’s policy of keeping the renminbi at an artificially low value. Were China to sell its dollar holdings, China would necessarily have to abandon its system of capital controls and currency undervaluation that supports its export-led economy. Such a move would allow the renminbi to climb in value against the dollar, thereby making Chinese exports to the United States more expensive and U.S. exports to China less expensive. This would be the opposite of what the Chinese capital controls are meant to accomplish.

The witnesses also noted some potential for short-term market instability and higher interest rates in the United States. For example, China might cause market fluctuations in the value of the dollar by announcing its intentions to sell dollars or to diversify its future purchases away from U.S. Treasury securities or dollar-denominated investments. However, the record size of China’s foreign exchange also leaves Beijing with few alternatives for its investments. Only the market for dollar-denominated securities is large enough to be a safe investment for China.
Witnesses pointed out that the United States would benefit by a decision by the Chinese leadership to systematically remove capital controls and to allow the renminbi to seek a market value. The witnesses encouraged Congress to consider a variety of means to persuade China to float the renminbi or to allow a significant appreciation. They included: building a coalition of countries harmed by China’s trade practices and pressuring China to reform; consideration of legislation to alter the Treasury Department’s review of currency manipulation activities and authorizing potential sanctions; bringing a complaint to the World Trade Organization alleging an illegal subsidy or alleging nullification and impairment of a previous trade agreement; bringing an anti-dumping and/or countervailing duty case against imports from China that benefitted from the currency manipulation; appealing to the International Monetary Fund for enhanced surveillance of the renminbi; bringing the issue before the G-20; or declaring an emergency and imposing a surcharge tariff on imports in order to halt the outflow of foreign currency reserves.

We note that the full transcript of the hearing plus the prepared statements and supporting documents submitted by the witnesses is posted to the Commission’s website at www.uscc.gov. Members of the Commission are available to provide more detailed briefings.

We hope these materials will be helpful to Congress as it continues its assessment of U.S.-China economic relations and their impact on U.S. security. The Commission will examine in greater depth these issues, and the other issues enumerated in its statutory mandate, in its Annual Report to be submitted to Congress in November 2010. If you have any questions or concerns, please have your staff contact Jonathan Weston, the Commission’s Congressional Liaison, at (202) 624-1487.

Sincerely yours,

Daniel Slane
Chairman

Carolyn Bartholomew
Vice Chairman

cc: Members of Congress and Congressional Staff
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OPENING REMARKS OF COMMISSIONER MICHAEL R. WESSEL
HEARING CO-CHAIR

HEARING CO-CHAIR WESSEL: Good morning. We have a full
day today on a topic that's of tremendous interest here in Washington.
Thanks to everyone for being here today. I'd especially like to thank
the Senate Committee on Rules and Administration for providing today's
hearing venue.

The transcript of today's hearing and panelists' written testimony
will be posted on our Web site and will be used in the preparation of
our annual report.

Today's hearing on "U.S. Debt to China" will provide a wealth of
information for that annual effort.

Today's hearing is focused on analyzing and understanding the
implications and repercussions of the United States' high and rising debt
to China. John Paul Getty is quoted as saying, "If you owe the bank
$100, that's your problem; if you owe the bank 100 million, that's the
bank's problem."

Today, we'll find out whose problem it is when the U.S. owes
China, its banker, as much as $1.5 trillion.

Our bilateral relationship has allowed the Chinese government to rely on exports to and capital investment from the United States to achieve phenomenal economic growth. At the same time, the United States has had its standard of living fueled, in part, by borrowing back the dollars that it sent to China.

China has pursued mercantilist policies to promote its interests and increase our dependence on their production and on their capital. At the same time, the U.S. has all too willingly accepted this situation and failed to take steps to rebalance the relationship.

Political and economic strains threaten this financial relationship. China has emerged from the global recession stronger than ever, expecting its status as America's banker to convey new political power. The United States government with its fiscal and monetary policy tools constrained by the recession cannot easily extricate itself from its growing financial dependence on China.

This unusual situation, its ramifications and implications, is the theme of our hearing today.

Before I turn to my co-chair, Robin Cleveland, I'd just like to identify some of the rules for our operations. Witnesses will have seven minutes to present their oral testimony, and then we'll turn to our commissioners for questions, which will be limited to five minutes for both the questions and the answers, and then, hopefully, we'll have an opportunity for more than one round of questioning.

Robin.

OPENING REMARKS OF COMMISSIONER ROBIN CLEVELAND
HEARING CO-CHAIR

HEARING CO-CHAIR CLEVELAND: Thank you.

In mid-December, the Treasury Department announced that there had been a decline in Chinese investments in U.S. securities. Over the next several weeks, we had competing and contradictory points of view and a public debate over exactly what had happened. Some experts suggested that the Chinese were shifting investments to longer-term securities reflecting optimism about U.S. economic trends while others expressed concern that they had shifted to short-term investments reflecting a loss of confidence.

In the ensuing months, understanding what the Chinese did has been as difficult to determine as why they may have done it. Whether they are exceedingly competent or overly cautious, the fact is that China owns over 20 percent of our privately-held public debt and is the largest holder of U.S. dollars.
The implications of this debt position, both for the U.S. and China, are the focus of our interest today. With the exceptional group of experts we have convened, and we thank the staff for the hard work that went into that, we expect to gain a better understanding of the political, financial, and economic calculations underpinning current investment decisions, as well as the long-term risks and opportunities which may lie ahead for both the United States and China.

I welcome the panelists. I join Commissioner Wessel in welcoming our first panel—Mr. Prestowitz is not here yet—but our first panel will look into China's lending activities in general and the current situation of the U.S. debt.

Dr. Johnson is the Ronald Kurtz Professor of Entrepreneurship at MIT Sloan School of Management. He's also a Senior Fellow here at the Peterson Institute for International Economics and a co-founder of the excellent resource BaselineScenario.com, widely cited on the global economy.

He's also a member of the Congressional Budget Office Panel of Economic Advisors, and has had a distinguished career and, as I said earlier to him, has survived the IMF and is here to speak to that as well.

Mr. Prestowitz is the founder and President of Economic Strategic Institute. He has had a long career in Washington, having served as Counselor to the Secretary of Commerce in the Reagan administration and having been appointed by President Clinton as Vice Chairman of the President's Commission on Trade and Investment in the Asia-Pacific Region.

He's also a member of the Advisory Board of the U.S. Export-Import Bank and is the author of several books including Three Billion New Capitalists: the Great Shift of Wealth and Power to the East.

And I should have said, Dr. Johnson, that you have a book coming out as well as I understand. So with that, Dr. Johnson, please.

STATEMENT OF DR. SIMON JOHNSON, PROFESSOR OF GLOBAL ECONOMICS AND MANAGEMENT, MASSACHUSETTS INSTITUTE OF TECHNOLOGY, CAMBRIDGE, MASSACHUSETTS

DR. JOHNSON: Thank you very much. Thanks for the opportunity to speak to you today.

Let me be quite brief in my opening remarks and make really three points or address three questions.

The first is whether China's holding of U.S. Treasuries gives them a power over us that we should fear?

The second is whether there's a threat—closely related to the first question—whether there's a threat they could dump U.S. Treasuries and
somehow cause a major economic problem for us or for other people we
care about around the room?

And thirdly, given that I'm going to argue that there aren't major
risks for us in this situation--there's actually a big opportunity to push
China on its exchange rate--I would like to address the question of how
we should do that because I think that's actually a tough question, but a
question very much, I think, hopefully, of interest to you?

So just to emphasize the key facts. By way of background, as you
already said in the introduction, the extent we know anybody's holdings
of Treasuries, and there are statistics and, of course, there are questions
about those statistics, but all the indications are that China owns around
$1 trillion of U.S. securities.

Now, that's partly what's in the official data, and it's partly
estimates the private sector has based on their reading of the Chinese
tea leaves, if you would. I think that's a fairly robust ballpark estimate.
That is a little bit under half of what we think all foreign official
entities hold in U.S. securities, and, of course, the U.S. dollar is the
preeminent reserve currency, as you know, in the world, and the
problems, for example, in the eurozone, I'll talk about very briefly--it's
in my written testimony more--are very serious right now and undermine
the attempts by some people to establish the euro as a rival reserve
currency.

So China's holdings are certainly large, and that's about one-
seventh of our total outstanding stock of U.S. Treasuries.

And there is a view, which I understand is held by many, that this
somehow gives them power over us because they could do something
like sell our Treasuries, and that would cause major problems for us.

Well, I actually think that's not correct--and hopefully we'll talk
about this at length in the question and answer--particularly at this
moment. The key point about "this moment," of course, is we're in a
deep recession; we have a very large so-called "output gap"; we have
very high unemployment, which is the counterpart of that.

The Federal Reserve's policy is to keep interest rates low at the
short end, and Mr. Bernanke reaffirmed that very clearly this week, and
also at the long end. Actually, the Fed has been buying Treasuries and
buying mortgage-backed securities and keeping the benchmark yield, for
example, on the ten-year Treasuries down.

If we were to get, if we were to see a revaluation of the renminbi,
which would be an effective depreciation of the dollar, that would be
good for us. That would help our exports; that would help us compete
against imports. I'm not saying this would end the recession or give us
a miraculous recovery.

I put my broader economic picture in the testimony exactly to
show you I'm not saying there's a magic bullet here, but it would be, from our point of view, this would be a sensible change and a welcome change in the economic environment.

The key point to focus on, and this, of course, fits, there's a long literature, there's a long debate about this issue, about the issue of the dollar and what happens if the dollar depreciates. Going back to the 1970s when there was dollar depreciation, it was traumatic, but that was an inflationary environment. Inflation has been brought down. Inflation expectations, as far as we can see, are low and under control.

The Federal Reserve believes, and I think it's correct in this belief, that if the dollar were to depreciate, even on, let's say, a real effective depreciation of 20 percent or more against all our trade partners on a trade-weighted basis--that would be unlikely, by the way. We're very much on the upper end of what you could imagine if China moved the renminbi-dollar bilateral rate.

But let's say there was a large real effective depreciation of the dollar, that would not be inflationary. The effect of that on our consumer price index would be very small. To be honest, the latest price data suggests we're rather on the edge of deflation, falling prices rather than inflation, and the key thing that I'm sure you've heard the Federal Reserve talk about endlessly and with good reason is that inflation expectations remain well anchored.

There is no evidence that people believe inflation is going to come back into the system, and as long as that is the case, we should not fear depreciation of the dollar.

So that's the key. This threat is a paper tiger, if you like, that China certainly could make statements. They have, if you like, threatened to make statements that would attempt to roil the market. This is completely contrary to their interests. They have a large part of their foreign assets held in dollars. If the dollar depreciates, they lose that value. If the dollar depreciates, we gain competitiveness.

And what would the Chinese buy if they sold Treasuries? If they bought private U.S. debt, that would lower the spreads between that debt and U.S. Treasuries. That would be helpful. The net effect on interest rates in the private sector would be almost certainly roughly nil.

If they bought U.S. equities, that would be good for the ability of our firms to raise funds, particularly in equity, which is exactly what we should want the financial sector to do right now.

If they bought a non-U.S. assets denominated in dollars, if they invest in the offshore dollar market, that would lower spreads in those markets. This is one big global market. Money is fungible, as you know. That would not adversely affect our private sector.
And if they were to buy Euros, which I wouldn't have any problem with--they're certainly welcome to buy them if they really think that's a good bet--that would contribute to the depreciation of the dollar, which, as I said, we should welcome under today's circumstances.

All of this raises the question of how we should move forward on this basis? So I'm arguing that China should be pushed hard to revalue the renminbi. I'm saying they cannot threaten us. These threats are empty threats. But there is a question of how to take it forward, and the approach preferred by the Bush administration and the Obama administration to date has been to rely on the so-called "multilateral approach," which works through the International Monetary Fund, and we can talk about the technical details if you want, but I was very much part of those efforts when I worked at the IMF through August of 2008.

That approach, to be honest, has failed. It is not going to work. You can try it again if you want. It will not work, in my assessment. I think we should not move precipitously towards bilateral threats of trade retaliation. I think we should develop a new multilateral process based around the World Trade Organization with legitimacy and authorization from the G20.

I think we should take the lead on that though. We should not be passive. We should be pushing this agenda. There are many other countries around the world, including emerging markets, such as India, for example, who also feel aggrieved at China's exchange rate policy and also feel that it is a type of unfair trade subsidy.

Now that's not how it's viewed under international law right now. That's not how it's treated by--the WTO has no jurisdiction over this issue. The IMF has completely dropped the ball, and we need to find a new approach, but I think the U.S. should not be fearful. The U.S. should be assertive, and the U.S. should take this issue directly to China through a new multilateral approach and build a mechanism around the World Trade Organization.

Thank you.

[The statement follows:]¹

Panel I: Discussion, Questions and Answers

HEARING CO-CHAIR WESSEL: Thank you.
Dr. Wortzel.
COMMISSIONER WORTZEL: Thank you for the written testimony and the oral presentation.

¹ Click here to read the prepared statement of Dr. Simon Johnson
When the Quadrennial Defense Review was released, Defense News ran the piece that said that the language in the QDR on any military threat posed by China to the United States was softened. The article quoted an unnamed Department of Defense official as saying that the language was softer because you don't make your banker mad.

So should we think of China as our banker? And if we should think about China as our banker, should we then adjust our defense and foreign policy because of that?

DR. JOHNSON: Thank you for the question. I'm obviously not an expert on defense matters. I confine myself just to the economics. No, we should not adjust other policies to somehow accommodate China, to recognize or to think that they somehow have a hold over us or they could do something to us.

Dr. Wortzel, I think in what you said there was an implied threat: if we weren't kind to them on some issues, they would be somehow tougher, demanding more interest, for example, and that's what people talk about, or pushing the dollar down. Well, they cannot push up our interest rates. That's not how the Treasury bond market works, particularly at this time with the Fed position as it is.

We should not fear depreciation of the dollar against the renminbi or in real effective terms against all our trade partners. So this threat is an empty threat; it is a paper tiger.

COMMISSIONER WORTZEL: Thank you.

HEARING CO-CHAIR WESSEL: Commissioner Mulloy.

COMMISSIONER MULLOY: Thank you, Dr. Johnson, for being here.

The article that you wrote in Atlantic magazine, I think a little over a year ago, was a terrific piece.

In your testimony, on page three, you state that China is obviously a currency manipulator and should be so labeled by the U.S. Treasury in its next report to the Congress. The next report to the Congress is due on April 15.

My own sense is that there's a broad consensus even in the economics profession that China is under pricing its currency to gain trade advantages, which then violates Article IV of the IMF Charter. They know what they're doing, and the Treasury by not telling the truth to the Congress in their mandated reports lets the Chinese think that they can buffalo us around. So it just seems absurd to me that we go on with this masquerade.

I also like your vision that we need a multilateral approach, and I've been thinking about that. There's a man of great stature and interest in the American financial commitment, and its Paul Volcker, the former Fed Chairman. Would you think that that would be something
that Secretary Geithner might task Chairman Volcker to take on, to give him this charge to get this exchange rate matter resolved?

DR. JOHNSON: I think that's a great suggestion. I think having a special envoy, somebody who has international standing and status on economic issues as the point person, is a very good idea. I would stress, though, that the agenda this person should be working towards, and let's say it's Mr. Volcker for the sake of argument, Mr. Volcker should have a mandate to develop a new multilateral tool for addressing this issue.

And, of course, the World Trade Organization stands in stark contrast to the International Monetary Fund. The International Monetary Fund has, as you said, not--this is a violation of the Articles of Agreement of the IMF and it's a violation of the Surveillance Decision, which is a more recently passed enhancement of IMF rules around currency manipulation.

But the IMF has found itself, for reasons I can explain if you're interested, but the fact of the matter is, it's found itself incapable of deciding that China is the equivalent of a currency manipulator in IMF language. It's not exact language, but it does map into the Treasury language.

Mr. Volcker, in that case, should pursue through multilateral means bringing other countries along, not going head to head with China. That's what Mr. Paulson--remember, Secretary Paulson preferred the head to head with China. Perhaps it was a good idea at the time. It really didn't generate any lasting benefits in this space.

Mr. Volcker should pursue a multilateral initiative. It would be under, I would suggest, the auspices of the G20. You have the right countries there. Many members of the G20 are seriously annoyed with China and the way China has behaved in this sphere, and the task would be to create a process that would go to the WTO, just like we take unfair trade subsidies as conventionally designed to the WTO, and this process would take some years to put together, but if the Chinese see you moving seriously in this direction, and if they see someone with Mr. Volcker's status leading this process, and with the ear of the President on it, and a lot of support on Capitol Hill, they will take you much more seriously than they do right now.

Right now, they don't take the U.S. or the IMF seriously on this issue, I can assure you.

COMMISSIONER MULLOY: Thank you, Mr. Chairman.

HEARING CO-CHAIR WESSEL: Chairman Slane.

CHAIRMAN SLANE: Dr. Johnson, thanks for coming.

Again, I wanted to refer to that great article you wrote in Atlantic almost a year ago. At the end of the article, you talk about two paths,
and the second path you go on to say that the second scenario begins more bleakly and might end that way, too. It goes like this: the global economy continues to deteriorate, the banking system in East Central Europe collapses, and because East Central European banks are mostly owned by Western European banks, justifiable fears of government insolvency spread throughout the continent.

Given what's going on today, do you see that scenario as more likely?

DR. JOHNSON: Aspects of that scenario certainly are, unfortunately, coming into play. The East Central Europe part, I think, was somewhat headed off by the G20 and by the extra money they put into the IMF, which we were arguing for very strongly at the same time as writing that article.

Of course, what we've seen is, nevertheless, a solvency issue has developed in Western Europe, and this is what I was referring to before as the problems around the eurozone. I don't know how much detail you want to go into, but the weakness of certain governments in the southern part of Europe, particularly Greece, but also fears about Portugal and Spain, mean that while I don't think that Europe will be plunged into a depression--they have large government sectors; they're not, I think, going to cut those back dramatically--they are talking about quite a lot of austerity, rather precipitously, in my view--their overall economic strategy is rather too tight. I think this is the German influence on the European Central Bank, for example.

On the whole, the eurozone looks unappealing as a place to park your money and hold reserves, and its growth prospects, which I touched on in the second part of my testimony, are not good. So I would think stagnation in Europe, struggling to recover, is part of the global picture, and if you want to think going forward, what does that do to global growth and what does it do for China, it's a big opportunity for China.

Emerging markets are going to drive growth, I think, and drive the next boom, and I fear actually the way that will interact with our banking system, which has got many problems that Mr. Volcker has flagged, and we've not dealt with. I mean I understand that's a different topic, but that is part of the global picture I would paint for you going forward.

CHAIRMAN SLANE: Thank you.

HEARING CO-CHAIR WESSEL: Good morning, Mr. Prestowitz. How are you? Thanks for being here. We're going to hear your testimony and then we'll resume questioning from the Commissioners. If you could limit your oral testimony to no more than seven minutes so we can get back into the flow of things, we'd appreciate it.

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Thank you.

HEARING CO-CHAIR CLEVELAND: We've already given you a glowing introduction.

HEARING CO-CHAIR WESSEL: Yes.

MR. PRESTOWITZ: Okay. Maybe I should have stayed away.

HEARING CO-CHAIR WESSEL: Sales of your book on Amazon have gone way up in the last 20 minutes.

STATEMENT OF MR. CLYDE V. PRESTOWITZ, PRESIDENT ECONOMIC STRATEGY INSTITUTE, WASHINGTON, DC

MR. PRESTOWITZ: Thank you so much.

I apologize. I think since we're borrowing so much from the Chinese, we should borrow some of that infrastructure investment.

Let me just quickly respond to questions that were posed in the invitation letter. Clearly, the U.S. is a large debtor globally, and China is, I guess, has been surpassed by Japan recently as the largest holder of U.S. Treasuries, but nevertheless, China is by far and away the biggest holder of dollars and the biggest overall creditor to the U.S.

So what are the implications of that? Some of them, of course, are positive. China's financing of the United States really facilitates, for example, the U.S. stimulus recovery program. Even more importantly, it facilitates the U.S. role as the world's hegemonic leader. No way would we be able to afford to maintain troops in Afghanistan and Iraq and, indeed, ironically, patrol the Western Pacific with the 7th Fleet around China if it weren't for Chinese money.

We wouldn't be able to rebuild New Orleans or do lots of the other things that we do without Chinese money. So, in many respects, it facilitates us, but, of course, it also has inevitably the burden of obligation. People often say that one does not argue with one's banker. That's not entirely true.

I think when we think about our relationship with China, we need to understand that the old aphorism that if you owe the bank $100, you have a problem, but if you owe the bank $100 billion, the bank has a problem has some truth to it, and the fact is that we and China are in a kind of a mutual destructive--what's it--MAD--mutual--

COMMISSIONER MULLOY: Mutually assured destruction.

MR. PRESTOWITZ: --assured destruction kind of situation. But we shouldn't press that too far. I often hear it said that China has no alternative except to continue to buy dollars and hold dollars, and that may be true in the short term, but it's not necessarily true in the long term, and moreover, even if it is true, it's also true that we have apparently no choice but to keep borrowing, and so there is leverage on
both sides.

But the history of this is not an encouraging one for debtor countries. In his great book, *The Rise and Fall of the Great Powers*, Paul Kennedy demonstrated that virtually all the great powers stopped being great powers when they become overstretched, over-indebted, and our own history with Great Britain, I think, is a great object lesson.

We were allies for the First and Second World War, allies throughout the 20th century, kindred countries. In 1957, Britain, France and Israel tried to seize the Suez Canal. They did for a little while. They had neglected to inform President Eisenhower of the escapade. Eisenhower didn't think it was in America's interests. He was furious, particularly for the Brits for not keeping him informed.

The U.S. was the big creditor for Britain at the time. Britain thought it was a world power, thought it continued to be a great power, had been one of the winners of the Second World War. Eisenhower threatened to ruin the pound sterling, and that was the end of the Suez caper, and it was the end of Britain as a great power.

Now, if that's what a friendly creditor will do to you, you can imagine what a less friendly creditor might do in trying circumstances.

So Polonius' advice to Laertes still holds true: neither lender nor a borrower be. I think that holds for great powers.

The trends at the moment, I think, are not good. The U.S. is kind of locked into an economic structure in which we have a chronic and large current account deficit, and indeed as our economy recovers, that deficit is likely, almost certainly, will become much larger, and at the same time, we are domestically locked into a structure in which the related federal debt, deficit, is also large and chronic, and so that suggests continued borrowing from China, increasing reliance on China and others.

I think it's important to emphasize we focus a lot on China, but as I said, Japan just surpassed China as the biggest holder of Treasuries. So Japan is a big lender, and let's not forget the Persian Gulf states, who are also big lenders, and, indeed, let's not forget Russia and some others who are also big lenders.

But in any case, the U.S. will continue to borrow, and these countries will continue to lend, but they will look for alternatives. China has voiced concerns about the safety of its holdings, and it's right to do so. I mean there's a certain hypocrisy in that because the Chinese are, to some extent, the cause of their own problem, but nevertheless, their holdings are at risk, and they're right be concerned about that, and they will seek to diversify, and it won't necessarily be easy because there aren't a lot of good alternatives to the dollar, but over time those can be developed, and if we stay on the present track, I think the
continued decline of American influence and the continued decline of U.S. economic competitiveness is virtually assured, and therefore important for us to get on a different track.

Thank you.

[The statement follows:]

Prepared Statement of Mr. Clyde V. Prestowitz President, Economic Strategy Institute, Washington, DC

Recent Federal Reserve Bank of New York statistics indicate that China has been replaced by Japan as the largest investor in U.S. Treasury Securities. In December of 2009, the bank reported that Japan held $769 billion of Treasury securities compared to $755 for China. However, the statistics also showed U.K. holdings of $303 billion, Caribbean Banking Center holdings of $185 billion, and Hong Kong holdings of $153 billion. Since other investors often make investments through the UK and Caribbean centers, the exact holdings of each country are not always clear. Moreover, since Hong Kong is a special administrative region of China, its holdings could be counted as Chinese which would put China back on top.

More important, however, is the fact that regardless of which country holds the most Treasury securities, China is far and away the largest holder of U.S. dollars with a hoard of between $2.5 and $3 trillion and rising. This, of course, makes it the largest overall financier of American debt as well as an increasingly major investor in a wide range of U.S. and third country assets. Indeed, next to the United States itself, China is probably the world’s most important financial player. What are some of the implications of this rise in Chinese financial power?

In one sense, it actually facilitates both America’s economic recovery policies and the further playing of its role as the hegemonic global power. Without the lending of the Chinese (and of others like Japan), U.S. economic stimulus efforts would be much more constrained and the United States would long since have brought the troops home from Iraq, Afghanistan, and many more of the over 800 bases it maintains around the world. So, in one sense, we could say that China is financing the rebuilding of New Orleans, the reconstitution of the U.S. banking system, and U.S. military activities around the world including the patrolling of off-shore China waters by the U.S. Seventh Fleet.

On the other hand, this financing can also be considered as vendor financing in a giant Chinese-American Ponzi scheme. China’s growth depends on exports and they depend to a significant extent on American consumption. Indeed, one could say on American “over-consumption.” China subsidizes its exports in a number of ways and the financing of U.S. debt enables the subsidization through currency undervaluation and other methods. In this way, it subsidizes U.S. consumption, but also undermines U.S. based production of tradable goods and services, and, in the long run, the productive base that underpins the U.S. global role.

Financial power is, of course, almost always linked to political power and influence. By dint of its financial role, China has gained significant political influence in the United States and around the world. As a major investor in some of America’s leading financial groups, Chinese government related funds have become a significant part of the Wall Street lobby that wields such enormous influence here in Washington. The U.S. government’s ability to enforce some of the key rules of international trade and finance is inhibited by America’s financial dependence on China. This is not to say that the United States does not have some countervailing power. It does. Just as America needs Chinese money, China needs the American market and the American provision of international public goods. So we have cards to play, but we play them much more cautiously than we otherwise might.

Historically, it has never been a good thing for countries to accumulate large debt burdens and especially it has not been good to accumulate such debt burdens to other countries – even to other very friendly
countries. In his book, The Rise and Fall of the Great Powers, Paul Kennedy records that a prime cause of the fall of the powers was the increasingly unsupportable burden of foreign debt. Perhaps the most telling example is that of Great Britain and the United States during the attempted 1957 seizure of the Suez Canal by Britain, France, and Israel. Britain still fancied itself a great power at the time and was so regarded by much of the rest of the world. It still maintained a vast empire and the sun still did not set on the British flag. But Britain was heavily in debt to, among others, the United States, its closest friend and ally among the nations. President Eisenhower was furious over the seizure of Suez and informed the Brits that America would ruin the pound sterling if Britain did not withdraw. And that was the end of the seizure. Now, America is not Britain and China is not America. But if that is how your friends can treat you when you owe them, it is not difficult to imagine that less friendly states could be quite difficult in certain circumstances.

China has voiced increasing concern about the future of America’s debt, the dollar, and the value of the Chinese dollar holdings. It has also indicated that it is trying to diversify its reserve holdings a bit away from the dollar. It is right to be concerned and it would be foolish not to attempt to diversify. That, after all, is the iron law of investment. Never mind that China may be the ultimate cause of much of its own concern. It nevertheless, must look at the trajectories and try to allocate its resources accordingly. Current trends indicate continuing U.S. current account deficits in the 3-7 percent of GDP range and U.S. federal budget deficits in the $1 trillion dollar plus range. If not reversed at some point, those trends will inevitably lead to the debasement of the dollar and the bankruptcy of the United States. So China will try to hedge against that by diversifying. Diversification, however, will not be easy because there is no good alternative to the dollar and because the very act of diversification may tend to undermine the value of China’s holdings. So it will move carefully and cautiously. It may buy more gold, more oil fields, more agricultural land in Africa, and so forth. But there will be limits to that as well. We and China and the world, desperately need to develop a whole new approach.

Panel II: Discussion, Questions and Answers (continued)

HEARING CO-CHAIR WESSEL: Thank you. We'll credit you with 18 seconds for another question later on. Thank you for staying in the time.

I'll pick up on the questioning, and then we'll go to those who have not yet asked and, hopefully, have a second round as well.

Let me make sure I understand both of your points just as it relates to the size of U.S. debt to China and the implications. Dr. Johnson, assuming I'm hearing you correctly, you don't believe we're close to a tipping point at which the implications of that debt seriously hinder our ability to pursue U.S. policy interests.

Mr. Prestowitz, I detect that you're saying that we're closer to that tipping point, and I know you weren't here for Dr. Johnson's testimony, but that the ability to pursue U.S. policy interests is at greater risk than—we still have control, but we're losing control.

Am I correct in terms of how each of you are portraying this?

MR. PRESTOWITZ: Well, I don't think that we're at some precipice at the moment.

HEARING CO-CHAIR WESSEL: Not at the tipping point.
MR. PRESTOWITZ: We're not at the tipping point right now, no.

HEARING CO-CHAIR WESSEL: Right. Okay.

MR. PRESTOWITZ: But I think the nature of these things is subtle, and it's not necessarily a tipping point issue in the following sense. It's not like up to a certain point--

HEARING CO-CHAIR WESSEL: Understand.

MR. PRESTOWITZ: --you've lost no influence.

HEARING CO-CHAIR WESSEL: Right.

MR. PRESTOWITZ: And beyond that, you've lost everything. It's a spectrum.

HEARING CO-CHAIR WESSEL: Right. You hit the apex and then--

MR. PRESTOWITZ: Yes.

HEARING CO-CHAIR WESSEL: --you start down the slippery slope.

And just for the record, Dr. Johnson, you were nodding your head, and so we'll have that for the record.

VICE CHAIRMAN BARTHOLOMEW: A what?

HEARING CO-CHAIR WESSEL: A head nod, please, if you can put that in. Agreement in terms of how I characterized your views.

Let me then if we're not at the apex, if we're not at the tipping point, and we recognize that the current path is not one we want to continue, what do you attribute the lack of action to?

If, in fact, we're not going to worry about dramatic changes in the yield curves, that we don't believe that China is going to do something dramatic in response to our actions.

For I don't know how many years now we've refused to name China as a currency manipulator. Next Monday, the Commerce Department in the next official action has the ability in a trade case to vote as to whether currency manipulation should be something that you can countervail as a subsidy.

Then we have the April 15 report coming up. Why are they not taking action? Why are we not if we believe it's our interests to get China to revalue?

Is it, Dr. Johnson, going back to your article of last year, which many of us referred to, talking about the financial elites, is it because our political system has become imbedded with financial elites and the control of the financiers?

Is it just fear, unwarranted fear, about what China will do? Have we lost the policy tools? I fear going to the WTO or G20 is a multi-year process. That may put us, while you don't think we're near the tipping point, closer to the apex that Mr. Prestowitz was talking about.

DR. JOHNSON: I would say that we do have serious problems in
this country around our fiscal deficit, but this is much more about ourselves and about our lack of a sustainable debt framework and the lack of a medium-term fiscal framework that puts our debt on a sustainable path.

That's nothing to do with China. That's our own fiscal affairs. And that's where I think we could discuss when is the tipping point and when do the markets start to give us a harder time on that? It's certainly not yet, but I would not lose focus on that issue.

As to why the U.S. doesn't pursue this issue more directly, it's a great question. U.S. policy has obviously been somewhat schizophrenic. At the level of the IMF and pushing for the surveillance decision, which was supposed to strengthen the resolve and give the IMF greater tools for determining if China was, in effect, a currency manipulator, the U.S. was pushing for that pretty hard under the previous administration.

But they refused to label China as a currency manipulator to Congress, and so there was a certain excessive politeness between Treasury and the IMF, no, no, you go first; no, no, you go first.

I don't understand that. I don't understand why Treasury doesn't take the lead. I don't think it's about financial, I don't think it's about capture by financial elites, which I do think is a big problem in our society. I think this is a policy mistake.

HEARING CO-CHAIR WESSEL: We'll come back and go around for a next round. Vice Chairman Bartholomew.

VICE CHAIRMAN BARTHOLOMEW: Thanks very much, and thank you gentlemen for all of the energy and ferment that you bring into these discussions. I think you make very important contributions, and we really appreciate that.

Dr. Johnson--and Mr. Prestowitz, you can answer this, too. I want to go back to this issue of how to deal with currency manipulation and tools essentially. I find it very interesting that you talk about establishing a new mechanism or increasing the mandate of the WTO, but partially in response to what you just said of the question of excessive politeness or why the administration hasn't done anything, I think part of the answer to that is that the Chinese government has always been very good, much better, frankly, than we have, at pulling levers or pushing buttons that might not be real but using threats.

What I wonder is if you could walk us through how you would see getting to a stage of either expanding the mandate of the WTO to deal with this or establishing a new mechanism because we see this in commercial deals--we see it in diplomacy--is that the Chinese are really good at divide and conquer, frankly.

How do we put together a new coalition to do any of these things if what we have to presume is that the Chinese government's response is
going to be picking off individually any of the countries that we are
going to need to do it, whether it's buying Airbus versus Boeing,
whether it's working at the U.N. Security Council to help on Iran?
There are any number of things, and they are not shy about using them.
So how do we do this? Can you walk us through how you would see it
work?

DR. JOHNSON: Certainly. And, of course, you're absolutely
right, the Chinese are absolute masters at this, and I would point out, if
you didn't notice, that yesterday a senior People's Bank of China official
was appointed to a top position at the International Monetary Fund, and
I personally would regard that as further evidence of capitulation by the
IMF on this issue.

I would be happy to withdraw that remark if China revalues its
currency in the next week sharply.

VICE CHAIRMAN BARTHOLOMEW: Significantly.

DR. JOHNSON: But, honestly, that's not going to happen; right?

HEARING CO-CHAIR WESSEL: We'll hold the record open for
that.

DR. JOHNSON: Thank you. So I think the Chinese have
outmaneuvered us, and the Chinese do have a divide and conquer
strategy, but the point to keep in mind is that many countries that
perhaps two or three years ago were reluctant to press China too hard,
the U.S. was more taking the lead at the level of the IMF, many of these
countries are now even more annoyed with China. There's something
about a recession that really concentrates your mind.

India is very clearly not in favor of this. The European Union has
become much tougher on China over the past 12 to 18 months. I think a
serious effort of economic diplomacy led by somebody prominent from
the U.S. side would be a good way to galvanize the support.

Obviously, there has to be leadership at the level of the White
House, and the G20 Summit is a very powerful mechanism because it's
heads of government meeting, 90 percent of the world's GDP at the
table, and President Obama actually could take the lead on this.

Now, the Chinese will push back very hard. There is no question
they will threaten you with Suez type consequences, but honestly 1957
was a very different moment. That was a fixed exchange rate system,
Bretton Woods. Depreciation of the pound, devaluation of the pound
would have caused inflation in the UK, a relatively small open economy,
which would have then led to contractionary monetary policy, perhaps
contractionary fiscal policies as they counteracted that, and a recession,
plenty of reason to fear that. That's not our situation.

We have a floating exchange rate. There's plenty of demand for
U.S. Treasuries. There is nothing safe in the world at this point apart
from U.S. Treasuries as far as many investors are concerned. We should
take advantage of this opportunity, and you have to take it to the
Chinese. There is no question. They will push back very hard. You
have to be willing to do this, and as for what they could do or threaten
or offer in other spaces, I can't speak to that.

Maybe you can do a deal. Maybe you let them have their
economic thing they want, and they give you other things, but I just
read the newspapers on the other issues. I don't see any great Chinese
outreach to the United States on those dimensions.

VICE CHAIRMAN BARTHOLOMEW: Well, the deal so far, I'm
afraid, has been they've implied that they would do other things. We've
made concessions, and then they haven't actually even done those
things.

Clyde, any comments or thoughts on this?

MR. PRESTOWITZ: I agree with Simon, that it's a little bit
baffling why we haven't been more active, and there are many things
that we could do. I completely agree that this is not just a U.S. issue.
Other developing countries are being hurt by China's policies, as well as
EU countries.

It has seemed to me for some time, it should be possible to build a
strong coalition of countries that are being harmed by China's policies
and to bring pressure that way, and certainly the WTO offers
opportunities to proceed in terms of anti-dumping, in terms of
nullification and impairment.

There are many clauses that a government that wanted to act
could take advantage of in the WTO, and of course there's the IMF
procedures which we have not availed ourselves of.

So that drives me back to the prior question which is, well, why
no action? And I think there are several reasons for it. I think one is
that, as all of you know, for a long time, U.S. foreign policy has
focused on geopolitics, not geo-economics. We have become
accustomed to subordinating our economic interests to geopolitical
imperatives.

We need China or we think we need China to deal with North
Korea, to deal with global warming, a lot of other issues, and so I think
the currency issue gets subordinated, number one.

Number two, some of you are familiar with the mantra "a strong
dollar is good for the American economy." How many times have you
heard that? Well, some of our top leaders believe that, and, in fact,
again, ask yourself if you have a weaker dollar, what's the impact of
that on the U.S. geopolitical role?

Well, it's somewhat negative. So Wall Street likes a strong
dollar. The Pentagon likes a strong dollar. The Treasury likes a strong
dollar. It makes it easy to finance the U.S. debt, and then let's not forget a large proportion of the imports coming into the U.S. from China are produced by American companies in China. U.S. CEOs, many of them, like a strong dollar. And so I think for all those reasons, no action has been taken, and I'm not sure that it will be.

HEARING CO-CHAIR WESSEL: Thank you.
Commissioner Reinsch.
COMMISSIONER REINSCH: Thank you.

First, I want to agree with what I think Dr. Johns on said in his last response to Commissioner Wessel. To me, the important question, the most important question here, is the size of our debt and what we're going to do about it, which is a question of U.S. policy.

Somebody has to hold it, and the Chinese holding it creates particular problems, which we're here to discuss, and I'm glad we're discussing it, but if it weren't they, it would be somebody else, and I think a more important policy question for the administration is how do we address the size of it and deal with it? So I'm glad you brought that out.

I have two questions, I think primarily for Dr. Johnson, but, Clyde, feel free to comment. First of all, the blogosphere, if you will, seems to be more or less universally predicting that the Chinese are going to let the RMB appreciate by some amount, and there's a debate about how much, but I think they would all put it in the relatively insignificant category, but there seems to be this widespread expectation amongst commentators that they are going to let it appreciate this year. In fact, possibly fairly soon.

Do you agree with that?

DR. JOHNSON: I'm not sure about the blogosphere, but Goldman Sachs, Jim O'Neill of Goldman Sachs, did say it was going to happen, and Goldman Sachs does have very good access. So I think some small but, as you said, insignificant appreciation would be exactly in line with their tactics, which is they're very clever about it. They're not "we will never move this ever, ever, ever." They're "what do you mean? We just moved it. Last Wednesday we moved it by a minuscule amount."

So, yes, they'll continue those tactics. Absolutely.

COMMISSIONER REINSCH: Clyde.

MR. PRESTOWITZ: Just a comment. I actually recently posed that question, in fact, just earlier this week, posed that question to one of the top advisors to the Chinese, to the People's Bank of China, and he told me privately that he didn't see any change coming. You know, maybe he's throwing me off the track, but I'm not sure that the blogosphere is necessarily correct.

COMMISSIONER REINSCH: Well, I wanted to get informed
opinions, and I appreciate them. Of course, nobody is going to tell you in advance that they're going to do it. They're all going to insist that they're not going to do anything until the day they do it, but it's interesting that he said that.

The second question goes where Carolyn was going. I continue to be kind of baffled about exactly what it is the United States could do unilaterally that would address this problem.

Let's assume, hypothetically, that multilateral efforts fail, and I agree with you that that's the wisest approach. It would be nice if we could get the IMF to do something, et cetera, et cetera, et cetera. It would be nice if we could get the WTO to do something. Let's assume that all that fails. Let's assume that the Chinese are functionally recalcitrant and don't do anything beyond token appreciation, and we reach a point where the situation is economically intolerable for us, from a policy perspective, what could we actually do as a government unilaterally that would rectify the situation in a relatively short period of time were we to decide to do it?

MR. PRESTOWITZ: Well, when you say assume the WTO and the other mechanisms haven't worked, I'm not sure exactly what you mean by that, Bill. I mean I think that the procedure should be obviously you try to reach some bilateral or multilateral deal, as Simon suggested. I don't think we've exhausted that. I don't think we've even really tried that.

So I think there's lots of opportunity there for just dealing, as I said, put together a coalition of major developed and developing countries and have a real serious discussion with the Chinese.

COMMISSIONER REINSCH: Yes. I wouldn't argue with you about where we are.

MR. PRESTOWITZ: Okay.

COMMISSIONER REINSCH: And what to do, but I'm trying to get beyond that.

MR. PRESTOWITZ: All right. Fine. Yes.

COMMISSIONER REINSCH: And say if all that fails, what do we do?

MR. PRESTOWITZ: Okay. So your talks don't work, so then you do identify China as a currency manipulator to the IMF, and you call on the IMF to take appropriate action, and you go to the WTO, and you say, hey, this is a subsidy. You file a case on subsidies, and you file a case on nullification and impairment, and maybe that sparks negotiations.

Okay. Now you want to say that all fails; right?

COMMISSIONER REINSCH: Yes.

MR. PRESTOWITZ: So then what? Well, Nixon imposed a
surcharge in 1972. You declare a balance of payments emergency under the WTO regulations, and you impose a surcharge.

COMMISSIONER REINSCH: Dr. Johnson?

DR. JOHNSON: One thing that Treasury will say in private is they're afraid that if they label China as a currency manipulator, that Congress will push for or actually legislate some form of bilateral trade sanction. This will cause a trade war. I personally don't think that's a likely outcome. I do think, though, that pursuing this, labeling them as a currency manipulator is completely obvious and even required in this situation.

That will have no effect on the IMF. Do not think for a moment that the IMF is a productive way forward on this issue. I think taking it to the WTO under existing structures is an interesting idea, and I defer to Mr. Prestowitz on whether that would have any chance at all.

The WTO experts I talk to say that under existing frameworks in international agreements, we would not win such a case because it's not within the jurisdiction of the WTO, and the jurisdiction of the WTO has to change, and that's the point of launching a multilateral G20 initiative, which we would lead, to change the terms of reference for the WTO.

Now, if this gets off the ground, the Chinese will pay attention, and they will change what they do because they're smart. If it doesn't get off the ground, then we're back to your question, your problem, which is if we can't bring the rest of the world with us, what do we do about it? And I think, you know, down the road, but as a very, very last resort and with great reluctance, I would go where Mr. Prestowitz just outlined.

Ultimately, countries have to be able to take care of themselves. The U.S. has a big global responsibility. We did help build the system. We have largely run the economic part of the system according to the rules. The Chinese are breaking the rules, the rules that they voluntarily agreed to, and the problem is because it's a rather good international system based on voluntary cooperation, there are not mechanisms for punishing countries outside what the WTO can do to you, and this is a big gap in global governance that the Chinese are exploiting.

COMMISSIONER REINSCH: Thank you.

HEARING CO-CHAIR WESSEL: Commissioner Blumenthal.

COMMISSIONER BLUMENTHAL: Thank you.

It seems, Commissioner Reinsch, you answered your question when you started by saying, what can we unilaterally do? We can stop going into so much debt, and, Mr. Prestowitz, one thing you said, that I think just doesn't resonate in any way with me, is that we somehow put our geopolitical interests above our economic interests with China. I
think it's exactly the opposite.

I think what we do is we're incredibly worried about very short-term buying of our debt every week or every couple of weeks or however the options work, and the Treasury Department puts enormous amount of pressure on the Pentagon and other departments in the short term to play down concerns and threats that China might make because it's so worried about financing its-- and this happens across administrations--financing its domestic programs.

So if I'm wrong about that, then I'd like somebody to correct me.

I think more broadly nothing in either the testimonies that you gave or in anything that we've read has persuaded me differently of this basic proposition. The Chinese are bluffing on the debt. There is nothing they can do. I think, Mr. Prestowitz, you said in the long term there's something they can do. Maybe they can put the money elsewhere, but it's bluff, and it's bluster, and our economy is so much stronger and our political system so much more stable, that if they really wanted to get into that kind of economic warfare with us, which is what, you know, they would, in the end, really pay the price.

As you said, Mr. Johnson, there's no other place for them to put their money, and they're so reliant on an undervalued currency because of their economic system, which they're not changing any time soon. I mean this is just bluster.

We're buying it, though, because Commissioner Wortzel read a Pentagon official who said that we've been softer on the Chinese in terms of our QDR, which I think we definitely have, because we're self-detering because we actually believe these threats.

Now, if I'm wrong about this, I'd like to be persuaded, but again nothing I've seen in any of our literature tells me anything but the fact that this is a bluff, this is bluster, and it's working because they have undue influence in Washington, D.C., where they affect policymakers and scare them with their threats.

DR. JOHNSON: I agree completely. I think it's a bluff, and the bluff should be called. I am not advocating economic warfare with China. It is not in our interests to destabilize a major trading partner, and that's not, I think, where this would go.

COMMISSIONER BLUMENTHAL: That wasn't my point.

DR. JOHNSON: Though there is a contradiction or a tension within what we see policymakers do in the executive branch. On the one hand, I think it's completely plausible. I have no first-hand knowledge of what Treasury is telling the Pentagon to do and so on.

On the other hand, I can tell you from my direct personal experience when I was at the IMF, that the Treasury was pushing for the Surveillance Decision, which was a strengthening of the IMF tools, in
the honest belief that this would give them a way to press China effectively to revalue the renminbi without going to Congress and without starting a potential trade war.

So the Treasury officials I'm talking about--Tim Adams, for example, was Under Secretary for International Affairs--they were very genuinely and seriously pushing this, and they were under the impression, which was given to them by the IMF, perhaps the IMF at the time was telling the truth--I don't know. It just hasn't worked out that way, and we should learn from that, but they were under the impression that this would work.

So, in other words, they weren't backing off from this issue completely. They were trying to take it through the multilateral mechanism. If you go back to the founding of the international currency system after World War II, the IMF is supposed to have jurisdiction over exchange rate issues.

That's the fundamental division of labor in global governance, and it did under Bretton Woods have not exactly this kind of power, but it had something analogous so it wasn't a crazy thing to do, and it wasn't a wimpy thing to do either three years ago, four years ago. It hasn't worked out. We should update on that basis, and we should take a new approach.

MR. PRESTOWITZ: Yes, my experience through many years of negotiation, both with China and with Japan and with others, has been that typically--there's not a contradiction between, in a sense, what you're saying and I'm saying. In my experience, Treasury has always been a supporter of a strong dollar, and what I've seen is that State Department, Pentagon, the National Security Council, typically, are reluctant to or even oppose any measures that might result in complicating the geopolitical scene.

Treasury's concern is not opposed to that, but it's parallel. Treasury tends to be, you know, pretty much for Treasury, but its concerns are typically not in the direction of shifting the status quo.

So, for example, to come back to it, Bob Rubin, strong dollar is good for the American economy; Larry Summers, strong dollar is good for the American economy; Alan Greenspan, strong dollar is good for the American economy. So you've never had, at least in my experience, a really strong push from Treasury in an opposite direction.

As far as the question of bluff is concerned, I don't know if it's, I don't know if it's that kind of a game. I think that, on the one hand, I think the Chinese have a real concern. I think that in a way they understand better than we do that ultimately the current structure is not sustainable, and in some way this goes to the question of our debt.

As Dr. Johnson and as Bill said, you know, on the one hand, you
have China's currency policy, which is a China policy, but a major piece of this picture is the U.S. fiscal situation and, even more broadly, it's not just the U.S. fiscal situation, but it's the whole U.S. debt situation.

We're a low savings country, and that's a fundamental issue, which is our issue, not a Chinese issue, and I think the Chinese look at that, and they're seeing that, okay, yes, today China doesn't have a lot of good alternatives to where it's going to put its money.

You're not going to buy euros today, and you're not going to go to yen, and there's only so many Swiss francs and loonies that you can buy. But, on the other hand, ten more years of U.S. current account deficits of four, five percent of GDP, ten more years of U.S. federal budget deficits, at a trillion, $2 trillion, 20 more years of that, somewhere it doesn't compute.

I think the Chinese are looking at that, maybe more seriously than we are. And, in fact, I'm somewhat sympathetic with the Chinese in this because I personally feel that in many respects, I mean this is going to sound crazy to you probably, but in a way, the U.S. would be better off if the dollar were not the world's currency.

Why do I say that? Because the fact that the dollar is the world's currency, and that, as we've been saying, there is kind of no alternative, means that there is also no discipline on the U.S.

It means, as Dick Cheney says, deficits don't matter. As long as deficits don't effectively matter to us, there's no real incentive for us to change this unsustainable underlying structure. And the Chinese are raising that issue. We should thank them for that, I think.

HEARING CO-CHAIR WESSEL: If deficits don't matter, then maybe they are sustainable. So, but who knows?

Commissioner Videnieks.

COMMISSIONER VIDENIEKS: Good morning, gentlemen. I'm looking at the prepared testimony.

China's share of the total outstanding debt is cited as being 5.6 percent of total U.S. Treasury debt in a table entitled "China's Holdings of U.S. Government Debt"--5.6 percent.

The numbers decreased from 9.7 to 5.6 over a short period of time. Are we overemphasizing the role of China in financing our trade deficit with China? The bilateral deficit is roughly ten percent of our projected fiscal deficit. Are we somehow, the country as a whole, press, everybody, overemphasizing the role of China with respect to our problems and potentially their actions geopolitically in the future?

Both of you, please.

DR. JOHNSON: Yes, I'd have to look at those numbers, Commissioner. I did check the official numbers yesterday, and I checked them with people who follow this issue closely. China owns
about a trillion dollars of U.S. Treasury securities. I put the calculation in my testimony. We have 7.3 roughly—it’s gone up a bit obviously since I started to speak—U.S. government securities outstanding.

So it's a substantial fraction. As for whether we're overemphasizing it, certainly, if we're emphasizing it, then we're overemphasizing it. This is not our main problem. The strong dollar, the strong dollar is not good for the U.S. economy in this current situation. What's good for the U.S. economy is strong fiscal policies and appropriate monetary policy. So keep inflation expectation under control and have your debt on a sustainable path.

And really the dollar, in that situation, in our economy, with our structure and with the floating exchange rate, doesn't matter.

We can talk about how Treasury got itself into this mantra. It's an unfortunate story to start with, and it's not got any better. And it does lead, I think, as you are saying, as Mr. Prestowitz is confirming, to a certain mentality around Treasury that is absolutely counterproductive and maybe fits your overemphasis point.

But I think, in general, the general debate, and I think also Mr. Prestowitz is right, if the Chinese are forcing us to think about our fiscal issues, they're doing us a favor. Our fiscal deficits, and I'm not calling for immediate fiscal austerity—I've testified to the Senate Budget Committee and other people on this very issue—you don't want or need fiscal austerity right now. What we need is a medium-term fiscal framework that's sustainable. That is a matter of national security and national priority.

And it doesn't matter who holds the debt. The question is can you afford the debt in 20 years? Do you bend the curve on Medicare and do you have tax reform? That's the issue.

HEARING CO-CHAIR WESSEL: Commissioner Shea.

COMMISSIONER SHEA: Thank you both for being here.

I'm going to ask you a speculative question so there is no right or wrong answer. I think a lot of us under appreciate the fact that China has got a lot of problems internally, and it's frankly a relatively poor country when you look at it from the perspective of GDP per capita. It's just a fraction of our GDP per capita and that of other Western nations.

But my question is this: if China were a democratic nation or if it had some democratic institutions, do you believe it would continue to engage in this process of taking our dollar and reinvesting in U.S. debt instruments rather than investing in meeting the more immediate domestic needs of the Chinese people?

MR. PRESTOWITZ: Yes, I do. I think that there are other examples. Japan and Korea, Taiwan, Singapore, Germany, all of these countries, are chronic trade surplus countries. China has really pretty
much imitated, with Chinese characteristics, if you will, but China has pretty much imitated the East Asian growth model that Japan pioneered, and all of them have been characterized by high savings, high investment, high exports, undervalued currencies, accumulation of large current account surpluses, which they invest in dollar instruments.

So I don't think that if China suddenly became democratic, that the economic dynamics would change dramatically.

DR. JOHNSON: I agree with Mr. Prestowitz. I think that this policy China has is not an accident or some sort of a mistake on that side. They have it because they are worried about the consequences of appreciation for a certain part of their economy.

COMMISSIONER SHEA: Jobs.

DR. JOHNSON: Well, I think their economy is pretty strong and rather robust, and you could shift it towards more domestic demand, but they're afraid of the consequence, I think, for employment, and a certain set of enterprises they feel would lose competitiveness if the exchange rate were to move, particularly, probably not vis-à-vis us actually, more compared to other third-party countries. So selling in Latin America or selling to us, for example, not U.S. I don't think it's particularly U.S.-China, that they fear we're going to take away market share from them because we produce very different things.

As somebody said earlier, it's our firms that run a lot of production in China. I think Mr. Prestowitz is exactly right, that there's a strategy out there that's actually one of the more successful development strategies we've seen in the last 40, 50 years, which is export-led growth, and export-led growth does not mean current account surplus necessarily, but in practice it often does.

I think the case of Japan and Germany is a very good gone. The Germans, by the way, will tell you today they're going to export their way out of this recession, they're going to run a current account surplus, and everyone else can sort out their own business including their eurozone partners. It's not a good attitude. It's not the attitude taken by the United States.

We have had a much more, much better leadership role in the global economy because we've not pushed that strategy. We've not been mercantilists, but I'm afraid that, you know--and this was an issue also within the Bretton Woods system. Japan's current account surplus, Germany's current account surpluses were part of what destabilized Bretton Woods and our current account deficit.

But I'm afraid where we are on China has gone a bit too far. I mean there's a limit to how much you should let countries do. There's a limit to what's fair, and there's a limit to what's reasonable, and China has gone beyond that. China is breaking the rules that it voluntarily
agreed to when it joined the International Monetary Fund. There's no
two ways around it.
It has played the game well so the IMF is not going to hold them
accountable. We should recognize that; we should move on; we should
find new mechanisms for holding them accountable in a responsible
multilateral way, which is the way the U.S. has run the world economy,
helped guide the world economy since 1945 with great results.

COMMISSIONER SHEA: Okay. Thank you.

HEARING CO-CHAIR WESSEL: Madam Co-chair Cleveland.

HEARING CO-CHAIR CLEVELAND: Dr. Johnson, if I could get
you to provide a little more detail when you say that we should hold
them accountable and a new mechanism. Other than the fact that a
number of countries are, as you described, aggrieved with China's
approach, why do you think the G20 forum would succeed where the
IMF has failed?

I think the WTO issue is quite different, but your emphasis on the
G20 is what interests me, given the fact that it's a relatively new forum
of consequence, and I just, I'm not seeing how, as I said, they would
succeed where the IMF has failed.

DR. JOHNSON: That's a very good and fair question. I think we
should pause and talk a little bit about why the IMF has failed. Understand that.

I think this is primarily because the IMF lacks legitimacy,
particularly in Asia, in the aftermath of the crisis in the 1990s, the way
that was handled, and the way that's perceived. Not all the perceptions
are accurate, by the way. But also, more generally, the key issue of
governance of the IMF is, of course, that the emerging markets are
underrepresented.

So the Europeans, actually interestingly, and somewhat ironically,
given that they now hold, they're now refusing to let the IMF come and
help them in their own problems in the eurozone, but the Europeans are
massively overrepresented in terms of both votes and particularly board
seats at the IMF.

Now there is a process, as you know, of IMF governance reform.
It makes the movement of glaciers look rapid. And the emerging
markets are not happy. The Chinese and other emerging markets, do not
feel that the IMF has the right, the legitimacy, to broker or to run the
sort of multilateral surveillance that will be tough on everyone, and the
fact that the IMF completely blew the call on the U.S. economy, did not
flag the substantive problems that we were heading into, further
undermines the legitimacy.

So if you talk, for example, to representatives of Brazil or Russia
or India at the IMF or the intergovernmental level, the G20 delegates
level, or South Korea, for example, which has one of the G20 Summits, they have very legitimate problems with just the way the IMF is run, the way the decisions are made, and this relates to the fact that the U.S. also has a veto there that no other single country has, but I think a lot of it is about the U.S. has actually showed more willingness to change on this governance issue, and the Europeans are a huge problem.

So governance just doesn't work at that level. We need a new governance structure, so put the G20 to one side. I agree. It's a new process at the intergovernmental level. Obviously it's existed at the Ministry of Finance level, at the Central Bank level, for awhile, but the heads of government level, we don't know what it can do.

It had a good year last year, but maybe it is not proven going forward. But the WTO has a proven and successful structure for looking into trade disputes, for letting small countries bring cases against big countries and letting big countries bring cases against big countries or against small countries.

It is regarded as legitimate, cumbersome, no doubt, imperfect for sure, but it's regarded as legitimate by all the players in the international system at the sovereign state level.

How would you change the rules governing what the WTO can and cannot do? That's where I bring in the G20. That's why I say the conversation should be at the G20 level. G20 has no voting mechanisms. You know there's no process for making decisions, but in terms of can you get, what pay grade do you need people to buy into this idea and agree to change what the WTO can do, it has to be heads of government.

This is another problem with the IMF. The IMF doesn't talk directly and enough to the President of the United States, to the people who run the other major countries. The G20 has everybody at the table. China will push back very hard. No doubt about it, but you have to show them you're serious, and you have to bring people with you. Otherwise, you're going down a bilateral route which is risky and not what I would recommend.

HEARING CO-CHAIR WESSEL: Commissioner Wortzel.

COMMISSIONER WORTZEL: Mr. Prestowitz, I'd like to restate a question that I asked of Dr. Johnson because you raised essentially the same point.

First of all, with respect to the Suez, it seems to me that things like extended nuclear deterrence and other security guarantees from the United States to Britain, France, and Israel were also a little bit of a factor in the level of pressure that the United States can bring to bear on those countries, particularly at that time, but that's not where I'm going. That's just a comment.
But what I asked Dr. Johnson, I cited a Defense News article that was published when the Quadrennial Defense Review was released, and it said that the language in the QDR on any military threat posed by China to the U.S. was softened, and the article quoted an unnamed Department of Defense official as saying that the language was softer because you don't make your banker mad.

That's pretty close to what you said also. The question I asked was should we really think of China as our banker? Is that the situation, and if so, should we then adjust our foreign and defense policies accordingly?

MR. PRESTOWITZ: China is one of our bankers, and at this moment, the most important banker, the biggest banker. But, as I indicated earlier, it's not the only one, and I think that the question of sensitivity of U.S. policy to China is a broader one than just the banker question.

I think the banker relationship could not avoid conditioning the thinking of U.S. policymakers, but it's also the case that U.S. companies are heavily invested in China. The CEOs of the Business Roundtable and Chamber of Commerce and major U.S. business organizations have big stakes in China, and I mean, for example, in the spring of last year, when the stimulus packages were being debated and passed, and there was discussion of Buy American provisions, a delegation of top U.S. CEOs went to the White House to warn the President that he should not even think about Buy America.

And that had nothing to do with our borrowing from China. It had to do with the fact that these companies were concerned about the impact on their business of some kind of conflict between the U.S. and China. So I think it's inevitable that you have an interlocked economic relationship such as we have with China, that that's going to condition the broader relationship and the broader discussion.

Now, you can look at that in a couple of different ways. On the one hand, one of the arguments for globalization for a long time has been that as economies become integrated with each other, it makes conflict or war less likely.

But, on the other hand, that clearly also has some impact on the freedom of action of the countries involved and on the freedom of action of the United States. And so I think that a major issue that has never ever been fully resolved in this U.S.-China discussion is how close, how dependent do you want to be or how closely integrated do you want to be or should you be with a country whose political and geopolitical philosophies and interests are very different than your own?

I think that's a question that will continue to hover over the U.S.-China relationship.
HEARING CO-CHAIR WESSEL: Commissioner Mulloy.

COMMISSIONER MULLOY: Thank you, Mr. Chairman. Again, I want to thank both of our witnesses for I always consider them as truth tellers. They have a great record of telling the truth to the American people.

Clyde, you weren't here when I spoke to Dr. Johnson earlier--this idea of the multilateral approach. One, he said name China a currency manipulator in the next report, which is due April 15. Two, he said we should pursue a multilateral approach.

The idea is maybe to appoint a special envoy, a man of great integrity, like Paul Volcker, to take that kind of chore on. I've always been one, though, who thinks like Teddy Roosevelt did that, we should speak softly, do a multilateral where we want to work this out. But I think we need a stick in order to get people to pay attention that this is a serious matter.

One idea is, Dr. Johnson said about a WTO, trying to change the WTO. I don't even think we need to change the WTO. You can file a case in the WTO. The only problem is, Dr. Johnson, the WTO will turn to the IMF and ask for their opinion of whether there is currency manipulation going on. But what could we use as the stick that we could have behind the multilateral approach? Dr. Johnson and, then, Mr. Prestowitz, you want to opine on that a little bit?

DR. JOHNSON: Well, the stick, obviously, has to be brandished with some care. The stick is the threat of bilateral trade sanctions down the road. There are circumstances under which it is acceptable in standard international practice for you to put a special surcharge on imports or to have some other kind of one-on-one negotiated restriction, voluntary export restriction, for example.

I think that is something you should go to with great reluctance. I think the Chinese could or perhaps even would find ways to retaliate, and that could be bad for both of us. As Mr. Prestowitz said, our economies are completely intertwined, but they have to recognize we're serious about this, and certainly if you can't even call them a currency manipulator and report to Congress, you're not serious, and the Chinese are very clear about what is power and what power means and how you use power.

So at the moment, we're in the seriously not serious category. And I think your point on the WTO is well-taken. The precedent is there. I mean the potential to move in that direction is absolutely there, but relying on the IMF, in my opinion, will always prove unsatisfactory in this context. The IMF does not have the governance, does not have, doesn't have the legitimacy. The people who run the IMF are not going to go there.
I strongly would advise you to bypass the IMF in this regard, which would be a substantial change to what the WTO is allowed to do. But the basic idea, you can take people to court, and then be allowed by that court to impose retaliation, is something we do all the time for all kinds of sensitive sectors in the U.S. Sometimes we win; sometimes we lose. But we do generally comply, perhaps not absolutely always. We do generally comply with what the WTO says.

MR. PRESTOWITZ: Yes, I completely concur. I think the real problem is the serious question. There are a lot of things that could be done, but we don't do them, and so the real, you come back to why we don't we do them, and it gets back to the things we mentioned before, and I think one of them is a kind of a reigning economic orthodoxy that is terribly concerned about potential for a trade war and that at the same time doesn't maybe see the harmful effects of the currency distortions properly.

But I think the real issue here is not so much what you can do but somehow persuading the U.S. authorities that they really should do something.

COMMISSIONER MULLOY: Thank you, both.

HEARING CO-CHAIR WESSEL: We have five people left with short, five Commissioners to question, so we're going to shorten the questioning time if we can at this point. I have a quick question.

VICE CHAIRMAN BARTHOLOMEW: But not the answers.

HEARING CO-CHAIR WESSEL: But not the answers. We'll try and get it all in the same time frame.

And Commissioner Blumenthal, I think there are many here who actually agree with you, that this is an act of self-deterrence, and having had discussions about tipping points earlier, that we have the power to act now, and we should use it.

As I recall from one of our witnesses today, the number is that one in five dollars of China's exports come to the U.S., and one out of every $20 of U.S. exports go to China, so we have substantial leverage in China. We have a deterrence with them as well.

Clyde, you were around during the 1980s as a trade policy negotiator, and it seems to me that what brought the Plaza Accord about was a rather activist Congress that forced the hand of the administration and showed the seriousness.

For some time, the last eight years, Congress has bowed to the efforts of the Treasury and the administration. Do you think it's time now for Congress to reclaim its constitutional role over trade and be more activist?

MR. PRESTOWITZ: Two things. In the '80s, for sure, the role of Congress was important, but let's not forget that Jim Baker at
Treasury and then at State played a tremendously, in my view, constructive role. Baker understood then kind of what we're talking about now and persuaded the Reagan administration act.

He was helped in that by the Congress. And so, yes, I think that there is a role for a more activist Congress, but it will have to somehow be, I think you still have to get back to the administration. Somebody in the administration has got to be there to play with the Congress.

HEARING CO-CHAIR WESSEL: Understood.
Mr. Johnson, any comments? Okay. Commissioner Bartholomew.
VICE CHAIRMAN BARTHOLOMEW: Thanks very much, gentlemen.
I think we could probably keep you here for hours. Focusing on China and the economic issues in particular, it strikes me that we all still continue to think in old ways, and that economic orthodoxy—perhaps what we're seeing is a breakdown, that the way things will happen is not going to be a reflection of the way things have happened.

We see it in them, the size, the extent, the speed with which China has changed. I, for example, have real questions about Ricardo's Theorem, which is what most trade policy and trade analysis is still based on. But I would like to follow up on one, where Commission Shea was going, this issue about the nature of China's government and whether it has any impact or not?

What I heard from both of you was, no, not really, but I'd like to put two points out there. One is if the Chinese government were more democratic, could they continue this centrally controlled command economy, which they currently run, and that has had a lot to do with the way that they have been able to build their economy? That's one thing.

Dr. Johnson, I know that you also do some work in Africa. The Chinese model I see is picking up steam, particularly with countries that are leaning authoritarian or leaning dictatorial or are one or the other of those.

Are they putting a credible model out there that might mean that the U.S. ability to lead responsibly, cooperatively, all of that, no longer becomes relevant?

DR. JOHNSON: I think that if China were more democratic, it would be perhaps more difficult for China to carry out some of the command elements of the economy, but I have to say that when we talk about the China model, I think that's a misnomer. Japan pioneered the East Asian development export-led model or you could say Germany did.

I lived in Japan in the '60s. It was a poor country. I saw Japan get rich following that model. The Koreans looked across the straits and said, hey, anything the Japanese can do, we can do better, and so
the Koreans picked up the model, and then the Taiwanese, and maybe Singapore is the best player of all, and now China.

So the model is a credible model. It has great power throughout the world because it works. And it has been carried out and implemented by democratic countries.

I did a year or so ago benchmarking analysis of several economies, including Taiwan, and I had the funny experience of being in Taiwan and meeting with a number of the top economic leaders who were telling me that it was getting complicated now that Taiwan was more democratic.

And so, probably being democratic makes it a little more difficult to carry out some of the more command elements of the model, but Japan is a democracy, Korea is a democracy, Germany is a democracy, and they still are able to implement that model. So I don't believe the democratization of China would dramatically change the situation.

I think democratization of China would help. I think you'd have more pressure for to allow domestic assumption to increase. Chinese citizens are not happy with them building up big stocks of dollars. What good does that do us if the dollar goes down? Then they lose their value.

I don't think it makes a big difference, as Mr. Prestowitz said, and I think there are democratic versions of something very similar. And I wouldn't hold your breath for democracy in China.

On Africa, you raise an interesting point. The Chinese are really helpful to people. They build stuff.

VICE CHAIRMAN BARTHOLOMEW: Helpful to some people.

DR. JOHNSON: Yes, exactly right, and they are, as we discussed before, very careful about who they help, and there are no doubt strings attached, some of which we're not aware of.

They are projecting influence and winning friends, and I don't think it's entirely zero sum game with American influence and friendship, but to some extent, they are competing with us, and that is something to be aware of. The more you can bring China on board through the international organizations, the more, for example, you can have them cooperate with the World Bank and funnel the aid that way, the better the governance you will have for everybody in those kinds of aid flows.

I think the results of the World Bank in trying to engage with China have been distinctly missed also. The Chinese know what they want, and that is to have a lot more say and a lot more people who vote for them when there are instances when countries get to vote.

HEARING CO-CHAIR WESSEL: Commissioner Shea.

COMMISSIONER SHEA: I just want to go back to the question
that Commissioner Wortzel asked: is China really our banker? I think that's a really important question because the answer to that question affects people's mindsets in policymaking circles. I think President Obama during the campaign said it's tough to go into negotiation—I'm paraphrasing—tough to go into negotiation with a country that's your banker.

Now is China really our banker? When I go to a bank and ask for a loan, the banker will look at my assets, will look at my income, look at my credit history, and may say—

MR. PRESTOWITZ: Really. Don't you get those ninja loans?

COMMISSIONER SHEA: May say your finances are atrocious, and I agree with you that the fact that China has raised questions about U.S.'s fiscal policies is a positive thing, but ultimately the banker can decide yes or no, and a negative decision will have a negligible, if any, effect on the banker's balance sheets.

So if what you're saying is true, that China has no choice if it's to pursue an export-led strategy and have capital controls but to invest in U.S. debt instruments, is it really fair to say it's a bank, our bank, or rather a captive investor in the United States?

DR. JOHNSON: It's not our banker in the sense that you're asking the question, that it has some leverage over us. Think of it like this: if you're creditworthy and if there's a competitive market for banking services, and some banker annoys you, for example, they raise your credit card fees, which is happening to, I think, all of us right now, and you can go, you can take out a new loan, you can obtain new kinds of credit relationships as long as you're creditworthy.

You have a problem if these people are doing you some sort of favor, if when they cut you off, you can't go out and get new credit; right? But that's about your characteristic, your creditworthiness, and it's about the competitiveness of the market. Also, by the way, there is some transaction issues so if they cut you off, how quickly can you get a new loan?

Well, you, the individual, don't have the Federal Reserve standing behind you willing to buy your debt and keep the interest rates at a certain level, which is the point that I was emphasizing earlier. So they are in an accounting sense holders of a large amount of our debt, as we've been discussing.

They do not have the leverage over you that you get either in a banking relationship where you can't go to somebody else or in the kind of Suez 1957 situation where you have rigidities in your economy that they can threaten disruption that will be damaging to you by withdrawing support, and you got nowhere else to go for that kind of financial support in the short term.
That's now how the world financial market works. We are the only reserve currency issuer in the world, which may have its drawbacks over a longer period of time, but that's the reality today. The Federal Reserve has a very clear policy on short rates and on long rates, and the Chinese threat on those terms is a bluff, and that bluff should be called.

HEARING CO-CHAIR WESSEL: Commissioner Slane.

CHAIRMAN SLANE: Gentlemen, as you know, it's our responsibility to make recommendations to Congress, and I think that one of the things that I find that is so distressing is our tax situation in which we encourage consumption and penalize savings and investment, and in my opinion, the only hope that we have is to change our tax structure and enact some sort of a VAT tax. Would you agree with that, and would you support a recommendation to Congress on that issue?

MR. PRESTOWITZ: Yes. No, I mean we have, we've structured our economy so that we heavily incent consumption, and we disincentivize savings, and we need to stop. And there are a number of different ways you could do it, but the VA, the VAT tax, I think is a good one.

It has the advantage that it's a broad-based tax. It generates a lot of income, and it also would put us in consonance with the rest of the world, by which I mean, as you know, that the VAT is rebated on exports. Because we don't have a VAT tax at the moment, we're at a bit of a disadvantage in international trade with countries, most of which, most of our trading partners do.

So it would bring us into conformity and would make life a lot easier for our exporters, and it would incent savings.

I have a pet project, which is what I call "reverse income tax." The idea is that instead of keeping track of your income and paying tax on that, you keep track of your expenditures, and you pay tax on expenditures. So the more you spend, the more tax you pay. And actually, technically, it's a more effective mechanism than the VAT, but it's a less well elaborated and thought-out system so practically I think the VAT is probably the way to go.

DR. JOHNSON: I agree completely with the principles that you stated, and I agree that tax reform is needed in the United States, even I think in the most optimistic case with regard to changing the future costs of Medicare, which is a big item on the spending side.

You also have to address tax reform to get to a sustainable position. I agree that the VAT is a promising line to explore. I would emphasize that it depends--how regressive it is depends on how you implement it, and I don't think, given what we've seen in terms of income inequality and what's happened to the lower 40 percent of
income distribution in the United States, that we should ignore that dimension.

You can make your VAT system more or less regressive, and I think that's something that should be considered as well.

I think the consensus, by the way, is moving in your direction, and I think if you pressed it by yourselves, perhaps it wouldn't have that much effect, but I think if you add your voice to a broader set of bipartisan voices that are calling for a tax reform along this dimension, it will definitely have some impact, and I would encourage you to do that.

CHAIRMAN SLANE: Thank you.

HEARING CO-CHAIR WESSEL: Mr. Chairman, I just might add that as we look at these issues, there are seven forms of taxes, as I recall, that are eligible for rebating at the border under the WTO GATT system including a financial transactions tax, which some are pushing in Congress. So if we're going to look at the tax deficit budget issue, we have a broad array of issues before us, and there is another commission that does that, but we'll leave that for the moment.

For the last question, Commissioner Blumenthal.

COMMISSIONER BLUMENTHAL: Yes, I wanted to come back to this question of unilateral action. What if we shocked the world and we balanced our budget, and we, as you say, Mr. Johnson, bent the cost curve on the entitlements and did everything right, and we're back in budget surplus, and so on and so forth. Took everyone's favorite hobbyhorses and put them together and had high growth with budget surpluses, like in the late '90s, I suppose. What would happen to China's economy?

DR. JOHNSON: Well, that's a great question. It depends obviously on how we balance the budget. Now I'm not calling for an immediate balancing of the budget. I'm saying you need a medium-term fiscal framework which would not require big tax increases or big spending cuts, but let's say, for the sake of argument and to take your question literally, that we do immediate fiscal austerity, let's say we cut massively, which would have to include the entitlement programs, and let's say we also raised taxes, for the sake of argument. That would cause global growth to crater.

There's no question about it. We're 25 percent of world GDP. We are struggling to recover, it is true, but given that the eurozone is in bad shape, all the indications we have is the emerging markets can grow rapidly if the developed world is where it is now, which is stagnant in Europe and struggling to recover in the U.S., if all the industrial world goes into deep and lasting recession, which is what would be brought on by too much fiscal austerity too soon, the emerging markets, I think,
would not be able to grow by themselves.

So the entire world would slow down, and you would go from a situation today where we can argue if the world will grow at say three percent or four percent per annum on a headline basis, using the IMF definitions, to wondering if we can stay positive, can we get one percent global growth? We've been in a prolonged global slump, and for many millions of people around the world, it would feel like a second Great Depression.

COMMISSIONER BLUMENTHAL: The Chinese should really fear us getting our fiscal house in order?

DR. JOHNSON: They are very smart, sophisticated people who know as much economics as we do, and they do definitely fear that. They also feel that they can rattle their saber and get things from the U.S. authorities and get better treatment--I don't know if it's from the Pentagon or someone else--by playing this game. It's a dangerous game from their perspective as well as from our perspective.

From our perspective, there is nothing they can threaten us with. We can hurt ourselves, no question, we have hurt ourselves. We continue to hurt ourselves in many ways on the fiscal side, and on the way we treat, what we allow our financial sector to get away with. But the Chinese are not a threat to the United States on this dimension.

COMMISSIONER BLUMENTHAL: If either of you have a final comment on this? So what I would say from that is if we do all the things that we think, I think, collectively we think are necessary, which is to get ourselves out of debt and deficit, it could have a contracting effect on the global economy and, in fact, actually have possibly a contracting effect on our own economy?

DR. JOHNSON: No, I would put it this way. If we do, if we take the responsible fiscal actions that we need, for example, establish a fiscal commission, as has currently been discussed, that really has congressional support and that reaches sensible, bipartisan agreement, that is not an immediate fiscal contraction. That is putting our medium-term budget into a sustainable framework.

That would not cause the world to contract. That would not cause recession. That would be stabilizing. That would be good for China and good for everybody else.

HEARING CO-CHAIR WESSEL: Thank you to the two panelists. We are deeply appreciative of your participation today and your help in the past and look forward to having you at some future time.

Now we'll turn over to Co-chair Cleveland.

HEARING CO-CHAIR CLEVELAND: Do we have our witnesses here?

Thank you very much to both of you. Could we seat the next
panel, please? We'll take a quick break so that we can get ourselves organized here.

[Whereupon, a short recess was taken.]

Panel II: CONGRESSIONAL PERSPECTIVES

HEARING CO-CHAIR WESSEL: Our next witness is here. If the audience can take their seats. Congressman Wolf, we are deeply appreciative of your being here.

Welcome, and I hope it's okay if I call you Mr. Chairman, as you have been a great friend to this Commission over many years, and to many of us on the Commission, so thank you for your being here today and for all your help over time.

Congressman Wolf represents the 10th District of Virginia and is the most senior of the 11 members of the House of Representatives from Virginia.

Congressman Wolf sits on the powerful Appropriations Committee, where he is the lead Republican on the Commerce, Justice, Science Subcommittee.

In addition, he is the co-chairman of the Tom Lantos Human Rights Commission, a bipartisan organization made up of more than 200 members of Congress, who work together to raise awareness about international human rights issues, and on these efforts he has been a tireless advocate over his entire career.

Congressman Wolf is one of the foremost leaders in Congress on issues related to China and the U.S. debt, and we are honored to have him here today. Please.

STATEMENT OF FRANK R. WOLF
A U.S. CONGRESSMAN FROM THE STATE OF VIRGINIA

MR. WOLF: Thank you, Mr. Chairman, and thank you for asking me to appear. I appreciate it.

The year was 1956 and the Suez Canal crisis was unfolding. Egypt announced that it was going to nationalize the canal, which outraged the British and the French, which then devised the plan to use military force to keep control. The U.S. wanted to avert conflict. President Eisenhower threatened to sell the U.S. reserves of the British pound, which would essentially result in a collapse of the British currency. The British changed course, and the British and the French both left.

This historical account is relevant today, and if you've read the article, the Pew Research Study that was in today's Washington Post, I
think it kind of highlights that. This historical account is relevant. Only this time, the U.S. is in a much more precarious position. Rather than operating from a place of financial strength, we are increasingly at the mercy of foreign lenders.

China is among the bigger bankers, which is the focus of today's hearing. The implications of the U.S. debt to China are many and wide-ranging, encompassing everything from our national security to our ability to advocate for the repressed and the persecuted people.

Wall Street Journal columnist Gerald Seib recently wrote, quote: "The federal budget deficit has long since graduated from nuisance to headache to pressing national concern. Now, however," he said, "it has become so large and persistent that it is time to start thinking of it as something entirely different: a national security threat."

According to the Congressional Research Service, quote, "On March 9, 2009, the Pentagon reported that PRC ships and aircraft operating in the South China Sea had been acting in increasingly aggressive ways toward two U.S. Navy ocean surveillance ships operating in the area."

China is taking an increasingly aggressive posture globally and their interests rarely intersect with ours. Consider the 2008 Senate testimony of the Director of National Intelligence. He said:

"China continues to develop and field conventional theater range ballistic and cruise missile capabilities that will put U.S. forces and regional bases throughout the Western Pacific and Asia at a greater risk. China's arm sales in the Middle East are also destabilizing and a threat to U.S. forces, while missile sales to Iran pose a threat to U.S. forces in the Persian Gulf."

The U.S. intelligence community notes that China's attempts to penetrate U.S. agencies are the most aggressive of all foreign intelligence organizations. Almost every, as you know better than anyone, the cyber attacks against our government. China's aerospace industry for decades has provided missile technologies and equipment to rogue regimes like Iran and North Korea.

China's aims globally are often directly at odds with those of the U.S. According to the Pentagon, weapons that the PRC entity supplied to Iran, quote, "were found to have been transferred to terrorist organizations in Iraq and Afghanistan," two places where American men and women are fighting and serving today.

China has failed to use its influence to bring about a peaceful resolution to the multiple crises in Sudan. It is a major arms supplier and source of economic strength to the regime, and Bashir has been basically indicted for crimes against humanity. 2.4 million or 2.5 million people have died in the North-South thing and in Darfur, and
China is, in essence, the number one supporter of the genocide regime in Khartoum.

China has been no friend in our engagement with Iran. U.S. efforts to exert diplomatic pressure against Iran's nuclear weapons program have been thwarted time after time by China's opposition to U.S. Security Council sanctions, and time after time, they did the same thing with regard to U.N. resolutions in the Security Council with regard to Darfur and other human rights issues.

In a recent column, Robert Samuelson, who I think probably has a better understanding than most people, summed it up this way: "China's world view threatens America's geopolitical and economic interests."

Our different world views. Consider them. The U.S. was founded on the premise that liberty is the birthright, that individual human rights is sacred, that freedom to worship according to the dictates of your conscience is paramount. The Chinese government--and let me just say the Chinese people are wonderful people--I'm talking about the Chinese Communist government operates antithetically to those beliefs. There is no clearer indication of the gulf that exists between our two countries than its treatment of its own people.

The Cardinal Kung Foundation--there are 34 or 35 Catholic bishops in jail, and when I see some of the comments, and the Pew Foundation is a wonderful group. The Pew Foundation, one person is quoted today as saying I see this as the same thing that took place in the '70s with regard to Japan. People said Japan was taking over. Japan didn't have 35 Catholic bishops in jail. Japan didn't have hundreds, hundreds of house church leaders in jail.

Japan was not plundering Tibet. I've been to Tibet. I went there with a trekking group years ago and saw what they've done in Tibet. Japan wasn't persecuting the Uighurs. Japan wasn't having cyber attacks against us.

So to make the connection, well, overreaction, this is sort of we went through with regard to Japan, there is no connection. There is this Simon and Garfunkel song called "The Boxer." They sang it in Central Park. They said a man hears what he wants to hear and disregards the rest. We're just disregarding the reality.

And, of course, unfortunately, we know that China has big law firms in this city on retainer. Before the Chinese ambassador comes up to speak to a Congressman or Senator, he's checking with their law firm to see who is this, what are they going--so the analogy of this is just like it was with Japan is not accurate.

Ronald Reagan once spoke of the U.S. Constitution as a covenant. He said, "we have made not only with ourselves but with all of mankind." I believe we risk breaking that covenant with the kind of
posture that we display today.

I guess it boils down, and I'm going to end with it, it boils down to our economic situation where we are. This is the most bipartisan, divisive environment that I have ever served in since I have been in Congress 30 years. I believe the answer is, and I was the author on the House side with Jim Cooper—a little bit different of what they've done in the Senate—a bipartisan bill that puts every spending program in the government, every single one, and puts it on the table and sets up a bipartisan commission that requires the commission to go out among the American people. This cannot be done at Andrews Air Force Base or it can't be done within the nation's capital or the Beltway, to go out and hold public hearings, to tell the American people here's what the danger is with regard to debt to China.

Here's what the danger is in 2028. Every dollar that comes in goes for Medicare, Medicaid, and Social Security and interest on the debt. This is what it means with regard to there will be no money for cancer research or research on autism or research on Parkinson's or research on Alzheimer's or infrastructure.

You go to China today and you see their infrastructure compared—and so you would go out with the American people and let them know, similar to what the Heritage Foundation and the Concord Coalition and Brookings are doing on their wake-up tour, and then listen to the American people.

I think the American people are ahead of Washington. And then using the Base Closing Commission language that requires that whatever proposal it is, that it be sent up to Congress and Congress vote on it up or down. I believe if we do that and get control of the debt that we have, we can have a renaissance, we will have a renaissance in this nation, but to allow the debt and the deficit to increase and with the saber rattling that China is doing and the reality of what this problem is, these are going to be very, very tough times for the country, and so until we deal with this economic issue, hopefully, in a bipartisan way, because if this thing goes on to the degree that many people, Samuelson and many others, believe, everyone will suffer.

And, frankly, it's embarrassing. When I think of the suffering and the pain and the agony that George Washington went through on that Christmas Day, crossing the Delaware to Trenton to defeat the British and the Hessians, and the sacrifice, and then here we are almost pretending that this is not even taking place, and we see that Moody says we're going--well, Moody says we lose potentially our AAA bond rating in 2013.

If you want a piece that clarifies this, read Anne Applebaum's piece in the Washington Post last week. She sees Greece in our future
if we don't deal with this. Greece is having a tough time. Ireland has lost their AAA bond rating. Portugal has lost it. Spain has lost it. Dubai. And we have to kind of deal with it.

So, hopefully, the commission that Jim Cooper and I have is a bipartisan way that brings this together, where whereby if we deal with this, we can deal with this issue with regard to China, and we can have a renaissance in this country creating more jobs and doing this.

But it's like Simon and Garfunkel say, you cannot ignore the reality of where we are, and I think to address it and deal with it, but to come back to you, it deals fundamentally with a national security issue with regard to China.

HEARING CO-CHAIR WESSEL: Thank you.

I know that Commissioner Bartholomew has a quick comment, and we also know that you have a very busy schedule, and we appreciate your coming over to talk to us today and all your help over time.

VICE CHAIRMAN BARTHOLOMEW: Mr. Wolf, I just wanted to thank you both for coming here today, for your long support of this Commission, and even more importantly for your advocacy over the years, certainly, I know, going back to the time of Tiananmen Square.

The fact that you have worked to keep the light shining on the people in China who are fighting for their basic rights is a very important thing so thank you for your leadership on all of that.

MR. WOLF: Thank you, Carolyn. Thank you very much. Thank you.

[The statement follows:]

Prepared Statement of Frank Wolf
A U.S. Congressman from the State of Virginia

The year was 1956 and the Suez Canal crisis was unfolding. Egypt announced that it was going to nationalize the canal, which outraged the British and French which then devised a plan to use military force to keep control. The U.S. wanted to avert conflict. President Eisenhower threatened to sell the U.S. reserves of the British pound which would essentially result in the collapse of the British currency. The British changed course.

This historical account is relevant today. Only this time, the U.S. is in a much more precarious position. Rather than operating from a place of financial strength, we are increasingly at the mercy of our foreign lenders.

China is among our biggest “bankers,” which is the focus of today’s hearing. The implications of U.S. debt to China are many and wide ranging, encompassing everything from our national security to our ability to advocate for repressed and persecuted people.

Wall Street Journal columnist Gerald Seib recently wrote, ‘The federal budget deficit has long since graduated from nuisance to headache to pressing national concern. Now, however, it has become so large and persistent that it is time to start thinking of it as something else entirely: a national-security
According to the Congressional Research Service, ‘on March 9, 2009, the Pentagon reported that PRC ships and aircraft operating in the South China Sea had been acting in increasingly aggressive ways toward two U.S. Navy ocean surveillance ships operating in the area…’

China is taking an increasingly aggressive posture globally, and their interests rarely intersect with ours. Consider the 2008 Senate testimony of the director of National Intelligence: ‘China continues to develop and field conventional theater range ballistic and cruise missile capabilities that will put US forces and regional bases throughout the Western Pacific and Asia at greater risk….China’s arms sales in the Middle East are also destabilizing and a threat to US forces, while missile sales to Iran pose a threat to US forces in the Persian Gulf.’

The U.S. intelligence community notes that China’s attempts to penetrate U.S. agencies are the most aggressive of all foreign intelligence organizations. China's aerospace industry for decades has provided missile technologies and equipment to rogue regimes like Iran and North Korea.

China’s aims globally are often directly at odds with those of the U.S. According to the Pentagon, weapons that PRC entities supplied to Iran were ‘found to have been transferred to terrorist organizations in Iraq and Afghanistan.’

China has failed to use its influence to bring about a peaceful resolution to the multiple crises in Sudan. It is a major arms supplier and source of economic strength to the regime in Khartoum.

China has been no friend in our engagement with Iran either. U.S. efforts to exert diplomatic pressure against Iran’s nuclear weapons program have been thwarted by China’s opposition to U.N. Security Council sanctions against Iran.

In a recent column, Robert Samuelson summed it up this way, ‘China’s worldview threatens America’s geopolitical and economic interests.’

Consider our differing worldviews. The U.S. was founded on the premise that liberty is a birthright, that individual human life is sacred, that the freedom to worship according to the dictates of your conscience is paramount. The Chinese government operates antithetically to these beliefs. There is no clearer indication of the gulf that exists between our two countries than the Chinese government’s treatment of its own people.

According to the Cardinal Kung Foundation, currently every one of the approximately 35 underground bishops of the Catholic Church is either in jail, under house arrest, under strict surveillance, or in hiding. Protestant house church pastors are routinely intimidated and imprisoned. Their congregations worship in secret. According to the Congressional Executive Commission on China's Political Prisoner Database, as of July 2009, there were 689 Tibetan prisoners of conscience, 439 of whom were monks or nuns. Uyghur Muslims face persecution by the Chinese government as well. China maintains an extensive system of slave labor camps as large as that which existed in the former Soviet Union.

This is but a snapshot of what can only be described as a grim human rights situation in China. But rather than being a voice for the voiceless, we see U.S. government officials heading over to Beijing and kowtowing to the Chinese government. Ronald Reagan once spoke of the U.S. constitution as a covenant ‘we have made not only with ourselves, but with all of mankind.’ We risk breaking that covenant with the kind of posture we display today.
Our advocacy for dissidents and for long-cherished American ideals of freedom, liberty and respect for basic human dignity have been sidelined in our bilateral relationship with the Chinese – all the more so in the midst of a shifting dynamic whereby China owns our debt, and in so doing, is starting to influence, both subtly and overtly, elements of our foreign policy.

Simply put, we are presently borrowing hundreds of billions of dollars from a country which pursues aims that are at odds with our national interest and values both directly and indirectly. This borrowing is necessitated by our exploding debt and deficit.

Nearly four years ago I proposed an independent bipartisan commission, based on the successful federal base closing process, to address unsustainable federal spending. The SAFE Commission – short for Securing America’s Future Economy – would operate in an authentic and transparent way, holding a series of public meetings across the country to hear from the American people. It is the only debt reduction commission legislation in play that mandates public engagement on this scale. It is also the only commission plan that would force Congress to vote up-or-down on a legislative package borne from the commission’s work. There would be no avoiding the hard choices.

In his State of the Union address, and then formally last week, the president proposed the creation of a “fiscal commission” by executive order. I am deeply concerned that a commission established through executive order will make it look like Washington is finally doing something to address runaway spending, but without the teeth to require legislative action, it will amount to nothing more than another report collecting dust on the bookshelf.

Given the enormity of the country’s financial turmoil, and the implications both at home and abroad of failing to address this looming threat, I remain convinced that bold steps, like the SAFE Commission, are needed.

A recent Newsweek cover story included the following: ‘This is how empires decline. It begins with a debt explosion. It ends with inexorable reduction in the resources available for the Army, Navy and Air Force . . . If the United States doesn’t come up soon with a credible plan to restore the federal budget to balance over the next five to 10 years, the danger is very real that a debt crisis could lead to a major weakening of American power.

Our debt crisis is only exacerbated by who our bankers are – China foremost among them. We have a responsibility to our own children and grandchildren and to the millions in China who long for freedom and basic human rights and look to America to be their champion, to not stand idly by and tolerate a major weakening of America power.

HEARING CO-CHAIR WESSEL: We're going to take a short break, no more than five minutes, have our next panel seated, and then go right into the next witnesses.

Thank you.

[Whereupon, a short recess was taken.]

HEARING CO-CHAIR CLEVELAND: If we could ask the witnesses to be seated, please. Before we start, if I could ask my colleagues on the Commission to put their phones on vibrate and not take calls while we're in proceedings, it would help because I get distracted fairly easily.

Our second panel will comment on China's current holding of U.S. debt, as well as other securities, and will testify on the implication for American businesses and the U.S. economy.

Mr. Hindery is the Managing Partner of InterMedia Partners, a media industry private equity fund he first founded in 1988—the year my son was born. It was a good year.

He has formerly served as the CEO of several major companies, including The YES Network, a regional sports network; GlobalCenter Inc., a major Internet services company; and AT&T Broadband.

Mr. Hindery is also Chairman of the US Economy/Smart Globalization Initiative at the New America Foundation and a member of the Council on Foreign Relations.

Derek Scissors is a Research Fellow for the Asia Economic Policy at The Heritage Foundation.

In addition to his duties with the think tank, Dr. Scissors is Adjunct Professor at George Washington University where he teaches on the Chinese economy.

And he comes highly recommended by Dr. Wortzel. So I'm not sure that helps you or hurts you, but—

DR. SCISSORS: I'll try to fight through it.

COMMISSIONER BLUMENTHAL: I seconded the recommendation.

DR. SCISSORS: Oh, no, that's two anchors.

COMMISSIONER REINSCH: If it would really worry you, I seconded the recommendation, too, and that should really cause some concern.

HEARING CO-CHAIR CLEVELAND: Wow. Bipartisan. So, with that, I'm reminded by my colleague to remind you of the seven-minute rule in terms of oral testimony, and we will try to keep our first round of questioning to five minutes each.

So, Mr. Hindery, if you'd like to proceed.
STATEMENT OF MR. LEO HINDERY, JR.  
MANAGING PARTNER, INTERMEDIA PARTNERS VII LP  
WASHINGTON, DC

MR. HINDERY: Thank you.
I should have taken the advice of the earlier panel and just continued to listen to them, as it was a remarkable panel. It's a privilege to be here. I won't reintroduce myself, and again, I'm very grateful to all of you for this invitation.

I myself finished, as some of you did, a recent trip to Southeast Asia, to China, to Vietnam, and Thailand via Cambodia, and I said in my prepared comments that it's a trip I think everybody who has a concern about the unprecedented real unemployment rate in the United States—a number which I calculate at around 19 percent—and the long-term welfare of our workers should make soon, and a trip certainly that's germane to today's topic.

It's my belief that without some immediate and dramatic changes soon in our trade and economic policies and practices, that the Great Recession of 2007 in America will prove to be China's "Great Opportunity."

I last visited China in February 2008, just after the Recession started. As you yourself have observed, just two years later, construction cranes that briefly fell silent are back erecting high-rise buildings, infrastructure is being built again, and ports that for awhile lay fallow are now loading ships throughout the night.

The Chinese consumers are obviously back shopping and eating out, and we've seen the return of the far-western migrants into the cities.

As I said, the Recession here has turned into an extraordinary opportunity for China. It's manifest in so many ways. We've seen our American companies cutting their payrolls and their capital spending, driving business to China, at the very same time that China with the support of its partner central government is increasing the competitiveness of its own manufacturers.

As others have testified to you, we've seen a dramatic rise in China's share of our deficit in manufactured goods, along with a similar increase percentage wise in its share of the overall trade deficit of this country. Roughly $330 billion a year is coming in as imports from China and less than $90 billion is going out as exports from the U.S.

I do applaud the President for his comments on February 3 when he told the DPC of the Senate that one of the challenges we have to address internationally is currency rates, specifically how they match up
to make sure that our goods are not artificially inflated in price at the same time that foreign goods are artificially deflated in price, which puts us at a huge competitive advantage.

No one who will testify to you will take exception to the undervaluation of China's currency, and you've heard from experts as to the magnitude of its impact.

Yet, I think we all know first-hand that the Chinese manipulation of currency is just the tip of its trade iceberg, albeit a very big tip. I'm always struck by how manufacturers here in the United States react to China. An esteemed CEO out of the Seattle area recently commented that his reason for siting his plants now in China is not because of cheaper labor but because of government support, because of the infrastructure that's laid out properly.

Certainly one of the growth opportunities in the future is the green economy for which we will spend out of our stimulus package $80 billion; China, by contrast, will spend $217 billion, using its massive foreign reserves that we're going to talk about here in a moment.

We've known for several years, and I think this is an important point for this panel, that contrary to popular opinion in this country, 90 percent of the cost differential in manufactured goods vis-à-vis China is due to something other than labor costs.

I think the magnitude of this ratio deserves your continuing attention. 90 percent is due to subsidies of one sort or another, including, of course, currency manipulation, and to China's abysmally low environmental standards. China's trade advantages now may be so well imbedded that no matter what we do for years to come, they will dominate in certain industries, regardless of what we might try to do.

The implications of this are really quite remarkable. Richard Haass, the President of the Council on Foreign Relations, of which I'm a privileged member, has commented that we've already reached a point where there's an intimate link between our solvency and our national security, and it's easy to see as you listened to the last panel why this is the case.

I won't repeat the magnitude of the accumulation. I will simply point out that we should not be naive about the implications of this. There's now an immutable blurring between China's reserves, its financial institution, and its sovereign wealth fund, that, all being centrally governed can act as one with nary a moment's indecision.

Given the pernicious trade practices of China that here in the United States we've become almost inured to, it should come as no surprise to anyone that China's global aspirations are extreme and extensive.

On February 4, this Commission listened to Deputy Assistant
Secretary of State for East Asian and Pacific Affairs David Shear's testimony. I thought most of his comments were Pollyanna-ish in the extreme.

It didn't strike me as being particularly informed to say, as he did, that China does not have the, quote, "intention at this time to create a political hegemony in Southeast Asia or to displace American influence in the region," unquote

I was just there; sure, they do, just as they intend to use their foreign reserves accumulation to acquire blocking positions in resources and agriculture in Australia, Africa and large parts of South America.

I also thought it was dangerously naive for Mr. Shear to suggest that, quote, "China's arms build-up is consistent with modernizing military forces in general and is not in the fashion of an arms race," unquote

The heck it's not. Chinese Admiral Wu Shengli, on April 14, 2009, confirmed in great detail the 'blue water' naval aspirations of the Chinese, including its homegrown submarines with nuclear-armed ballistic missiles, and we should have no sense, as Mr. Shear again commented, that China's investments in our critical resources are anything but adverse to our interests.

I think that, in closing, I'd like to, Mr. Chairman and Madam Chairman, just give you four things that I think we need to do.

I think we have to go after all subsidies, not just currency manipulation. A dear friend of mine, former Senator Slade Gorton, has suggested that we amplify this effort with particular attention to the theft of intellectual property, which I detail in my comments.

I've been a long-term advocate of Buy American/buy domestic programs that are in sync with China's. And I think that China's Indigenous Innovation Act, which we will discuss in the Q&A, needs our particular and immediate attention. I think we need to address the risk to this country of planned investments by China in our militarily and otherwise critical technologies and companies.

I was delighted a few years ago to be Vice Chair of Congressman Wolf's HELP Commission to reform U.S. foreign assistance. As an amplification of that activity, I think we need to match dollar for dollar, and action for action, China's influences in the foreign affairs arena.

Again, it's a privilege to be here. And I apologize if I ran a minute or so over.

Thank you.

[The statement follows:]

Prepared Statement of Mr. Leo Hindery, Jr.
Mr. Chairman, other Commission members, I am Leo Hindery, Jr. and I am Chairman of the US Economy/Smart Globalization Initiative at the New America Foundation and a member of the Council on Foreign Relations.

From 2005 through 2007, I was Vice Chairman of the Presidential and Congressional HELP Commission which in December 2007 made recommendations to Congress for the reform of U.S. Foreign Assistance. Career-wise, I am the former chief executive officer of AT&T Broadband and its predecessor Telecommunications, Inc. (TCI) and of Liberty Media and several other major media and telecom companies, which employed tens of thousands of American workers and aggressively competed throughout Asia and Europe.

Several days ago I finished a two-week trip that began in China, continued down throughout Vietnam, and ended in Thailand via Cambodia. It is a trip that everyone concerned about the nearly unprecedented 19% ‘real’ unemployment rate in the United States – and the long-term welfare of our workers – should make soon, and a trip that is germane to today’s topic.

For in short, without some dramatic changes soon in our trade and economic policies and practices, it is clear that America’s Great Recession of 2007 will continue while at once becoming much of Asia’s and especially China’s ‘Great Opportunity’.

I last visited China in February 2008 just after this Recession started. Now, exactly two years later, construction cranes that briefly fell silent are back erecting high-rise buildings, important infrastructure projects that were halted are back being built along with new ones, and ports that had container ships laying at anchor are now again loading ships through the night. Chinese consumers are back shopping – and eating out – with complete abandon, and workers from the far-western provinces and rural China have again left their villages to return to work in China’s major cities.

The Great Recession has in fact quickly turned into China’s ‘great opportunity’, with American companies cutting both their payrolls and their capital spending, thereby driving business to China, at the same time that Chinese manufacturers are boosting their global competitiveness, directly on their own and indirectly through subsidies from their partner central government. In just the last year, China’s share of our nation’s trade deficit in manufactured goods jumped from 69% to an almost unbelievable 80% today, while its share of U.S. imports overall, non-resources and resources combined, increased 20%. And in dollars, China right now is exporting about $330 billion annually to the United States, while purchasing less than $90 billion here.

President Obama got it right on February 3, albeit in my opinion late by about a year, when he told the Senate Democratic Policy Committee that: “One of the challenges that we've got to address internationally is currency rates and how they match up to make sure that our goods are not artificially inflated in price and their goods are artificially deflated in price. That puts us at a huge competitive disadvantage.”

Certainly no responsible American economist disagrees with the President’s assessment that China’s currency is undervalued compared to the dollar (and the Euro) by at least 25% and up to 40%. According to economist Peter Morici, with whose work this Commission is very familiar, this artificial devaluation of China’s currency alone creates a staggering 25% illegal subsidy on its more than $300 billion of annual exports to the U.S.
Yet currency manipulation is actually just the tip of the Chinese trade iceberg, albeit a very big ‘tip’ – at least as concerning are China’s overall unfair trade practices.

And contrary to what American workers have been told repeatedly by America’s multinational corporations and by the U.S. Chamber of Commerce, the critical issue is not China’s relatively low labor costs. As Norbert Sporns, a Seattle-based CEO, recently said, “The major reason why we’re [now] sited [in China] is not because of cheaper labor, but because of government support, because of the infrastructure that is laid out properly”. And this same logic applies both to computers and consumer electronics, where China’s role now extends far beyond assembly where it started, and to China’s increasingly dominant role in the ‘green economy’ that all developed nations, including our own, were counting on to jumpstart their own economies.

To this latter point, while our ongoing stimulus package devotes $80 billion to ‘things green’, China plans to spend, out of its enormous accumulation of foreign reserves, nearly three times as much, or $217 billion, over just the next five years on such efforts. And, as it has already done so successfully in other industries, China is making all of its domestic green economy expenditures in ways that are at the same time positioning it to become the largest global exporter of such components to the U.S. and other nations, while essentially ‘locking out’ any of them from importing products into its domestic initiatives.

We have known for several years that something on the order of 90% of China’s domination in manufactured goods vis-à-vis the U.S. is due to its subsidies to domestic and foreign-owned manufacturers alike – subsidies based around plant sitings and financings, taxes and of course currency – and to its extremely low environmental standards. And the sad reality is that after years of accumulating market share and building the infrastructure it needed in order to dominate much of the global marketplace, all with the help of massive subsidies and a massively undervalued currency, China’s trade advantages in many vital industries are either now so embedded – or, as in the case of the ‘green economy’ and special-purpose materials, quick becoming so embedded – that they will exist for years to come even if President Obama is successful in confronting China’s manipulated exchange rate, which of course is far from assured.

So, where does all of this leave the U.S. otherwise, which is in essence the topic of today’s discussions?

According to Richard Haass, the president of the Council on Foreign Relations, “We’ve [already] reached a point now where there’s an intimate link between our solvency and our national security.” And it is easy to see why Mr. Haass comes to this conclusion, since the U.S. government in 2010 will borrow one of every three dollars it spends, half or so of which will come from foreign countries.

Not even accounting for the forecasted $1.6 trillion federal deficit this year, the $1.3 trillion deficit next year, and the $8.5 trillion combined deficit for the next 10 years, the U.S. already has about $7.5 trillion in accumulated debt held by the public, of which China, with more than $2.4 trillion in foreign exchange reserves, is the largest single holder. And of course all the while China is every day accumulating ever more American dollars as our nation’s largest non-resources importer – its foreign exchange reserves increased $453 billion (or 23%) just in 2009 alone.

And we should not be at all naïve about China’s true global financial capability, which far exceeds the extent of its foreign exchange reserves, as large as they alone are. There is an immutable blurring among China’s reserves, its financial institutions, and its sovereign wealth fund, all of which are centrally governed and together can act as one with nary a moment’s indecision. By market capitalization alone, China has three of the world’s four largest banks, the two largest insurance companies, and the second-
largest stock market – this capability combined with its already-largest-by-far accumulation of foreign reserves gives China also the largest ‘potential’ sovereign fund, since it would take only a few wire transfers to turn its government development funds, its government investment corporations, and the overseas investments of its government-owned enterprises into an unparalleled ‘financial hegemony’.

Given China’s pernicious trade practices and how it has already employed and deployed its ever-increasing foreign reserves position:

- There is no reason to believe that China’s immediate threats in response to President Obama’s February 3rd speech, both its explicit ones and its implied ones, are false, despite Deputy Assistant Secretary of State for East Asian and Pacific Affairs David Shear’s ‘Pollyannaish’ testimony the very next day to this Commission that they probably are.

- It does not seem particularly informed to suggest, as Mr. Shear also did, that China does not have the (quote) “intention at this time to create a [political] hegemony in Southeast Asia or to displace American influence in the region” (unquote) – of course it does. Just as it also intends to use its foreign reserves to acquire ‘blocking positions’ in resources and/or in agriculture in Australia, Africa and large parts of South America.

- Mr. Shear is simply wrong as well in suggesting that China’s arms buildup is (quote) “consistent with modernizing military forces in general and [is] not in the fashion of an arms race” (unquote) – it absolutely is an arms race for China, and a global one at that, as senior Chinese Admiral Wu Shengli confirmed on April 14, 2009 when he spoke about China’s “accelerated and soon [to be] completed deployment of a full-scale ‘blue water’ navy, including home-grown submarines with nuclear-armed ballistic missiles”.

- And we should expect no self-restraint in China’s investing in America’s vital financial, infrastructure and resource companies and in our ‘militarily critical technologies’.

It now seems inevitable that some individual American companies, for example the Boeing Company and those involved in oil exploration off the Vietnam coast, will suffer from Chinese trade retaliation, as likely will parts of our foreign policy and defense agendas. But the Obama administration’s job is to look after our national interests first and foremost, and not after individual multinational corporate interests, which means above all else keeping the U.S. economy strong, which is about the only part of Mr. Shear’s testimony with which I agree.

Going forward, it is imperative – for financial, employment, competitiveness and national security reasons – that the United States change its growing deficit with China. So, using whatever tools are available, the administration and Congress need to:

1. Go after all of China’s illegal subsidies, not just its currency manipulation, just as they need to put a quick halt as well to China’s persistent theft of America’s hard-gained, valuable intellectual property or IP, which zaps our economy almost as much as China’s adverse currency moves. Regarding the latter, a quick and easy solution, courtesy of former Senator Slade Gorton (R-WA), would be to make a finding at the end of each year of the total value of the IP the Chinese have stolen, followed by a tariff during the next year on everything they sell us levied at a rate calculated to recover 150% to 200% of that stolen value.

2. Adopt "Buy American" requirements related to all federal government procurement, which currently makes up about 20% of the American economy. The U.S. is almost alone among the
developed nations and China in not having a significant buy-domestic government procurement program, yet no single stimulus effort would do more to resuscitate U.S. employment, especially manufacturing employment, and materially reduce our nation’s massive trade deficit.

3. Bring what’s called a Section 301 case at USTR against China’s "Indigenous Innovation Production Accreditation Program" that was promulgated on November 15, 2009. This Program, which limits all Chinese central and provincial government procurement to companies that have “indigenous” – or Chinese – innovation, is far more restrictive than any other buy-domestic program in the world, and its adverse impacts will very quickly be felt across all industries, but especially in computers and consumer electronics, ‘things green’, autos and aviation, and specialty materials, where we are desperately trying to hold on to our own manufacturing capabilities. (Because China is still not a member of the WTO Government Procurement Code, a Section 301 action is unfortunately the only remedy currently available.)

4. Because China’s heavy reliance on illegal subsidies and currency manipulation as mainstays of its trade practices is a fair predictor of its likely future sovereign fund practices, make review of China’s planned investments in the U.S. with much more actionable transparency and in a manner consistent with protecting our national interests and security. Of specific concern are any proposed investments in our nation’s ports and transportation industry, natural resources, financial markets, “Advanced Technical Products” manufacturing, and items deemed by the Defense Establishment to be “militarily critical”. Before controlling or influencing investments are made in companies in these industries, they should have extensive federal government review, to include a newly-created “national security impact statement” prepared jointly by Commerce and Defense for the Congress and the administration which would consider the investment’s defense, security and infrastructure implications.

5. Promote development assistance not only as a core pillar of national security and American moral values, but, importantly, also as a counterbalance to China’s mercantilist practices in the developing world, practices that are as relatively unfair and harmful to these economies as they are currently unfair and harmful to our own U.S. economy and long-term interests. This means specifically that the U.S. should: follow through on its oft-repeated commitments to the Millennium Development Goals; harmonize U.S. foreign policy commitments in development with the actual U.S. development assistance budgets and programs; aim to achieve the development assistance ‘target’ of 0.7% of GDP by 2015; and use the full range of development instruments, including development assistance, trade openings, aid for trade, and partnerships with civil society.

In closing, I should note that none of these five recommendations – particularly the “Buy American” and the “national security impact statement” recommendations which will likely attract a lot of immediate self-serving criticism – is protectionist or anti-globalization or un-American. Alone and collectively they are simply good, necessary, balanced and, I should note in particular, reciprocal economic policies.

Absent them and related actions, however, China’s ever-growing foreign reserves, especially its accumulation of U.S. dollars, and its pervasive global mercantilist agenda will have even more dire implications to and repercussions for America’s competitiveness in the world and our overall economic wellbeing – and for our national security.

Our two countries must quickly agree on a fundamental readjustment of our current bilateral trade relationship, and the strategic threats to both, should we fail, are obvious. But to start, given how inextricably linked America’s economic security is with national and military security, the United States
must, as an overriding principle, be as aggressive in defending its economic interests as China is in advancing its.

Thank you.

HEARING CO-CHAIR CLEVELAND: Dr. Scissors.

STATEMENT OF DR. DEREK SCISSORS
RESEARCH FELLOW, THE HERITAGE FOUNDATION
WASHINGTON, DC

DR. SCISSORS: Thanks to the Commission for having me back again. I hope that means the last time wasn't too much of a disaster.

I'm going to follow the two previous speakers, Congressman Wolf and Mr. Hindery, by agreeing that we have a lot of very serious concerns about Chinese activity around the world, economic, political and military.

I'm also going to agree very strongly with Congressman Wolf in saying that this is a wonderful topic for the Commission to be addressing, that in fact our debt is a national security threat as well as an economic threat. We can talk about both of them.

I would characterize it as the single-biggest threat to U.S. leadership. However, I'm going to depart from both previous speakers, certainly Mr. Hindery, by saying that China is not relevant to our debt. The debt is our problem. China is merely a distraction from us addressing our problem, and, in particular, it's a distraction — because I would think that Simon Johnson mentioned this—China cannot stop buying our bonds under the current situation. Were they to rectify the situation and allow themselves to stop buying our bonds, it would address many of the issues that Mr. Hindery is concerned about.

There's a reason there's confusion over this. And it's a specific policy reason I would love for the Commission to be able to address. We have very bad data on what the Chinese are doing. We have bad data from the Chinese; we always get bad data from the Chinese. They are opposed to transparency.

But we also have bad data from our own government on what China is doing, and it obscures the situation and confuses the policy discussion. In particular, that pertains to Treasury bonds and other U.S. bonds. It also pertains to Chinese investment in other countries.

I'll boast a little bit about the Heritage Foundation. We have a data set tracking Chinese investment outside of bonds, which is actually trackable to some extent, but we cannot track Chinese investment in the
U.S. government bonds. That has to be done by the U.S. government, and the U.S. government is failing to do it.

I will get to that in my remarks. I'm going to talk about the matter of China's inability to stop buying bonds first. China cannot spend its foreign exchange reserves at home. That is not a matter of opinion. It's a fact. They physically cannot do it.

I would be happy to explain it if anyone on the Commission still is not aware of this, but the $2.4 trillion they have in foreign exchange reserves--and it's going to go up again and again and again because of the mercantilist policies that Mr. Hindery has mentioned--cannot be spent at home.

So we're not in a competition to see how China can spend its foreign exchange reserves at home and outpace the U.S. economy because they can't do it. Why does that matter for the Commission? After stockpiling commodities and the various other things they did last year, China added $450 billion to its foreign exchange reserves in one year. You can talk about buying gold. That's about $20 billion a year if they can grab every bit of gold that's available. They can't spend this money anywhere but one, our economy. We're the only ones who can absorb it, period.

We don't allow them, nor does anyone else, to pour hundreds of billions of dollars a year into the stock market. The only place China can recycle its balance of payments surplus is the U.S. bond market.

The way that that would change is if China would change the rules. What are the rules that they would have to change? These are their own rules, not our rules. They would have to float the renminbi and allow money to freely leave the country. I would argue that the number one thing we would like the Chinese to do in terms of reform is allow money to freely leave the country. Other people would say it's allow the renminbi to float.

In both cases, the changes they would make to stop having to buy our bonds would be in America's interests. The only other thing that would happen is if their balance of payment surplus dropped like a stone. The only way their balance of payments surplus is going to drop like a stone is if their trade surplus with the U.S. drops like a stone.

Of China's $2.4 trillion in foreign exchange reserves, over the period that they've accumulated it, $2.1 trillion is from bilateral trade with the U.S. So the way China stops buying our bonds is to make adjustments either voluntary or involuntary that we want them to make.

All right. Why don't people recognize this? Well, first of all, there's the Chinese contribution which is they're not going to tell us what they're doing. Unfortunately, there's also a U.S. government contribution to this as well. If you think China's official Treasury
holdings, which are now at $755 billion, having fallen in December is important, I have something for you.

This is a graph of China's official Treasury holdings. It's the red line. They go up, they go down, they go up, they go down, and then the blue line is U.S. interest rates, which don't do anything. Okay. So if you think that China's official Treasury holdings matter, you're wrong. Here's the graph. You're wrong.

The problem is China's official Treasury holdings don't mean anything. Why don't they mean anything? Because they're based on physical location, not the actual identity of the ultimate bondholder. And, in particular, what happened last year when China's Treasury holdings appeared not to budge is that the Chinese just routed their purchases through Britain and Hong Kong.

The State Administration of Foreign Exchange has offices there. They have a compulsion to buy U.S. bonds. The British and the Hong Kongese do not have any such compulsion. China hides its purchases through third countries for domestic political reasons. There's a lot of criticism in the PRC that the Chinese are subsidizing a rich country and wasting their money on zero return U.S. bonds because they don't understand that China has to buy the bonds as well. Okay. That's U.S. Treasury bonds.

The other half of the equation is China holds a lot of bonds outside U.S. Treasuries. In particular, agency bonds from Fannie Mae and Freddie Mac. In June 2008, China held more in terms of agency debt than it did in Treasury debt. Now, you might say why are you quoting me June 2008 numbers? Because that's the last ones we have from the Treasury.

We do not have numbers updated for the financial crisis. We don't know what China is doing. We don't know. Not what China is doing in Sudan or Venezuela where they tell a bunch of lies about every deal. In our country, we don't have public information on what the Chinese are doing.

So the number one request I would make to the Commission is to push this argument. We need better data from the government made public. I hope that Brad Setser, who is now in the White House, has real data, but when he was out of the White House, he didn't have real data, and he was guessing, just like I am guessing right now. The data we have doesn't tell us what we need to know. So a specific policy recommendation.

I don't want to use up too much time. I am going to mention the fact that if you have questions about Chinese investment outside of bonds, including investment in the U.S., we have tracked Chinese investment for the last five years. Our numbers are much better than the
Chinese numbers for a variety of ways, in particular, because China claims it's investing most of its money in Hong Kong. Of course, just like in trade, the money then leaves Hong Kong and goes someplace else. We tell you where it goes. They don't tell you where it goes.

China's investment outside of bonds began to accelerate after a pause for the financial crisis in May of last year because that's one way for them to use their foreign exchange reserves which they can't use at home. The sky is the limit. They're spending about $55 billion a year. It could be twice that in two years if they're permitted by their host countries and if they give the green light at home because Chinese regulators have a lot of questions about Chinese outward investment.

U.S. is the second-biggest target. Australia is the first. Australia is mostly iron. The U.S. is mostly finance.

Third and fourth-biggest targets, probably of particular concern to the Commission, Iran and Kazakhstan. Why? Of course, oil. We can talk about that at great length.

There's also a lot of failures, a lot of bumps in the road for the Chinese. There's a lot of disinformation put out by countries like Venezuela and Iran. We can also talk about that.

I want to make the same thing that my colleague did and use the extra time for a quick policy conclusion. Transparency is a boring issue, but we have to have it. If the Chinese change their rules, we've got to know what they're doing. Right now we have a distorted discussion because we don't know what they're doing, and we think that they're manipulating their Treasury exchanges when they can't; it's just that's the only information we have.

You want to know what the Chinese are doing in Venezuela, Iran, Sudan, Saudi Arabia--Heritage Foundation has some good information on that. I would really like a partner in the U.S. government to help, to talk to, and say, hey, what have you got on the ground? We don't have that either. Allies around the world, the Australians, flooded with Chinese investment, recognize the benefits, recognize China's rights to invest, but are also worried, as we should be.

We should understand China has a right to invest around the world. We, at Heritage Foundation, support open markets. We also have concerns. We have people around the world that we could cooperate with on this subject, but the first step is we need to know what's going on.

[The statement follows:]²

² Click here to read the prepared statement of Dr. Derek Scissors
HEARING CO-CHAIR CLEVELAND: Thank you. Compelling testimony.

Commissioner Blumenthal.

COMMISSIONER BLUMENTHAL: Thank you both for the testimony.

I have a comment/question for Mr. Hindery, and then I have one for Dr. Scissors. A lot of the prescriptions that you provide in some ways make us a little bit more like the Chinese.

So when you say that they are spending three times as much as we are on green technology, I'm guessing that you don't suppose that they are going to get three times as much return on investment for that green technology. Just spending, because they're spending it, it could be incredibly inefficient, and so on and so forth.

Things like subsidies and going after them on subsidies, things like Buy American, because they're doing Buy Chinese.

Wouldn't it be better to be more consistent with our own past economic policies and be more competitive in terms of attracting investment and talent than trying to match them one for one on this very statist economic policy that they're following, which we don't know what the outcome of it is? They could spend $500 million on green technology; we still don't know what the return on investment might be. So that's my question for you.

For Dr. Scissors, I know there're probably a lot of reasons why they're not letting their money leave the country or floating the renminbi, but let me flip a question that I asked before, which is what if they did everything we wanted them to do, what would happen to our economy if we did nothing? What if they floated the renminbi, allowed for greater consumption, let money leave the country, and we still ran these huge deficits and got into all this debt?

MR. HINDERY: You want me to answer first, Commissioner?

COMMISSIONER BLUMENTHAL: Yes.

MR. HINDERY: I do think consistency is an imperative, but the question is who do you want to be consistent with? Yourself or your trade competitors? I would argue for the latter. And I will abandon all premises of buy domestic and Buy American when these countries do the same.

The $217 billion versus $80 billion comparison is actually a wonderful example. 100 percent of the $217 billion will be spent in China. There is no such assurance that our much smaller number will have any domestic component. There's no predicate for it except on the
fringe.

The Indigenous Innovation Act of November 2009, which applies to China’s central and all provincial governments, is an immutable obstacle to any American company being a participant or any European country as a counterpart being a participant, in that $217 billion of purchases.

I start with several premises, but harking back to the last panel, I think the best thing that the Chinese could hope for is that we call them "our bank." I don't think they give a crap about being our bank. I think that all they really care about is growing their manufacturing base and pursuing their mercantilist policies and practices, in the process shifting manufacturing to their domain from ours and others.

I think they have an acute interest in building a global military presence. I think their own admirals and on-the-ground commanders will confirm that, and I think that overnight their interest has moved from the region to the globe. A blue water navy is the best example and best confirmation of that, and I think that if this panel and Commission and others treat China as the United States's bank, they'd be thrilled.

COMMISSIONER BLUMENTHAL: That wasn't my question.

MR. HINDERY: Well, but the question--

COMMISSIONER BLUMENTHAL: Well, I'll go on. We're running out of time. You could spend a lot of money very inefficiently and not get any return for it, and anyway.

Dr. Scissors.

DR. SCISSORS: Your question to me is a very good question. I'm going to do something controversial and say let them do whatever they want with the renminbi. Let's just lift capital controls so that money can move freely outside of China. That can be technically difficult.

Let them do whatever they want with the renminbi. I'm going to just assume they're going to lift capital controls. You can do that. Technically it gets a little difficult, but just for the sake of being provocative and saying the renminbi doesn't matter, which is not true, but focuses us on what does matter. If money can move freely outside of China, they can't subsidize nearly as much as they do.

They can still subsidize. I don't mean to imply that they can't offer subsidies. It just becomes much, much harder because when private holders of money see Chinese banks making these terrible loans, they start to not trust Chinese banks and they send the money elsewhere. But now they can't. So there's no choice.

What happens then is, what would happen immediately upon capital controls being lifted is the bilateral trade surplus that China runs, our trade deficit, would drop a great deal. In particular, it would
be much harder for China to subsidize what would be otherwise inefficient state firms so that U.S. goods would have greater market access, and Chinese exports would decline.

The Chinese have all sorts of countermeasures they might take, but if they did everything we wanted, we would get a significant drop in the bilateral trade surplus because so much of it is funded on the Chinese side by subsidies, and that means they have less money to plow back into U.S. bonds, just as a mechanical thing.

They have to take their balance of payments surpluses and put them in U.S. bonds. If their balance of payments surpluses decline because they've liberalized and stopped subsidizing everything, stopped being mercantilist in this way, then they have less money to put into U.S. bonds.

If we're going to insist then on running $1.5 trillion deficits on into the future, it's going to cost us more, and I have to say frankly I like that outcome on all sides. I like the outcome that we get better access to the Chinese market. I like the outcome that their subsidies stop distorting the international market, and I like the outcome that we actually have to pay for spending money we don't have.

So great outcome for the U.S., in my opinion. Some people, of course, who want to be able to run $1.5 trillion deficits endlessly at no cost, would disagree, but eventually that's going to catch up to us, and we'd be better off if the Chinese actually would liberalize.

COMMISSIONER BLUMENTHAL: Thank you, both.

HEARING CO-CHAIR CLEVELAND: Mr. Hindery, I had the feeling that you had one more comment before we turned to the next question.

MR. HINDERY: Just an observation to the Commissioner. The $217 billion can be spent efficiently just as easily as it can be spent inefficiently. We can all speculate just how efficient they are--I for one find them shockingly efficient.

HEARING CO-CHAIR CLEVELAND: Thank you.

Commissioner Wessel.

HEARING CO-CHAIR WESSEL: Thank you, both, for being here. Dr. Scissors, good to see you again, and, Mr. Hindery, it's good to have you here.

Mr. Hindery, you've been a senior advisor in domestic policy circles for awhile here in Washington, and as you've followed this issue over the last several years and our changing debt situation, what impact has that had on U.S. policy interests and the ability or the willingness of government officials to pursue policy interests?

MR. HINDERY: I think it's a great question, Commissioner. The contrast between the 1980s, which Mr. Prestowitz was speaking about
in the earlier panel, and today is the influence of the Business Roundtable, which I find to be of greater moment than China's accumulation of foreign reserves, which is sort of the bogeyman in this room today.

Quite simply, we don't approach our relations with China in an unselfish fashion. And by that, I mean that we are unduly influenced by the multinational corporations domiciled here which dictate policy up on the Hill. Chairman Slane asked about the role of Congress going forward, and I think you did as well. Frankly, it's been greatly muted by that reality. The big change over the years is that we as a nation are tolerating very selfish behaviors that hurt our trade balance, hurt workers, hurt our military security, and hurt the national security of this country, all because these behaviors are in the best interests of multinational corporations and financial institutions that have an undue influence on Congress right now.

HEARING CO-CHAIR WESSEL: So do you believe there are steps? What steps could be taken to rebalance that? What governance issues, transparency, to go to an issue that Dr. Scissors had been raising, could we review that might help affect that outcome?

MR. HINDERY: It's a seminal crossroads where we're going to have to decide that some companies are going to have to get hurt here for the good of the nation. We saw, as an instant response to the President's February 3 speech and the contemporaneous sale of weapons to Taiwan, threats out of the Chinese that were very threatening. I thought the Assistant Secretary's testimony that they were of little consequence, again, was naive. The threats are real, and we will likely soon see their effects on the Boeing Company and elsewhere such as on the offshore drilling by American companies in the Vietnam Sea.

And we're going to have to live with that. It's going to be painful, but we have to achieve a better balance between the interests of multinational corporations and the national good.

As I said in the first paragraph of my opening comments, Commissioner, the drivers for me in all of this are the simply unacceptable real unemployment rate in the country today and the stagnant wages. And I find so much of this to be attributable to these behaviors in our trade relationships, especially with China and others in the Southeast corridor.

HEARING CO-CHAIR WESSEL: Understand.

Dr. Scissors, I am all for transparency, and I believe data should drive decisions. Tell me, how we get that data? Aren't a lot of these bonds held in street name bearer situations, et cetera? So if we're going to make recommendations about how to get better information, rather than just saying that, what specific steps can be taken to do that that do
not put undue restrictions on market activities?

DR. SCISSORS: I can give you a pat answer, and the problem with pat answers is there's always somebody who is gaming those pat answers. So I'll give you a pat answer, and then I'll tell you about the risk of the gaming.

We can, for example, ask the British what they're actually buying. We can get information from the British government and leave the--in this particular case--leave the unrecorded purchases or the unrecognized/unregistered purchases as Chinese because they are the dominant buyer. They have an office there, et cetera.

HEARING CO-CHAIR WESSEL: So you're saying that we would assume they were the buyer unless we had--

DR. SCISSORS: Right.

HEARING CO-CHAIR WESSEL: Okay.

DR. SCISSORS: And as an initial assumption, that's the correct assumption. So unregistered purchases in London are going to be completely dominated by the Chinese because the Japanese don't do that, because of the extent of foreign exchange reserves, and because SAFE has an office there, because of their patterns in other buying.

The problem, of course, is once we do that, the Chinese say, hey, um, I think we need to route more through the Cayman Islands. Let's see if you can get the information there, guys. So there are steps we can take. They will improve the situation, and they may only improve the situation temporarily.

I wish I could give you a happy answer. I can give you a happier answer on the other side. It is outrageous. I don't know what other--I'm a practitioner--it's not outrageous because the American people are outraged. I'm outraged that the Department of the Treasury only puts out information on non-Treasury bonds once a year, and it's nine months late.

HEARING CO-CHAIR WESSEL: So there are some data that could be reported--

DR. SCISSORS: Absolutely.

HEARING CO-CHAIR WESSEL: --better. There is also failure to access some data.

DR. SCISSORS: Right. There's improvement the U.S. government can absolutely make, and then there are things the Chinese are going to continue to do to hide their activity that are going to be tough for us to counter.

HEARING CO-CHAIR WESSEL: Okay. But the regularity of reporting would assist that?

DR. SCISSORS: Yes.

HEARING CO-CHAIR WESSEL: Thank you.
HEARING CO-CHAIR CLEVELAND: Commissioner Mulloy.

COMMISSIONER MULLOY: Thank you, Madam Chair.

I want to come to the question, do you both think that the Treasury in its April 15 report to Congress should cite China as a country that underprices its currency to gain trade advantage?

MR. HINDERY: Commissioner, I do for certain, yes. I think that in the prior panel, several comments were made about efficacy, and if you don't cite China, if you let another period go by, and don't, they'll know they have you.

DR. SCISSORS: I'm going to give an unfortunately compromised answer. China is absolutely undervaluing its currency, and I don't know that the Treasury citation would be at all productive. Two reasons: one, people seem to think the Treasury citation will actually mean some action on our part. It just means consultations. We've been down this road before.

And two, as Mr. Hindery said, quite correctly, the RMB is the visible symbol of Chinese mercantilism. It's not the most important thing. It's not the second-most important thing. I don't want to lead us down that path. There are more important things the U.S. should be concentrating on, even though the RMB is undervalued.

COMMISSIONER MULLOY: My view is they're doing it. The Treasury is charged by law to report current manipulations to Congress and Treasury should tell the truth. It may not be the silver bullet. There are a lot of other things going on, but I think Treasury--my own view is they should tell the truth, and then we go from there.

Secondly, I wanted to ask you both, Commissioner Shea raised an important issue before. China is our banker. People say the Chinese are buying so much of our debt; aren't they being great to us?

Here's the way I understand the situation, and then you can comment. When the dollars go to China as a result of running these massive trade surpluses with us, the Central Bank gets those dollars from the people who have earned them, and they give those people Yuan, and then they issue bonds to suck up that so that there is not inflation in China.

Then the Central Bank goes into Treasury auctions and buys U.S. Treasury bills. Now, the effect of this, as I see it, it keeps interest rates lower. But then it's like giving drugs to a drug addict, that we don't deal with our problems then because interest rates are so low.

The second thing I see going on is that then the Chinese then hold this over us, they say we should be grateful to them for doing this, but they have to do it in order to keep their currency underpriced. So they're not really our banker. Somehow it's different than that.

Do you want to speak to that, Mr. Hindery, and then Dr. Scissors?
MR. HINDERLY: I couldn't agree more, Commissioner. I don't care so much about the accumulation as how they spend it and the fact that it is the basis for the internal subsidies, the domestic subsidies.

And Dr. Scissors is right. We've also never been able to figure out the balance between natural resources going in and manufactured goods coming out precisely. We know what largely goes in, but we can't compute what comes out.

The Chinese use this accumulation for subsidies; they use it to build up their military presence; they use it for overseas investments, as both Dr. Scissors and I have said; and they use it increasingly to make critical investments to our national and military security.

So as I said in an earlier comment to one of the other Commissioners, I think they'd love you to just label them as a bad bank. But they're not a bank, they're an accumulator, and how they spend the accumulation is what should be of concern to us.

DR. SCISSORS: I agree with that presentation. I would actually strengthen it. The line I've used from the beginning of this is China has two choices: buy U.S. bonds or build a really big mattress. Those are the only two options for their money. So you've got the process absolutely right. I'm going to disagree in this case with Mr. Hindery. Those reserves are separate from domestic currency in exactly the way you outlined: by law, you cannot essentially hold foreign currency in China or use it. It all ends up back at the People's Bank, which means it cannot be used in subsidies; it cannot be used in military spending.

They've set up a system that has benefited them greatly, in particular with regard to defending the undervalued currency, but one of the costs is they've accumulated $2.5 trillion. They got people who make on average $4,000 a year, and they can't use the $2.5 trillion to help the people making $4,000 a year. They have to put it in U.S. bonds, as you pointed out. They can't use it at home.

COMMISSIONER MULLOY: Thank you both very much for being here.

HEARING CO-CHAIR CLEVELAND: Mr. Wortzel.

COMMISSIONER WORTZEL: Dr. Scissors, in 2002 or 2003, representatives of financial institutions told the Commission that China's holdings of U.S. financial assets, if you look at the whole U.S. market, were really small in comparison to the rest, to the entire market. And even if Beijing somehow divested itself, the effect on the whole U.S. market would be small.

So if China was able to divest itself of these holdings of Treasuries and bonds and go elsewhere or build this big mattress, what would the effect be on interest rates here in the U.S.? Is this going to be a disastrous thing?
DR. SCISSORS: I actually would really like them to build the mattress for my own reasons. But presuming they didn't do that, there are two parts to answer your question. The way they would do that would benefit the United States. It's the response to my question to Commissioner Blumenthal. But let's put that aside even though that's a crucially important issue.

The way they would actually stop buying our bonds would bring considerable benefits to the U.S. If they stop buying our bonds, we already know what would happen, which is nothing. Even in a situation where we're running a huge deficit, nothing.

If they were to go further than that and sell all the U.S. assets, it would cause them a tremendous amount of pain because you've got to have buyers or you're taking big losses. Even in that case--now, they hold more bonds than they did in 2003, mostly they moved out of agency into Treasury bonds--but even in that case, we're talking about a two or three percent increase in U.S. interest rates.

It's bad. It's especially bad now because we've mismanaged ourselves into a recession, but it's hardly a catastrophe.

COMMISSIONER WORTZEL: I bought my first house when Jimmy Carter was President, and my first mortgage when the Army moved me into the Washington, D.C. area and didn't have housing was 19 percent. That's bad. But to go up two or three percent is not disastrous; it's not good.

DR. SCISSORS: Agreed.

HEARING CO-CHAIR CLEVELAND: Commissioner Shea.

COMMISSIONER SHEA: Thank you both.

Reuters has a story on our hearing today, and it says that China's holdings of Treasuries fell in December to $755 billion, causing it to drop behind Japan as the biggest holder of U.S. government debt, and as I understand it, Dr. Scissors, that's factually incorrect if you include Hong Kong and these other--

DR. SCISSORS: It's almost certainly factually incorrect. I wish I could say for sure that it was, yes.

COMMISSIONER SHEA: Okay. Fair enough.

Second question, I think what I'm hearing is that China has no alternative but to invest in U.S. debt to support its export-led strategy and capital controls. Does the U.S. have any alternatives? If China were to reduce its dollar holdings, are there other investors who would readily come to the fore and invest in the debt?

DR. SCISSORS: Well, I'm not going to hold this up again although I'm sure there are people at Heritage who would like me to. We saw that already; right?

We jacked up the deficit to $1.6 trillion last year. The Chinese
bought two percent of it essentially in terms of Treasury purchases, if you believe this number, and other people bought Treasuries. Now, it's probably the Chinese still buying the Treasuries. So it's hard to tell.

But the deficit is a bad thing. We can finance it for an extended period because we happen to have the most liquid, biggest financial markets in the world. We happen to have the consumers with, even after the recession, by far the most discretionary income. We have a Fed that can build a gigantic balance sheet because American assets are so much larger than everyone else's, just using GDP, more than three times larger than the nearest economy.

So we can run that deficit. We can run another huge deficit without the Chinese at all next year and keep interest rates low. It's still a terrible idea.

COMMISSIONER SHEA: Right.

DR. SCISSORS: It's a terrible idea for two reasons. One, eventually it won't work anymore. Eventually you run out the string. And two, because it siphons resources from all around the world, but especially the United States, into the government; right?

COMMISSIONER SHEA: Yes.

DR. SCISSORS: Instead of saying to people, hey, what's the most productive thing for you, you demand that money for the government. We usually think of crowding out as raising interest rates. That's a perfectly reasonable fear with regard to big deficits and no financiers.

But the other fear is how much of the economy do you want running through the federal government, and I would like as little as possible, and we're headed in the wrong direction. So we don't need China, but we're still shooting ourselves in the foot.

COMMISSIONER SHEA: Mr. Hindery, do you?

MR. HINDERY: I don't disagree, Commissioner, with anything that Dr. Scissors said. I would simply add that my overriding concern on this issue is the 90 percent cost differential on manufactured goods that is, as we know, so artificially generated, and its implications to real unemployment here in the U.S.

We have, as you have heard from others who testified in front of you in the past, we have less than nine percent of our workers making things, and we need to double that. And we cannot do that-- and people on the right and on the left have come to common agreement that we need to roughly double manufacturing--we cannot do that with these behaviors.

I think that, again, China would love us to continue to focus purely on the financial side of this equation, but as Dr. Scissors can testify better than I, and certainly Commissioner Wortzel drove to this point as well, while it would be painful, it wouldn't be fatal.
What's fatal is 19 percent real unemployment that's goes on and on. That's fatal. Wage stagnation for the last ten to 20 years, depending on your income level, that's fatal.

COMMISSIONER SHEA: Well, I have a minute. I'll ask a question and maybe you can answer in the next round. But you mentioned, I've heard Council of Foreign Relations and Brad Setser during this panel, and he wrote a piece for the Council of Foreign Relations where he raises the concern that if China were suddenly, or China relinquished some of its U.S. debt holdings, it might encourage other nations who are friendly to the United States to relinquish their holdings or reduce their holdings, not out of an effort to hurt the United States, but out of an effort to protect their own position, and that we should negotiate with foreign countries.

He said, he writes, the next administration should consider negotiating with other allies to protect against such an eventuality. So do you have any thoughts about that?

DR. SCISSORS: Yes, the negotiations are going to be really short. The foreign countries are going to come to us and say you want us to not sell debt if the Chinese sell, then cut the deficit, because then it's a good buy for us. The Chinese want to sell; we'll buy it if we think it's a good investment. The reason we wouldn't think it's a good investment is because we think you're undermining the dollar, and we don't want to hold dollar assets.

So you're right: the Chinese could trigger a panic, but the panic is really about us. Do we want to hold American assets if the Chinese are selling? If American assets are worth holding because we have a sound growing economy and a sound fiscal position, people will buy. They'll tell the Chinese, oh, great, I get to buy your bonds at a cut rate. This is great for me. If our economy looks weak, that's when the panic sets in.

So what other countries are going to ask of us is get your house in order.

COMMISSIONER SHEA: Thank you.

HEARING CO-CHAIR CLEVELAND: Chairman Bartholomew.
Commissioner Bartholomew.

VICE CHAIRMAN BARTHOLOMEW: Thank you very much and thank you to both of our witnesses.

I actually don't have questions but two comments, one of which will be directed to Commissioner Blumenthal. We're early in our cycle, and I can see how some of these issues are going to be shaping up as we go through the year.

Dr. Scissors, I commend you. Your chart is terrific. Your metaphor about the mattress is certainly going to carry us through the year. I think that you really do. But I can't let go unchallenged your
comment about the deficits in the sense that there is a tendency in this city, in particular, to use shorthand in political discourse and to characterize people who are of a different party as believing in things that they might not.

Now, you and I are of different parties. So I'll put that out there; right. But you said that there are people who want to run these massive deficits, and I just really can't let that go unchallenged. Nobody wants to run these massive deficits. The disagreement is what to do in order to address them.

DR. SCISSORS: I actually would argue everybody wants to run the massive deficits because we had them with the Republican Congress and a Republican President, and now we have them with a Democratic Congress. It was not meant to be a partisan comment. It was meant to be a shot at everybody.

VICE CHAIRMAN BARTHOLOMEW: All right. Then that's fine. I just think we need to be very careful and clear that everybody is guilty of this, and it's not any party in particular that is carrying this forward.

Commissioner Blumenthal, while I agree with you certainly that inefficiency in spending is possible, and particularly when we look at China where there is no transparency and corruption is rampant, that is a very real possibility, but I think that using green technology as an example is probably not the best one.

What the Chinese government is accomplishing in terms of its investments in green technology is already being well documented. We're actually going to have a hearing on that, and that frankly it's undermining the success of our investment in green technology before we can even really get it off the ground.

What troubles me about what you said is that in some ways I think it might be perpetuating the myth that we have seen carried out over the course of the past 20 years of U.S.-China policy, that our intellectual property and our innovation is going to carry our economy forward.

I certainly agree with Mr. Hindery, that manufacturing does matter, and so when we look at these investments, I felt like what you were saying with green technology was implying, okay, well, so the Chinese are manufacturing, that doesn't matter all that much.

It does, and I think that we have to be really careful as we look at these issues to recognize that their efficiency in the sectors on which they've focused has increased dramatically, and I think we should expect and, in fact, we're seeing the same thing on green technology.

COMMISSIONER BLUMENTHAL: Do I get a comment?

VICE CHAIRMAN BARTHOLOMEW: You can use the time. I'm sorry to take it away from our witnesses, but I--
HEARING CO-CHAIR WESSEL: Equal time in--
COMMISSIONER BLUMENTHAL: Let me switch and pose the
question to the witnesses, which is--
DR. SCISSORS: Is this going to be a question where you say "am I not right about everything?"
COMMISSIONER BLUMENTHAL: Right. Given Mr. Scissors' I think rightful and I think most economists' rightful pointing out of how much of lack of transparency is in the Chinese economy, and the amount of corruption, the kinds of things we're seeing in terms of just getting money out the door and in easy loans and so forth, is there any way we can possibly account for 217--whatever it is--money going into green technology returning into three times as much return on investment as ours? Is there any possible way to even track that?
MR. HINDERY: Can I answer? I don't think it makes any difference what the return on China's investment--
COMMISSIONER BLUMENTHAL: Of course there is. Of course there is.
MR. HINDERY: Let me finish. Let me finish.
COMMISSIONER BLUMENTHAL: Well, no, I'm going to ask the question here. Okay. It does in the sense that you can spend a lot of money, you can put a lot of money into the economy, and you can waste a lot of it.
I'd like you to answer this following question: can you tell me or the Commission here with assurance that the money that they're spending is going to make them more profitable, given all, everything that Derek Scissors mentioned about their transparency issues, and everyone else says, that that's actually going to make--that these state-run industrial policies they have are going to make them more profitable than say if we got our act together in ways that we traditionally have competed?
MR. HINDERY: I cannot give you assurance to that question, but I can give you assurance that 100 percent of the $217 billion, 100 percent assurance, will go to Chinese manufactures, and I can give you no such assurance on any dollars of any amount spent on the green economy in this country.
DR. SCISSORS: Can I? I promise I'll be really, really quick. There is no way you can get that kind of assurance for the Chinese return on investment. You can't even be assured the Chinese are going to spend the money that they say they're going to spend because--and I can go into great deal of detail about that--whenever they give out something out to local governments, the local governments do what they want rather than what they're obliged to do.
So I think the real issue here is subsidies do change things. If
they didn't change things, we wouldn't be upset about them, and so we can't just say, well, we don't know what the Chinese are getting out of this, they could be wasting their money, so the subsidy doesn't matter.

The subsidy can matter.

My worry, and I don't mean to put words in your mouth, Commissioner Blumenthal, is we don't want to get into a battle of subsidies with the Chinese. That is not what we want. We're going to lose that battle or we're going to warp our economy, in fact, our whole society involved in it. They can raise the stakes on a subsidies battle in 25 different ways that we don't have available to us.

We know one of them. They'll just order their banks to make bad commercial loans; right. So their subsidies matter, and we have to worry about them; we have to be concerned about them. The response cannot be let's be just like China. We can't do it and we shouldn't do it.

HEARING CO-CHAIR CLEVELAND: I think we've finished that topic.

Commissioner Reinsch.

COMMISSIONER REINSCH: I'll do my best not to pound that one further into the ground. It always worries me when I agree with the Heritage Foundation, but I think that--

DR. SCISSLORS: We're sneaky that way.

COMMISSIONER REINSCH: I think that Derek is right in his deficit comments, and I think that he's right in apportioning guilt equally amongst the parties and also amongst the people. We consistently refuse to make choices that we ought to be making that would get the deficit down, and we instead take the expensive action, but that's not the purpose of today's discussion.

I do want to pursue for a minute with you, and if I have a moment left after that, a question for Leo, but I thought you provided an interesting explication of what would happen if the Chinese remove capital controls.

Let me pursue two lines on that. First, can you comment what would happen in the same context if they removed capital controls and floated the RMB? What would happen to the RMB in the short term?

DR. SCISSLORS: What would happen to the RMB, I hate to hedge like this, but the RMB would probably rise 30, 40 percent. If they really floated the renminbi, not this fake peg that they announced in June 2005 that they abandoned. That was not a real peg.

COMMISSIONER REINSCH: No. I mean a real float.

DR. SCISSLORS: A real float. It's difficult to tell because the removal of capital controls is such a big change that it's going to remove a lot of the upward pressure on the renminbi.

COMMISSIONER REINSCH: Exactly. That's why I asked the
question.

DR. SCISSORS: So, okay, all right. You do want to go that route. I didn't know how much detail you wanted to go into. If, without capital controls, I think the RMB is only undervalued by about five to ten percent.

The distortion is coming from they're keeping the renminbi low even as they're trying to subsidize their exports all this way. It's not the renminbi. We've seen this before. The renminbi went up 20 percent against the dollar and the bilateral deficit went up 50 percent. The renminbi does not drive our trade; the trade would drive the renminbi except the Chinese prevent the renminbi from moving.

So, in my opinion, the capital controls, the distortions, other distortions, in China, are what drive our trade relationship. The renminbi is a symptom of that. You remove all the distortions; you don't get much movement in the renminbi.

COMMISSIONER REINSCH: Hence, your emphasis on subsidies.

DR. SCISSORS: Right.

COMMISSIONER REINSCH: Which is a point well-taken. I think it's also your point that it's hard for us to compete dollar for dollar or dollar for Yuan on subsidies. Tackling it, though, is a little bit of a different situation. Perhaps you can comment on this. Maybe Leo wants to comment, too.

I think, in general, the way our laws work, attacking subsidies one by one, which is what one would do even if you wanted to say currency subsidy, undervaluation was countervailable, it's kind of micro remedy. You have to go case by case, and you spend a million dollars a case and file a lot of cases, and maybe four years from now you've got something.

Is there a better way to approach that problem?

DR. SCISSORS: That's why I emphasized capital controls. Right now there's energy subsidies, there's land subsidies, you know, there's tax subsidies. It's very difficult to get a grasp on all of them, and they can move them around in response to your cases. So you filed a successful case in one area, and they just shift the subsidy to someplace else.

Capital controls would strike at the heart of all this because fundamentally China's financial system holds up, despite policy-driven lending because you can't send the money anywhere else. So policy-driven lending to subsidize exports; money comes back in; it's all a closed system.

You allow people to move money out when the government says we're going to, you know, extend bill financing to a bunch of firms that would otherwise go out of business; there's no prospect of us getting a return on this loan; it's not going to happen. And you let people say I
want to send my money someplace else. It's certainly not going to solve
the problem—but it's the single-biggest cut at the problem.

COMMISSIONER REINSCH: I guess where I might disagree is
over the question of if they did that, how quickly the sequence of events
you're describing would occur? It seems to me, it's hard to imagine that
the effects you see, particularly in terms of capital movement and things
like that, would happen in the short term.

DR. SCISSORS: I'm going to do something illicit here and use
the People's Bank as my ally. When you ask them why you won't lift
capital controls, they say it's because there's going to be this huge flood
of money out of the country. Now, of course, they don't say that
publicly, and they may be saying it for posturing reasons, but there is
the risk of a very quick sharp adjustment.

You're absolutely right that that may not be what occurs, but the
pressure will change Chinese policy very quickly because they just won't
have the free hand that they have now.

COMMISSIONER REINSCH: Well, I'm not sure I believe the
People's Bank when they told Clyde they weren't going to let the
renminbi appreciate. I'm not sure I'll believe them this time, but a good
point.

Leo, one final quick question, if you might. I notice you alluded
to it, and then I looked at your testimony, and you referred to former
Senator Gorton's proposal about calculating the value of the IP that the
Chinese have stolen, I believe is the word in your testimony, and then
trying to recover that with a levy.

Did Senator Gorton explain how we would calculate that?

MR. HINDERY: I'm sorry, Commissioner. He actually hoped to
be here this morning, and the weather compounded his problems as well.

COMMISSIONER REINSCH: So I should have asked him
directly.

MR. HINDERY: Yes. He actually has put some great effort into
it and would be happy to share it with your staff.

COMMISSIONER REINSCH: Could you ask him to supply that?
I think we'd be interested in seeing that.

MR. HINDERY: I'd be delighted. And if I could add one
comment to Dr. Scissors. I think the removal of the capital controls is
so anti-Chinese in terms of behavior, compared to incremental
movements of the exchange rate that better suits them. You can't come
back from a removal of capital controls. There's no stepping back that's
not so obvious as to cause them political problems, I just don't see it in
the cards, Commissioner.

COMMISSIONER REINSCH: Thank you.

HEARING CO-CHAIR CLEVELAND: Mr. Slane.
CHAIRMAN SLANE: You both talked about the debt really being our problem, and that we have to get our house in order. Can you give me your thoughts on how we do that?

DR. SCISSORS: First, I am elected czar.

Laughter.

DR. SCISSORS: How we do that? I think Commissioner Bartholomew pointed this out. When one party is in charge, it says, well, we should cut these things and not these things, and the other party flips the priorities. I'll use a sports metaphor. The NFL and the players, they may not be able to get together, and maybe they both have to take their medicine.

We're now at the point of it's not 200 billion, it's not frittering, it's not we'll grow out of it, it's pretty much everything, let one side cut the other side's programs. I'm not a political person. I don't know what will actually work in negotiations, but the problem is so big that I think it needs something radical like the biggest enemies of program X get to decide how much program X is cut, and the enemies change with the program.

So everybody suffers a lot, and the amazing thing is here, and it's very difficult to see it because I'm not up for reelection, in three years everybody would be happier, much happier. It's pain, it's short-term pain, and a lot of gain, and it won't last that long. We just have to have the courage to take the drastic action now, and it's going to have to be absolutely bipartisan because the problem is bipartisan.

MR. HINDERY: Commissioner, I would take a much different tack. I think that near full employment is the most obvious way to reduce the deficit, and much of the rest is political gamesmanship. We know that we cannot reduce the deficit and have a 19 percent real unemployment rate at the same time. It can't be done.

You can't have stagnant wages for 90 percent of Americans for over a decade and reduce the deficit. Why I spend so much time on these jobs issues is because we've embedded such large implicit costs into the system from this massive real unemployment and wage stagnation that we have to address them first and foremost.

CHAIRMAN SLANE: Let me follow that up because 30 million Americans are looking for a full-time job, and I don't see how you get there without bringing manufacturing back.

MR. HINDERY: Nor do I, Commissioner. We know that there are two massive opportunities to create employment. One is on the infrastructure side and one is with unemployed out-of-school youth programs, but they also have to be coupled with buy domestic requirements. There are 30 million real unemployed workers, and for them to have a real unemployment rate of not more than five percent,
we need to create 22 million jobs. It's not the 9 million that the administration speaks of; it's 22 million.

Jeff Immelt of the General Electric Company and I are in common accord that the manufacturing sector must double in size, and that large-scale infrastructure investments coupled with buy domestic requirements that mirror those of our major trade competitors is the most obvious way to get started.

HEARING CO-CHAIR CLEVELAND: Commissioner Mulloy.

COMMISSIONER MULLOY: Thank you, Madam Chair.

Just to pick up on that, and you can't bring manufacturing back without dealing with the mercantilist trade practices in Asia; is that correct, Mr. Hindery?

MR. HINDERY: That's the circularity, Commissioner. It's why we started this initiative at New America, calling it the Smart Globalization Initiative. We recently amended it to call it the U.S. Economy/Smart Globalization Initiative. The linkage is simply too obvious at this level of real unemployment.

COMMISSIONER MULLOY: I have a question I wanted to ask you both. We've had in the discussion this morning the idea that the multinational corporations who have invested in China, they're driven by they want to get value for their shareholders and they find--and the CEOs whose compensation is tied to shareholder value, and the Chinese offer incentives--underpriced currency, subsidies--to move manufacturing from here to there and then ship it back here because once they get in the WTO, our average tariff is about 2.5 percent, so it worked for them. So I can understand why.

And in NAM, when there was a big debate in NAM between the U.S.-based companies and the multinationals on whether they should go after the Chinese currency when Congress was interested in doing that, and there was a big break between the multinationals, who were opposed going after the China currency, and the domestic-based companies that wanted to. So I understand where the multinationals are.

I don't quite get Wall Street. Why is Wall Street so opposed? How do they benefit from this underpriced currency, and why have they aligned themselves with the multinationals in inhibiting the U.S. from going after this issue?

Mr. Hindery and then Mr. Scissors.

MR. HINDERY: I think it goes back to Secretary of Treasury Rubin who drew an errant conclusion that the best interests of Wall Street were in a hands-off attitude toward China. I think they saw their own expansion being heavily tied in to financings and financial activities in Asia, and frankly that's proven to be the case. Now they all have
major presences there, and they are complicit in all of these initiatives, very selfishly I might add.

This question follows up on Commissioner Wessel's earlier one. I think, Commissioner, that there are now two players at the table that were not around in the '80s when we were confronting similar issues, especially with the Japanese. They are the multinational corporation and the multinational financial institutions, whose compensation practices and returns on investment, are all based on laissez-faire practices in these areas.

DR. SCISSORS: I have a simple answer and then a more complicated answer. The simple answer is we've already talked about it. It's $2.4 trillion in foreign exchange reserves that needs to be managed. So there's a lot of money available for Wall Street firms. There's a lot of money in the China business just like there's a lot of money for multinationals.

The complicated answer is it's--I know you're not doing this. I just want to clarify. It's a fundamental mistake to represent U.S.-based manufacturers as virtuous and multinationals as not virtuous. What do U.S.-based manufacturers want? They want protection from competition. Okay. Well, why do they want it? They're delivering value to shareholders, the same way the multinationals want to deliver value to shareholders.

It's the firms are acting the way they're supposed to act and that we're happy that they act, the U.S. firms that are wanting protection from competition, unfair competition and fair competition. Companies love protection from fair competition and not just unfair. They're doing the same thing the multinationals are doing, the same thing the Wall Street firms are doing. I don't think which side the corporations are on, is particularly relevant. There is a lot of money to be made in China, and there's a lot of money to be lost in China.

COMMISSIONER MULLOY: But when you produce in the United States, you contribute to U.S. GDP. When you produce in China, you contribute to China's GDP; is that correct?

DR. SCISSORS: Not necessarily, although I know what you're saying. If you employ in the U.S., you're employing workers here, and if you employ in China, you're employing there. GDP is not such a great measure.

The point is if you produce in the U.S. because of government subsidy, you're not necessarily contributing to U.S. GDP.

COMMISSIONER MULLOY: Right.

DR. SCISSORS: If you produce in China and send back products that allow people with lower income to buy a lot of stuff that they couldn't otherwise buy, you are adding to American welfare. So just the
location of the production is not enough to tell you whether this is a good or bad policy.

The problem on the Chinese side is there are subsidies, not the relocation of U.S. assets by itself.

COMMISSIONER MULLOY: Mr. Hindery, did you want to comment?

MR. HINDERY: Just quickly. I wouldn't parse "fair" and "unfair" as precisely as Dr. Scissors. Let's first give our guys "fair" and then worry about "unfair". As I said in my testimony, 90 percent of the cost differential in manufactured goods between ourselves and China is not labor-based—it's other things, many of which are either illegal or unhealthy to our long-term environment.

COMMISSIONER MULLOY: Thank you both very much.

HEARING CO-CHAIR CLEVELAND: We'll wrap up with Mr. Wessel.

HEARING CO-CHAIR WESSEL: Thank you.

Let me just follow through and I would welcome long-term your comments on this as well. Dr. Scissors, you've talked about transparency, and I'm of the view that sunlight is a great disinfectant on a lot of things. So we want to work with you on finding other ways to make sure that Treasury is providing data on a more timely way. To whatever extent we can get to disaggregate the data and find out more about it, we'd like to do that as well.

Leo, you talked about earlier—I believe the number is 58 percent of Chinese exports to the U.S. are from foreign-invested enterprises. So that we have in many ways a structural deficit that's building here, that supplying the U.S. market, the rate of return issues, et cetera, are not necessarily a function of market forces since China is not a market economy, but there's some disequilibrium, there's some structure that's being created here.

In the past, the Commission has suggested that there should be greater corporate reporting of flows of products, contracts, et cetera. In discussions with some companies, they've indicated that when they make investments in China, their finance committee is required to do an IRR analysis, and they have access to all of the subsidy information because they're the ones getting it, but our Treasury Department, our Commerce Department, our SEC, does not have access to this data.

So a quick comment, a quick question on transparency, and if you have ideas about how we as a Commission can find out other ways of shedding light on the disequilibrium and the relationship of the market versus non-market forces, and how data can help drive some decisions, that would be very helpful.

Leo, first.
MR. HINDERY: Just a quick comment, Commissioner. While I didn't address the 60 percent figure in my oral comments, I did raise it in my written comments, and this figure answers in very large part Commissioner Blumenthal's question. Obviously, the foreign-owned manufacturers in China which are responsible for 60 percent of China's exports into the United States are earning a very high rate of return or they wouldn't be there.

So it's nonsensical to suggest that other aspects of China's activities somehow realize low IRRs, when someone like IBM China goes over there and earns a high one. I think there's an imbalance in the logic.

I think, Commissioner Wessel, that there are a lot of disclosure problems and failings, and I also think that the Treasury doesn't even want these numbers. If in the public domain we had better numbers, we could react to them and there one place where good numbers exist on a real-time basis is within corporations.

So we should demand that the reports to the SEC include this information. As we are now asking companies to give us more information on executive compensation, we should ask them to give us as well all their information on their foreign investments, in a way that doesn't cause them competitive problems.

HEARING CO-CHAIR WESSEL: Dr. Scissors.

DR. SCISSORS: Yes, three-pronged approach. The first one would just be to get Treasury to report on our bond situation better than they are.

The second one would be to recommend that the administration not just pay lip service to transparency but include transparency explicitly in one of the negotiations. Just give the Chinese some incentive, carrot and stick, to be more open. Why can't SAFE, the State Administration of Foreign Exchange, put out a "freaking" quarterly report, a year after the fact? We're not trying to anticipate their market movements. It can be a page long. That would be infinitely more than what they put out now.

That should be part of U.S. negotiations with the Chinese. The first thing we have to do to negotiate well with the Chinese is to get a better sense of what they're doing. Why are they different than negotiating with the EU? We have big commercial clashes with the EU, but we have an idea of what U.S.-EU economic relations look like that we don't have with the PRC.

So, internal negotiating with China. On the corporate side, I think Mr. Hindery has a better sense of it than I do. I came from the business world and so I'm naturally defensive. I think if you told corporations, look, we're going to give you proprietary protection.
We're not going to name the corporations where we're getting this from. It's all going to be pooled. We're not going to have like, oh, we got aerospace information. I don't know who that could be from. Not Boeing. I mean they're the only ones.

There is going to have to be some limits on U.S. government action, but within those limits, there are definitely sectors in manufacturing where we could get information from companies, protect them, not onerous information, not 1,500 page documents submitted every quarter, simple stuff. One of the advantages to starting with such a low base is almost anything is going to improve things greatly.

So I think there is progress to be made, not unlimited, but some progress to be made on all fronts.

HEARING CO-CHAIR WESSEL: A quick comment on that, and thank you. I think the intention would be to keep all of that information, BPI, it's not about releasing the competitive structure.

If you could, both of you, in the follow-up, have any comments on the Bilateral Investment Treaty negotiations, both the model BIT, as well as the discussions with China, to get at your transparency issue with SAFE, et cetera, if there are things that we as a Commission might want to share with our client Congress as to how the BIT can be improved to get at some of the data questions you're raising here, please let us know, and we'd like to look at those.

HEARING CO-CHAIR CLEVELAND: Is that it? Okay. Thank you very much for appearing. It was terrific. You both lived up to your reputations, and we'll take a break and be back at one o'clock with the next panel.

[Whereupon, at 12:05 p.m., the hearing recessed, to reconvene at 1:05 p.m., this same day.]

A F T E R N O O N S E S S I O N

I M P L I C A T I O N S  O F  U. S.  D E B T  T O  C H I N A

HEARING CO-CHAIR WESSEL: Good afternoon and welcome back. We appreciate your being here. Our third panel will address the political, diplomatic and security implications of U.S. debt held by China.

Daniel Drezner is a Professor of International Politics at the Fletcher School of Law and Diplomacy at Tufts University and is Senior Editor at The National Interest.

Dr. Drezner is an occasional commentator for Newsweek International and NPR's Marketplace and keeps a daily Weblog for
Dr. Drezner, if you'd like to start.

STATEMENT OF DR. DANIEL W. DREZNER
PROFESSOR OF INTERNATIONAL POLITICS, THE FLETCHER SCHOOL, TUFTS UNIVERSITY, MEDFORD, MASSACHUSETTS

DR. DREZNER: Commissioner Wessel, Commissioner Cleveland, the rest of the Commission, thank you very much for having me testify.

I want to focus on three issues in my oral testimony. The first as a political scientist is basically what are the worst case scenarios we can think of with regard to China's financial holdings of U.S. debt and other forms of U.S. dollar denominated assets?

The question is can China translate its financial leverage into foreign policy leverage vis-à-vis the United States?

The second issue is whether China can translate its financial leverage into foreign policy leverage vis-à-vis other countries, third-party countries?

And then third, the sort of nuclear scenario we just talked about, which is, is China's talk about moving away from the dollar as the reserve currency something that should be taken seriously?

On the first issue, to use the language of security, I think China's financial power without question increases its deterrent power in the sense of it has much greater ability now to resist pressure from the United States to alter various foreign economic and security policies.

That said, its compellence power over the United States, the notion of that it can somehow sell or use its financial holdings to influence U.S. foreign policy, is incredibly limited, and part of this is the reason that if you take a look at the sort of history of trying to use this kind of financial holding as a form of economic statecraft, the
conditions under which it will actually be useful, particularly with regard to a great power like the United States, are incredibly limited.

A rare combination of factors have to kick in for this to work. The first is, is that the targeted country, and the targeted country here is the United States, would have to have no alternative sources of credit, both domestic and internationally.

If the debtor state is an awful credit risk or if the primary creditor state, in this case China, could form some kind of cartel of creditors, then, in fact, you would be talking about some potential financial leverage. Unless those conditions are met, the threat is largely a hollow one.

The second condition is that the debtor state can't retaliate, which is to say that if, in fact, the United States was targeted, U.S., if it had no resources at its disposal to therefore punish China, it would also be under a problematic situation.

Third, there would have to be low expectations of future conflict, and by that I mean future political issues on the horizon where the two states would anticipate being at opposite sides of the fence.

Finally, if the debtor state was trying to adhere to a rigid monetary regime, either through some sort of fixed currency arrangement or some kind of currency peg, then it would also be vulnerable.

What is interesting is if you look at the Sino-American relationship at this point, despite China's impressive holdings of U.S. debt, the Sino-American relationship meets none of these criteria. It's exceedingly unlikely that China will be able to secure a concert of creditors. The other foreign creditors that loan money to the United States have relatively divergent foreign policy interests from China, and as we'll talk about a little bit later, I actually think China has alienated many of these other creditors.

The United States would certainly have the capacity to retaliate in the form of cutting off market access to Chinese exports, and given China's export-driven model at this point, it's still somewhat dependent, and by somewhat, I mean extremely dependent on access to U.S. markets.

Are there expectations of future conflict? Well, I think we can take a look at the behavior of the last two months and assume safely yes, we don't need to worry about that.

Is there a rigid monetary regime? Well, there is a rigid monetary regime except the rigid monetary regime is imposed by China and not the United States. And so as a result, if China were to actually threaten to do what it is often feared of doing, the result would be to end China's peg to the dollar, which is not what it wants to do at this point in time.
So, in fact, in this circumstance, China is not able to translate its financial leverage into foreign policy leverage, and I have a longer article in International Security that I believe some of the Commissioners have perused that sort of demonstrates why, in fact, they've gotten so little as a result of this foreign policy leverage.

Now, that said, I will state that China's status as a capital exporter has increased its political power vis-à-vis the international financial institutions and other states out there that have more restricted access to credit. China has been able to use its veto power in the International Monetary Fund to block investigations as to whether or not China has been manipulating its currency value. It's used its power within the Asian Development Bank to block loans to India and so forth, and of course it's signed a whole variety of contracts over the past year with other countries, such as Kazakhstan, Iran, other countries that are more constrained in terms of getting access to capital.

Does this translate into foreign policy leverage? In a very subtle sense, absolutely, I think it does. On the other hand, I would be cautious in interpreting this in a pernicious manner. This is what every country does if it's a capital exporter. So it's hardly unique to China that it's engaging in this kind of activity.

In terms of whether or not China might decide that it would want to switch away from the dollar as a reserve currency and consider alternative currencies as one form of foreign policy leverage, the simple fact is, is, to paraphrase Winston Churchill, the dollar might be a lousy rotten form of a reserve currency until you consider the alternatives, and the fact is, is if you don't have the dollar as the reserve currency, you're going to have to choose another one to be a reserve currency, and all of the other alternatives stink. There is just no other way to put it.

The only viable option at this point in time is the euro, and I think we can safely say the euro has had some issues recently that pose some problems. But I think the most important thing to consider is that the euro, the European Central Bank, specifically, does not want the euro to be a reserve currency.

Jean-Claude Trichet has explicitly stated this in interviews. And furthermore, from the Chinese perspective, the last thing they would want to do would be to switch away from a dollar to a currency where they even have less influence over that region, and you could argue they have much less influence over the European Union than they do on the United States.

Once you eliminate the euro as a possibility, all of the other currency options really are nonstarters. The yen, the pound, the Swiss franc, they're all too small. The possibility that China floated of the
Special Drawing Right is comical in the sense that the SDR is really the Esperanto of international currencies. It's not an actual real international currency.

It functions as a unit of account, and it's certainly expanded its use in part because of what China has done over the last year, but you're still talking about less than $400 billion of this stuff floating out there and no real private transactions in it so it's not really a viable option.

In the long term it's possible that China could convert the renminbi to become a convertible currency, and I think Dr. Prasad will testify about that as well, but I would say, just because I only have ten seconds left, they are quite a ways off from doing that, and so I don't think we have to worry in the short-to-medium term about that contingency.

Thank you very much.

[The statement follows:]

**Prepared Statement of Dr. Daniel W. Drezner**

**Professor of International Politics, The Fletcher School, Tufts University, Medford, Massachusetts**


China’s sense of economic strength has clearly affected both its foreign policy and its response to foreign criticism of its domestic policy. At the Copenhagen climate summit, for example, Chinese and American diplomats engaged in a furious war of words over who should pay what to whom. By the end of the summit, President Barack Obama had to barge in on a private meeting between Wen Jiabao and Indian Prime Minister Manmohan Singh to try to craft a compromise. According to numerous press reports, a mid-ranking Chinese official berated Obama for his rudeness at a follow-up meeting. On issues ranging from Iran to Taiwan to human rights to internet censorship, the Chinese leadership has responded with rhetorical invective and vague threats to sanction U.S. firms such as Boeing.

It should be stressed, however, that it is China’s combination of strength and weakness helps to explain its recent bellicosity. The fundamentals of China’s economy are strong, but compared to the United States, its weaknesses are also legion. The one-child policy has created a rapidly aging demographic profile. The Han Chinese elite is ever wary of simmering ethnic tensions that plague many of the border regions. Beijing faces periodic riots in Xinjiang and Tibet, daily worker unrest, unruly provincial leaders, and mounting ecological catastrophes. It has three enduring rivals (Japan, India and Vietnam) on its borders.

For all the concern about Chinese cyberattacks, internet experts agree that the United States possesses more online offensive capabilities than any other country in the world. But by any conventional measure – GDP, GDP per capita, military capabilities, scientific and technological capacity – the United States remains the most powerful country in the world, and it’s not close.

Perhaps China’s greatest source of perceived strength is the size of its currency reserves and dollar-denominated debt. In response to the announced arms sale to Taiwan, Major General Luo Yuan recently told a Chinese magazine that, “we could sanction [the United States] using economic means, such as dumping some U.S. government bonds.” The power of credit between great powers has been exaggerated in policy circles. Amassing capital can empower states in two ways – the ability to resist pressure from
other actors, and the ability to pressure others. As states become creditors, they experience an undeniable increase in their autonomy. Capital accumulation strengthens the ability of creditor states to resist pressure from other actors. When capital exporters try to use their financial power to compel other powerful actors into policy shifts, however, they run into greater difficulties. As the economic statecraft literature suggests, the ability to coerce is circumscribed. When targeted at small or weak states, financial statecraft can be useful; when targeted at great powers, such coercion rarely works. There are hard limits on the ability of creditors to impose costs on a target government. Expectations of future conflict have a dampening effect on a great power’s willingness to concede. For creditors to acquire the necessary power to exert financial leverage, they become enmeshed in the fortunes of the debtor state. More often than not, the attempt to use financial power to exercise political leverage against great powers has failed. Looking at recent history, what is surprising is not the rising power of creditors, but rather how hamstrung they have been in using their financial muscle. To date, China has translated its large capital surplus into minimal foreign policy gains. China’s policy preferences have had no appreciable effect on either American foreign economic policy (sovereign wealth fund regulation, fiscal policy, protecting Chinese financial assets, intellectual property rights, trade openness) or national security policies (Taiwan, naval surveillance, Iran). The most that China’s rising financial power affected was a tamping down of human rights rhetoric and a delay in a presidential meeting with the Dalai Lama. Indeed, if anything, Chinese bellicosity has triggered a mild anti-China backlash in recent weeks. It is convenient that Chinese threats to dump dollars always seem to emanate from officials who have no influence whatsoever over China’s foreign economic policy. For the medium term, a Chinese threat of decoupling from the United States is not an economically viable one. China is now the world’s largest exporter, and the United States is their second-largest export market. Beijing’s economic policies since the start of the Great Recession suggest that they are doubling down on their export-driven model of economic growth. China’s economy remains heavily reliant on American markets. The tight coupling and complex interdependence between the United States and China will cause the incentive structures in global finance to more closely resemble the logic of nuclear deterrence. A “balance of financial terror” implies a more peaceful coexistence, but at the same time it is a relatively nervous coexistence. China’s status as a capital exporter has increased its influence vis-à-vis international financial institutions and smaller states. From 2006 onwards Beijing effectively vetoed any discussion within the IMF to investigate whether China’s currency was fundamentally misaligned. China vetoed Asian Development Bank loans to India because of a territorial dispute with New Delhi. In concert with the other BRIC economies, China agreed to contribute to IMF reserves. However, it did so through the purchase of IMF bonds denominated in Special Drawing Rights, a weighted basket of major currencies. In doing so, Beijing modestly advanced its goal of generating alternatives to the dollar as a reserve currency. China’s capital surplus also increased its ability to offer inducements to countries beyond the United States. In 2007 China’s State Administration of Foreign Exchange (SAFE) purchased $300 million in Costa Rica bonds – and $150 million in untied aid – in exchange for that country switching its recognition from Taiwan to the government in Beijing. In February 2009, Chinese banks signed more than $40 billion worth of deals with state oil firms in Russia, Iran, Venezuela and Brazil, guaranteeing China a steady flow of oil for decades at reasonable rates. China was able to get good terms on these deals because these countries – unlike the United States – had greater difficulties obtaining foreign capital. There are clear examples of China using its capital surplus to persuade nations to drop recognition of Taiwan or to secure long-term access to energy resources and strategic minerals. However, the prevalence of these trends is not clear. Beyond the Costa Rican example, there are no recent instances of China using its financial power to advance its Taiwan policy. Indeed, both Taiwan and the People’s Republic have shied away from “bribe wars” in recent years to secure recognition from other countries. Similarly, on energy, China has begun to participate in market bids for energy resources in Iraq and elsewhere. In December 2009, for example, China National Petroleum Corporation (CNPC) won a contract to help develop Iraq’s Halfaya oil field. CNPS is also involved in the development of Iraq’s largest oil reserve at
Rumaila.

Another concern is whether China will diversify from dollars or support an alternative global reserve currency. The head of the People’s Bank of China drafted a white paper in March 2009 suggesting a shift away from the dollar as the world’s reserve currency. Such a switch would have serious implications. Control over the reserve currency is a significant perquisite of monetary power in the global political economy. The McKinsey Global Institute recently estimated the reduction of the U.S. borrowing rate to be at least 50 basis points. They further calculated the net economic benefits of reserve currency status to range between $40 and $70 billion a year – a not insignificant sum.

The dollar is a “negotiated” currency at this point. This means, to paraphrase Tennessee Williams, that the dollar depends the kindness of strangers. Given the overhang of dollars held by central banks, sovereign wealth funds, and other government investment vehicles, there is some economic incentive to switch to a new reserve currency. If the rest of the world – and the Asia-Pacific region in particular – were to decide to coordinate around a different reserve currency, a switch would be possible. In September 2009, World Bank President Robert Zoellick warned, “The United States would be mistaken to take for granted the dollar’s place as the world’s predominant reserve currency. Looking forward, there will increasingly be other options to the dollar.”

While a switch away from the dollar is always a latent possibility, the probability of it happening remains exceedingly remote. Even when an economic superpower is on the decline, reserve currencies are remarkably persistent entities. The network externalities of having a single unit of account and medium of exchange are massive. Every major historical and theoretical analysis of currencies stresses the rewards from creating a single focal point currency. A single reserve currency reduces the transactions costs of international exchange by ensuring a single unit of account. A common medium of exchange also reduces the political uncertainty that might exist with multiple reserve currencies.

China’s adjustment costs in switching away from the dollar would be considerable. As the size of China’s external portfolio increases, so have the Chinese leadership’s domestic headaches. There is a fierce bureaucratic rivalry between finance ministry, central bank, and development bank officials – all of whom want to manage China’s foreign exchange portfolio. Domestic discontent has been brewing about China’s foreign investment strategy. Both officials and citizens debate whether holding so many dollars serves Chinese national interests. The political leadership has had to cope with the incongruity of investing trillions of government dollars in the developed world while tolerating significant pockets of domestic poverty. When these investments performed poorly, they faced fierce internal criticism. Officials at the China Investment Corporation received considerable domestic flak for their May 2007 investment in Blackstone, after that firm’s stock value plummeted by 40 percent.

A decision by China to switch away from the dollar would lead to a dramatic fall in the value of its sizeable portfolio of external reserves. Officially, China declared $2.4 trillion in hard currency reserves at the end of 2009, but that does not count holdings beyond the People’s Bank of China. In all, Chinese state investors are estimated to possess roughly $3 trillion in U.S. assets in September 2008, with approximately two-thirds invested in dollar-denominated debt. That figure has only increased in 2009. Any switch away from the dollar would cause that currency to fall in value – which would trigger concomitant losses to roughly two-thirds of China’s holdings. Crudely put, a 10 percent appreciation of the renminbi would translate into a book loss of 3 percent of China’s GDP in its foreign exchange reserves. Any financial losses from a switch away from the dollar – even if it was coordinated – would dramatically outweigh the losses to Blackstone.

The domestic political fallout would be equally great. While the initial decision might receive nationalist support, the economic costs would be significant. In addition to anger at dollar losses, the Chinese leadership would have to cope with the effects of a dollar depreciation. Any appreciation of the renminbi would hurt the Chinese export sector. The only way for China to make up for that lost demand would be to boost domestic consumption. China has been well aware of this need in recent years, but has been unable to increase personal consumption. Current projections have China’s consumption remaining below 40% of GDP for the next fifteen years; even if extraordinary policy measures are implemented,
anticipated consumption levels are projected to remain below 50%. China needs global export markets to thrive, which means it would bear massive adjustment costs from letting the dollar depreciate. Perhaps the hardest constraint on a concerted change in currency regimes is finding an alternative to replace the dollar. In order to engage in coordinated action, the key actors would need to construct or discover a new focal point around which to develop a reserve currency. This leads to an awkward observation – the euro, the only truly viable substitute for the dollar, is not located in the Asia/Pacific region. It would be unlikely for the ASEAN +3 countries to agree to switch from the dollar to a new currency over which regional actors have no influence. This problem is compounded by the euro’s weaknesses as a possible reserve currency. The European Union has no consolidated sovereign debt market. This places a severe liquidity constraint on euro markets. More importantly, the European Central Bank doesn’t want the euro to become the new reserve currency. They have placed high barriers on any country joining the eurozone. In November 2009, ECB president Jean-Claude Trichet flatly stated, “The euro was not created to compete with the U.S. dollar or to replace the dollar as the international reserve currency…. The ECB does not campaign for the international use of the euro.” Other alternatives are even less attractive. Candidate currencies beyond the euro – the yen, pound, Swiss franc, Australian dollar – are based in markets too small to sustain the inflows that would come from reserve currency status. The yuan remains inconvertible for now, and China’s leaders will be reluctant to give up their control over the country’s financial sector in the future. A return to the gold standard in this day and age would be infeasible – the liquidity constraints and vagaries of supply would be too powerful. The People’s Bank of China suggested using the Special Drawing Right as a template for a supersovereign currency, but this is an implausible solution. As it currently stands, the SDR is not a currency so much as a unit of account. Even after the recent IMF authorization, there are less than $400 billion SDR-denominated assets in the world, which is far too small for a proper reserve currency. As one Chinese economist put it, the SDR is the Esperanto of currency options.

China’s ability to charm the rest of the Asia-Pacific region into a coordinate shift away from the dollar for geopolitical reasons would be a difficult task. Any metric of power is a relative measure, and according to recent Chicago Council of Global Affairs surveys, U.S. soft power still outperforms China in the Asia-Pacific region. Furthermore, more aggressive Chinese ‘soft balancing’ against the United States would be likely to encourage a self-defeating counterto trend – greater soft balancing against China. States on the Asia-Pacific periphery are likely to be more comfortable with a distant hegemon with a decent history of restraint than a local hegemon with a persistent history of territorial disputes.

On the currency question in particular, Beijing’s post-2008 strategy of pegging the renminbi to the dollar has created tensions between China and other Asian exporters. The renminbi is strictly pegged to the dollar while other Pacific Rim currencies are pegged to a basket of currencies. Any fall in the dollar’s value increases China’s competitiveness at the expense of other exporters in the region. This forces other countries to either permit the appreciation in their own currencies (Japan), purchase more dollars to keep their currency from appreciating (ASEAN), or impose capital controls to forestall speculation about future appreciations (Taiwan). The situation likely triggers resentment against U.S. macroeconomic policy – but the greater object of ire is China’s reluctance to allow the renminbi to appreciate against the dollar. This is not fertile ground upon which to build a geopolitical coalition against the United States. History suggests the absence of a correlation between realpolitik concerns and the degree of cooperation among monetary authorities. In the years prior to the First World War, for example, central banking authorities cooperated across Europe to avert systemic crises even as foreign ministers engaged in balancing behavior on the continent. As Barry Eichengreen has observed, “In 1898 the Reichsbank and German commercial banks obtained assistance from the Bank of England and the Bank of France. In 1906 and 1907 the Bank of England, faced with another financial crisis, again obtained support from the Bank of France and the German Reichsbank. The Russian State Bank in turn shipped gold to Berlin to replenish the Reichsbank’s reserves.” Despite heightened concerns about geopolitical rivalries, central bankers continued to act to preserve the status quo in international monetary relations. It was not until the 1911 Agadir crisis that this pattern of international monetary cooperation began to break down, and the
Reichbank in particular began to hoard specie in preparation for armed conflict. Looking at the current situation in geopolitical terms, China in particular and the ASEAN +3 in general appear to be pursuing a “hedging” strategy rather than a revisionist strategy to topple the dollar. China’s tactics suggest that it is not prepared to challenge the dollar’s hegemonic status at any point in the near future. Recent steps allow Beijing to lay the groundwork for a long-term challenge, while placating domestic pressures in the short term. Institutionally, initiatives like the Chiang Mai Initiative have the potential to act as a possible substitute for the International Monetary Fund and other international financial institutions, creating the ability for Pacific Rim economies to forum-shop. Creating an “exit option” for the region enhances bargaining power within existing power structures. At the same time, these institutions remain embedded within the rules of IMF. Countries in the Pacific Rim can agree on the need for expanded regional influence, and emergency measures in case the international monetary regime falls apart. Beyond this hedge, however, the countries of the region appear to be perfectly content to operate within the existing rules of the game – including the dollar’s reserve currency status.

HEARING CO-CHAIR WESSEL: Thank you.
Dr. Prasad.

STATEMENT OF DR. ESWAR PRASAD, NANDLAL P. TOLANI
PROFESSOR OF TRADE POLICY, CORNELL UNIVERSITY,
ITHACA, NEW YORK, AND SENIOR FELLOW, BROOKINGS
INSTITUTION, WASHINGTON, DC

DR. PRASAD: Chairman Wessel, Chairman Cleveland, and honorable members of the Commission, thank you for this opportunity to talk about this important issue. In recent years, there has been a subtle but perceptible shift in the balance of power between China and the United States, but I think the narrative has gotten ahead of itself. China has very effectively controlled the perception, and I'm going to argue that facts are important, but perceptions are going to be very important, as well, in managing this relationship.

This hearing is especially timely because the backdrop is very interesting: the exploding levels of U.S. public debt and the exploding levels of Chinese reserves. Of course it is tempting to see these as mirror images of each other, and there is a relationship, but I'm going to argue it's a somewhat subtle one, and that's going to have fairly serious implications even in its subtlety for how this relationship evolves.

How dependent is the U.S. on financing from the Chinese? We don't really know. We have a reasonable idea, and I'm sure you've heard from the other panelists that our data from the Treasury are not comprehensive, but it does give us some idea. Based on the Treasury data, it looks like China holds a little less than ten percent of the net debt outstanding and that is held by the public.

Foreigners hold a total of about a quarter of it. Even if it assumes, which is a usual rule of thumb among analysts, that China
holds about 70 percent of its foreign exchange reserves in dollar
denominated instruments, and if you take out their identifiable holdings
in agency bonds and other kinds of instruments, the amount of
Treasuries that China holds would be somewhere in the range of 14 to
15 percent, and by some estimates, as high as 17 percent. So not an
overwhelming number by any means, but a fairly significant number.

The question is whether this number is enough to give China
leverage? That brings us to the question of whether China is locked
into its holdings of U.S. Treasuries? The standard way this narrative
plays out is that China holds a lot of U.S. bonds. If it were to get rid of
those bonds, or if it even were to say it's going to get rid of those
bonds, the prices of those bonds would plummet, interest rates would
rise, which is the other side of it, and China would take a very large
capital loss on its holdings.

But you have to remember that that is on a mark-to-market
current domestic currency basis. If you think about the Chinese amount
of holdings, they have about $2.4 trillion worth of reserves. They don't
need any of this money very soon. They think of themselves as hold-to-
maturity investors. So if you think about the fact that even if they were
to take a precipitous action of some sort and even if bond prices were
to fall, in real terms they're not going to lose their principal and they're
not going to lose their interest payments.

In fact, at the margin, if you think about interest rates rising,
every additional dollar that they put into U.S. bonds, they're going to
get a higher return so the notion that China needs to fear fallen bond
prices is, to my mind, not obvious, again, except on a mark-to-market
accounting basis, which is, in my view, is not the way they look at it.

Another possibility, of course, is that with the fall in the value of
the dollar, they lose again in domestic currency terms. If China were
even to threaten that they were going to stop investing in U.S.
Treasuries, this could be a problem. Are they likely to do this? They
could, but if they did, again, so long as they keep the renminbi fixed to
the dollar, it doesn't matter.

If they have about 30 percent of their holdings in euros, yen and
other types of currencies, they will take a bit of a loss. But it's about,
let's say, the dollar falls by ten percent, it would be ten percent of 30
percent, and this is a cost that they presumably feel they can bear.

What if their currency appreciates, and this is a potential issue for
them because if the dollar falls and the pressure is on them to allow
their currency to appreciate, rise, that is an issue.

As Dr. Drezner pointed out, there is a possibility that over time,
the renminbi will become more internationalized. They could get more
seigniorage revenue from this as they allow their capital account to
become more open, and if the exchange rate appreciation goes in tandem with that, the benefits could sort of offset each other.

So, in my view, if you put all these together, China does have a credible threat that it could move out of U.S. Treasuries. Will they? The question then becomes where will they go? And this is where I think the real power lies of the U.S. because if you think about China having the amount of reserves it does and accumulating reserves, again, at the rate of 400 to $450 billion a year, there simply ain't any other place to go.

The euro and yen bond markets and other bond markets are simply not deep or liquid enough to be able to absorb this amount of liquidity.

So is China going to continue accumulating reserves? Here the growth model that Dr. Drezner pointed to is an important issue. Over the last year, the Chinese economy has done remarkably well in the midst of this crisis. They did it partly through an extensive stimulus program, both fiscal stimulus, which is about $600 billion over two years, but more important, a massive amount of bank lending amounting to about $1.5 trillion in just 2009, and that pace has continued into the first month of this year.

Much of this has gone into investment, state-owned banks, financing investment by state-owned enterprises. This is creating even more excess capacity in industries where there is already spare capacity to begin with, so to push that capacity out and to maintain employment growth, they're going to have to rely more on exports. So I don't see them doing very much on the currency in the short run.

In my view, the narrative has become very important. The Chinese have taken a very aggressive stance that the U.S. has become more dependent on China, and this narrative, in my view, has been abetted by the U.S. administration, which has seemed almost to be going to the Chinese and arguing that the Chinese should continue to please continue financing our deficit. I think the U.S. has more power than it has been willing to use.

So what should be done? I think the real solution ultimately lies in how vulnerable the U.S. is making itself by the level of debt it is accumulating, and that really is the root of the problem. It is not a Chinese problem. It is not a matter of how much foreigners are financing but the sheer level of debt.

Right now the private saving rate in the U.S. has gone up. If it stabilizes where it is right now, or worse if it were to decline, the vulnerability of the U.S. economy to a spike in interest rates is going to be a serious problem. China has a very important role here because even though the absolute amounts of financing are not large, just the threat of their being able to create turmoil at the margin by saying that
they could move out of Treasuries could lead to a spike in bond prices, a fall in the value of the currency, which could be potentially problematic for the U.S.

So I think the U.S. needs to control the narrative. It needs to be much more assertive in this relationship, and I think it needs to bring on board other emerging markets and other countries in terms of thinking about how Chinese currency policy is responsible for perpetuation of a number of imbalances in the world economy right now, and I think this is where, again, the U.S. needs to be able to control the narrative and not let China control it.

And finally I think there is a danger that the sort of discussions about trade issues and other minor disputes could very easily ratchet up into much bigger things with this debt issue becoming one of the potential points of conflagration. So I think maintaining the high level dialogues is going to be important, but the U.S. needs to be more assertive in this relationship.

Thank you.

[The statement follows:]³

Panel IV: Discussion, Questions and Answers

HEARING CO-CHAIR WESSEL: Thank you. Thank you, both.

I'll begin with the first line of questioning. Let me understand what the anticipated impact would be for the U.S. What do you think would happen with the yield curves here if China was to make a very credible and serious threat?

Dr. Scissors earlier today said--I don't know if you were here for this chart, but it's showing there's essentially a situation that our yields are the same no matter what China's Treasury purchases are. That may be true with the volume that we were dealing with before, but if you were to have a large dump or threatened dump by China, what do you think would happen to the yield curves here?

DR. PRASAD: The context is hugely important. In the period we were looking at, the deficits were much lower, and there was at least some prospect of the deficits being brought under control. I think the political debate in Washington plus the numbers that we are seeing have made bond markets and currency markets remain much more on edge, and this is where I think China really has power.

You don't see it in these charts, but there was an occasion a couple of years ago and even one last year when there was a perception

³ Click here to read the prepared statement of Dr. Eswar Prasad
in markets that China was aggressively moving out of Treasuries.

That created a tremor in bond markets and for a couple of days it was a problem. That was just a couple of days. But the right now, given how fragile sentiments are, I think China could potentially have a much more serious impact on bond prices as well as the level of the currency.

HEARING CO-CHAIR WESSEL: So you would see it as a longer-term reset of the yield curve rather than an aberration meaning?

DR. PRASAD: My concern is that markets are nervous, and when markets are nervous, events can trigger a shift in expectations. We've seen time and again that there can be a discrete jump in expectations triggered by small events that in and of themselves may not mean very much. This move, for instance, could trigger concern that the U.S. may not be able to finance its deficit because not just China, but other countries, especially emerging markets, taking the Chinese lead might shy away from U.S. bonds. So I think that threat is a real one.

HEARING CO-CHAIR WESSEL: Dr. Drezner.

DR. DREZNER: I would only add two things. I think the context is important here. With regard to the debt story, I don't disagree with Dr. Prasad, but I think it's hugely contingent on two other factors, which is, first, what is the rate of U.S. economic growth?

If the U.S. economy starts to recover significantly, then I mean one of the reasons why you're seeing such ghastly debt pictures is tax revenues, which have been depressed significantly because of the depressed economy.

If, in fact, you have robust economic growth, and that translates into a better sense of fiscal health, then suddenly I think the concerns that Dr. Prasad have raised are probably going to be alleviated somewhat.

I think the second question, and this is really something that I'm not entirely sure what the answer is, is what is U.S. savings rates going to do from here on in? I think the key question is, is did the Great Recession trigger a permanent shift, an increase in U.S. savings rates--I would add in the long term a healthy shift--in an increase in U.S. savings rates?

Or if the economy starts to turn more robust, is the response by consumers or the response by Americans will be to stop saving as much? I don't think we have the answers to those questions.

HEARING CO-CHAIR WESSEL: Well, help me through and give me some timing, if you could, of where you see tipping points.

Leo Hindery testified earlier and has done a lot of work on the question of both the unemployment and the real unemployment rate, which by some estimates is 18, 19 percent. How do we sustain the
higher savings rate we've gotten over the last year or more with that kind of unemployment? Does that fuel or limit the impact of this?

The question is, as we look at time horizons, are we losing the ability to affect this? Dr. Prasad, you talked about the narrative getting ahead of us. At what point might the narrative catch up? What are our opportunities? What's the time horizon? How can we affect this?

DR. PRASAD: Ultimately, what's going to matter for the U.S. is the national saving rate, which makes us more vulnerable. And even if the private saving rate stabilizes where it is right now, which, as Dr. Drezner pointed out, is hardly a sure thing, if the public net dissaving rate remains as high it is, it's going to create a serious problem for us because even a private saving rate of five to six percent is not going to keep debt sustainability within control.

On the flip side, we have the Chinese doing what perhaps we should be doing, which is saving a lot more. In fact, the precautionary saving motive seems to be driving saving in China along with a number of other structural factors, and in fact, they are saving more.

So if the private saving rate in the U.S. were to decline, we would be exactly back to a repeat of 2007 except, as Dr. Drezner pointed out, the context would have changed to a much higher level of U.S. debt and much higher holdings of U.S. Treasuries, of Chinese holdings of U.S. Treasuries.

So it would be a replay of 2007 in worst circumstances from the U.S. perspective.

HEARING CO-CHAIR WESSEL: Does that mean in relation to your comment earlier that the narrative is catching up?

DR. PRASAD: Yes, I think there is a definite danger of us losing control of the facts and the reality.

HEARING CO-CHAIR WESSEL: Dr. Drezner, any?

DR. DREZNER: I would mildly dissent in the sense of I understand Dr. Prasad's concern, that the narrative has actually gone ahead of the reality, and I think actually one of the things that's happened over the last two months and the reason we've had so many contretemps with the Chinese is, in fact, the Chinese bought this narrative as well. I think one of the things that's sort of shocked them in terms of how they've behaved in the last two months is the fact that even though on issues ranging from climate change to Tibet to Taiwan, they've made it clear what they would like the United States to do, the United States hasn't changed their position on any of these things.

And so I think one of the things that's going to happen going forward is whether or not the Chinese are also going to reassess their power position because it's not simply the United States that I think they've alienated in their behavior in the last two months. It's also the
rest of the Pacific Rim, India and the European Union.

It takes a lot of work to really annoy all of those countries at the same time, and so one of the interesting questions going forward is whether or not the Chinese themselves recognize that they might have overplayed their hand in the short term.

I understand Dr. Prasad's concern about sort of the medium-term about whether or not the U.S. will have more vulnerability, but I think right now, even given the debt picture, the Chinese have actually overplayed their hand on this issue.

HEARING CO-CHAIR WESSEL: Thank you.

Dr. Wortzel.

COMMISSIONER WORTZEL: Thanks for great testimony. I appreciate it very much. I understood it.

[Laughter.]

COMMISSIONER WORTZEL: Big test.

VICE CHAIRMAN BARTHOLOMEW: He's come a long way.

COMMISSIONER WORTZEL: Five of the six panelists that have been here today have pretty firmly told us that the perception of China's leverage over the United States because of debt holdings is wrong, and I believe that also.

That leads me to two questions. How, what actions can be taken? How can we correct the public and the policy community misperceptions about the leverage that may not be there because of that debt?

And then, second, if the Chinese tend to be believing their own "bullshit," how do we communicate to China that it's really a mistake to believe your own "bullshit"?

DR. DREZNER: I'll take the lead on this.

First, in correcting the policy misperceptions, as I said, I think that's in the process of happening right now. The U.S. has to be the country that can say no. I agree with Dr. Prasad. I think there were some missteps in the early stages of the Obama administration where you had Secretary of State Clinton and then Secretary of the Treasury Geithner almost pleading for China to buy U.S. bonds when, as Dr. Prasad said, and I agree, there's no other place that that wealth can go. So I think that might have sent an errant signal to the Chinese.

I think one larger point and one smaller point. The larger point is that I think this administration, and to be fair, it's not just this administration, it's a lot of administrations before it, had been very bad at understanding that particularly in the Pacific Rim, economic policy is foreign policy.

The notion is that you want to have the first concerns are always security issues, and then economic issues are an add on. To the Asia-
Pacific region, economic policy is first, second and third in priority, and I think the fact is this administration has been woefully, but it's not the only one, behind in terms of trying to understand the role that foreign economic policy should play in dealing with the rest of the region.

So, for example, one of the more useful initiatives that I think the administration has talked about is the idea of starting the Trans-Pacific Partnership, joining the TPP, with the notion of actually organizing allies on the Asian-Pacific Rim that might actually have equal and in some ways more concentrated beefs with Chinese currency policy as a way to demonstrate that there are other alternative pathways out there, except, to put it bluntly, I'm not sure how much political capital this administration is going to be willing to put into issues such as trade expansion or, not trade expansion, but rather trade legislation.

So I think one of the things they have to start doing, and I agree with Dr. Prasad completely on this, is start working with states that have similar economic interests vis-à-vis China to develop a common policy platform.

DR. PRASAD: There are two sides to the perceptions, and one part of it, that the U.S. needs China to finance its deficit, actually has some substance, but like I said not because of the absolute amounts involved, but when you're facing a deficit of $1.6 trillion, every billion helps, and the Chinese are forking over something like $300 billion. So, at the margin, it is quite important.

My point was that the other side of the narrative, which Dr. Drezner pointed out, that the Chinese need our export markets and need our bond markets in the U.S., that part is not as well highlighted so what I think needs to be brought out is that there is more of a balance here than we perceive.

So one part of the perception is, in fact, correct, but there is the other part that often gets unstated.

The second point is really a critical one, and Dr. Drezner has pointed out that we need to think about how the U.S. can bring other countries, especially the other emerging markets, on board.

If you think about global economic circumstances right now, emerging markets are getting squeezed on both sides by loose U.S. monetary policy, on one side, and Chinese currency policy, on the other side, because this is fueling money flowing into emerging markets. If they absorb that money and allow their currencies to appreciate, they lose competitiveness against China.

So the second part of the narrative has gotten lost because China has been very aggressively putting forward the first part of the narrative, that by taking care of its own economy, the U.S. is doing damage to the world economy. So this balance needs to be shifted.
But the problem is that the Chinese have very effectively deployed their economic power in strategic terms. They have created relationships within Asia where many countries are dependent on them for trade and finance, and they are financing other countries.

If you look, countries as far as Latin America, Brazil sends a lot of commodity exports to China. So they do not want to irk the Chinese. The Indians have less at stake, but they're not sure if the U.S. is going to be a fair-weather friend or not so they don't want to create problems with China because they have the climate change agenda where they need to maintain a common front.

So I think this is where the U.S. really needs to make an effort, to think about how to bring the emerging markets on board, and shifting the narrative is going to be an important part of that.

HEARING CO-CHAIR WESSEL: Vice Chairman Bartholomew.

VICE CHAIRMAN BARTHOLOMEW: Thank you, gentlemen, and I echo my colleague Dr. Wortzel's comment. Thank you for making these complicated issues intelligible for those of us who are not economists.

My question is a variation on Larry's question, but Dr. Prasad, it sort of gets to how is the Chinese government controlling the narrative? You actually, though perhaps inadvertently, just gave an example of how they control the narrative, by citing Brazil, which is that Brazil doesn't want to upset the Chinese government because it wants to sell its resources.

The flip side of that is that China needs to acquire a lot of resources, but somehow the narrative is out there that they are the drivers in all of this, and how have they done that?

DR. PRASAD: It's a combination of economic and political power being deployed at the same time. Essentially, what they have done is create a sense of dependence and constituencies in many of these economies that are very eager to maintain good relationships with the Chinese, and it's not just emerging markets.

Even in the U.S., we have a fairly significant constituency, and there are good reasons why. Because China is seen as a large, very dynamic market, and it makes sense for the business community to want to maintain good relationships; it makes good sense for financial professionals to want to have an entree into the Chinese market.

So that constituency essentially is driving part of this, and the Chinese have been able to provide enough incentives for those groups to make sure that the domestic narrative within each of these countries is controlled. In China, actually this narrative is put forward partly because it serves to satisfy a number of nationalistic tendencies in China, to be honest.
It is very easy when the government is very keen to maintain control and is able to deliver it through providing good economic outcomes, but to also manage the domestic venting, so to speak, which does not have a way of venting itself through a political process, by focusing it on an external power, and the U.S. is a very easy external power to focus on, given the history that China has had with imperial powers.

VICE CHAIRMAN BARTHOLOMEW: Dr. Drezner.

DR. DREZNER: I think there are three things that you need to consider. The first is simply it's not just China's manipulation of this, but it's also the media perception in the United States of the relationship, and there is a tendency to exaggerate trends and assume that if you extrapolate from where we are now, there will be a major shift in the distribution of power.

This is a quote from the New York Times coverage when Obama, President Obama, went to visit China in November: "This is no longer the United States-China relationship of old but an encounter between a weakened giant and a comer with a bit of its own swagger."

This is the sort of rhetoric that was being written about the entire time during President Obama's trip, and I'm not sure that the administration did as good of a job in terms of pushback on the media frame. This does not necessarily mean, by the way, that the relationship has changed. It just meant that if there was this sort of perception, this perception has filtered down, not just to at least within Washington, D.C., but also within broader public opinion.

I'm not sure if you saw this. There was a poll that Pew released in December 2009 asking Americans about their perceptions of global economic power, and a majority of Americans believe that China was the leading economic power in the world.

This is not to say that Chinese economic power in a relative sense hasn't grown in the last few years, but as I said in my written testimony, if you compare any metric of economic power, GDP, GDP per capita, investment in science and technology, you name it, the United States is the leading power, and it's not close. It might get closer in the future, but it's not close now.

I think one other thing I would say on this, is that it might be in the United States, we've gotten into some lazy and bad habits being the hegemon and being the undisputed hegemon for the last two decades. We're simply unused to the notion of other countries actually voicing opinions that might be somewhat at variance with the United States and then having sufficient power to resist U.S. pressure to alter their views.

So there's no doubt that Chinese power has grown, and as I said, their deterrent capability, their ability to resist U.S. pressure, has also
grown. I think the big question is how do we as a country respond to that, and I think it is crucial that we don't respond through overreaction. I think underreaction is equally problematic, but I think overreaction would lead down a very dangerous path in terms of repeated conflict with China, which I think would be unnecessary.

VICE CHAIRMAN BARTHOLOMEW: Thank you.
HEARING CO-CHAIR WESSEL: Chairman Slane.
CHAIRMAN SLANE: Let me craft another scenario for you. My feeling is that the only way for us to get out of this deficit situation is to go back to being a high-tech export-driven powerhouse. If that does not occur, it's not outside the realm of possibility that we would default. Am I wrong here? I'd be interested in your comments.

DR. PRASAD: There are two parts to the issue. One is the budget deficit and, second, how it feeds into the current account deficit? I think your question touches upon both of those.

What is increasing the vulnerability of the U.S. economy right now is the high level of the budget deficit, which translates into a high level of public debt, and then the question becomes whether that exposes us to dependence on foreigners or not? And that essentially comes through the current account deficit.

The current account deficit essentially gives us a handle on how much financing the U.S. is requiring from the rest of the world. So if you're running a very large budget deficit, but the current account deficit was close to zero, it would mean that domestic saving is enough to finance that budget deficit. So the answer to solving both problems, however, may lie in what you're talking about, which is trying to think about how the structure of the U.S. economy is going to respond to the challenges it faces.

The notion of the U.S. becoming an export-driven economy I think is a useful one to organize our thoughts around, but it's not going to be a reality any time soon because just in terms of sheer quantum of exports that one can generate through these high-tech channels, it's not going to be enough to overcome the sort of trade deficit we have created.

One has to look at structural factors that are causing this problem. I think the lack of the political will to tackle the budget deficit really is the core problem because if you think about productivity issues, the fact that we have a large budget deficit is invariably going to require some revenue measures, i.e., higher taxes, and that's going to be distortionary. It's going to imply less spending on education, infrastructure, and so on. That's going to imply less productivity.

So unless we can come up with the will to deal with the budget deficit problem, to talk about an export-led economy, solving part of
these problems may simply not happen.

DR. DREZNER: I would add on the microeconomic side, I agree with what Dr. Prasad has said, particularly in terms of the effect of high-export sectors on jobs, which is there's actually not necessarily all that much of a correlation. High-tech sectors don't necessarily lead to massive amounts of job expansion.

The further problem is that when you talk about high tech, the question is, of course, which high tech? Which sector do you think will be one of the leading sectors that will lead to impressive job spillovers? And then you start talking about things like industrial policy, and to put it gently, the history of U.S. industrial policy has not been a glorious one.

The history of industrial policy, period, in the world had not been a glorious one. So I'm not entirely sure that, while I completely agree with the sentiment, that it would be appropriate to do this. I'm not sure that there are any active policy measures beyond the macroeconomic ones of getting our budget house in order that would actually contribute towards achieving that end.

CHAIRMAN SLANE: Thank you.

HEARING CO-CHAIR WESSEL: Commissioner Mulloy.

COMMISSIONER MULLOY: Thank you, Mr. Chairman. Thank you both for being here and your very thoughtful prepared testimony and also your presentations here.

I want to ask a couple of quick shorter questions and then ask you to opine on a larger issue. Do you both think that China is under pricing its currency to gain, as part of its export growth strategy?

DR. DREZNER: Yes.

DR. PRASAD: The answer is yes, but I would wonder if that is the key question. So we can come back to that.

COMMISSIONER MULLOY: Secondly, you both agree that, and Mr. Prasad, you say on page nine of your testimony we have to be more assertive. Do you think the Treasury in their April 15 report to the Congress should name China a currency manipulator in order to inform the Congress of the reality of the situation?

DR. PRASAD: I'm not sure there is an amendment like the Fifth that covers this, but I would rather not provide a yes or no answer to that question. I think it's a complex one, and I would prefer to give you a more detailed answer if that's permissible?

COMMISSIONER MULLOY: Yes, go ahead.

DR. DREZNER: I'll yield the floor to Dr. Prasad for the more detailed and complex answer.

DR. PRASAD: The key issue is in this relationship what we should be refocusing on. The Chinese have long argued that the--
COMMISSIONER MULLOY: If you could help me on that, Mr. Drezner, what would you do if you were Treasury?

DR. DREZNER: I think partly it depends on how China—-I'm in a similar situation as Dr. Prasad. I am not sure that reporting China as a currency manipulator will get you all that much except stating what everyone knows to be the truth.

You can argue there are virtues in being honest. However, I'm not sure that that yields in any policy gains vis-à-vis China's actual manipulation of the currency. It is possible that dangling the notion that maybe you will do that might be an interesting brush back to China given their rhetoric recently.

COMMISSIONER MULLOY: If I could comment, and then I'll ask the next question. We've been threatening to do that for six years without success so I always think truth is a great antidote to a lot of things, and if you tell the truth, then you can move onto the next step.

If China is a currency manipulator, you both agree—whether you would name them is unclear—do you think that it would be wise to appoint a very high level figure in the American government, like Chairman Volcker, to lead a multilateral effort to deal with this issue which has created such imbalances and harm to the global economy?

DR. PRASAD: You mean a commission that—

COMMISSIONER MULLOY: A special envoy of the Treasury Secretary to go out and negotiate on this issue.

DR. PRASAD: With the Chinese?

COMMISSIONER MULLOY: Globally, multilaterally.

DR. PRASAD: The question is what is the right mechanism to do this? The G20 has set up a mechanism through the IMF. Whether it's going to be effective or not is an open question. The reason that previous multilateral consultations with the IMF did not work very effectively was there was a sense that neither the U.S. nor the Chinese were particularly interested in hearing what the IMF had to say about them.

Circumstances have changed in one very important respect. The U.S. has now signaled very clearly that it is willing to listen seriously to the IMF's advice. Whether it takes it or not is a different matter, and I think that's the way it should be. But at least they're going to give serious cognizance to the IMF's advice so I think there is a platform out there already to do this.

The question is whether that can be made effective, and I think the real solution goes back to this point Dr. Drezner made, that it has to be through a multilateral forum. If it becomes a U.S.-China issue focused on the currency, and that is very often how this debate is set up, it's the currency and the implications for the bilateral trade
relationship, I think that is not a very productive way to approach this issue because that really doesn't have anything to do with the big problems, either on the Chinese side or on the U.S. side, which is why I think that the currency needs to be put in the proper context of what are the key problems you need to solve, and what are the constraints imposed on it by the currency regime?

And there are constraints imposed on it, but that, that's the context it needs to be phrased in.

COMMISSIONER MULLOY: Dr. Drezner.

DR. DREZNER: I agree that this has to be handled in a multilateral context. I think one of the mistakes that have been made sometimes in the United States is the belief that China's current manipulation affects only the United States.

In fact, you can actually argue that other countries have been affected in a far more deleterious fashion than the United States so I certainly agree with the idea of multilateral consultation.

That said, I think what you're proposing I'm not sure would gain you that much leverage, in large part, because, first of all, both the G20 structure and the Strategic and Economic Dialogue are relatively young creations. I think it would be a mistake to then try to create a new mechanism that would somehow circumvent both of those. It would probably undercut them both in the process. So I'm not sure it would gain the result that I believe you want to achieve.

COMMISSIONER MULLOY: Thank you both. That was very helpful.

HEARING CO-CHAIR WESSEL: Taking the prerogative of the chair, I'm going to ask a quick question just to follow up, and then, Commissioner Reinsch, we'll go to you.

Not knowing whether this is a Mobius loop, a Gordian knot or some other idea about this, naming China as a currency manipulator triggers a number of provisions in U.S. law, one of them being that their manipulation can be treated as a subsidy which is countervailable in trade cases.

What impact do you think that would have? I understand what you're saying about overall utility, that it's debt, that there's a lot of other things that all come into play here, but there are micro issues that are affected by that that are not. Therefore, we have industries that are being hammered, machine tools, and many others, because of the bilateral trade flows. Where do you see that playing a role?

DR. DREZNER: I think it would have two effects. The first is it would launch an entire new round of trade restrictions, both on the U.S. side, and there's no doubt that China would retaliate as well, so you'd have that first step.
The second and inevitable step is that this case would go to the WTO, and the United States will lose because I don't believe the WTO law on this corresponds to the U.S. provision on this. The WTO does not want to touch currency policy with a ten-foot pole. They're going to therefore say that the measure is illegal, and eventually the United States will then be faced with a choice of continuing to insist on the policy it has and violating WTO strictures, which would allow China to impose trade sanctions on the United States, or, in the end, acquiescing to the WTO, in which case perhaps the measure has achieved a short-term political boost, and in the end is inconsequential.

HEARING CO-CHAIR WESSEL: Dr. Prasad, any view on this?

DR. PRASAD: To be honest, I think it would be a real distraction on both sides. In the U.S., a lot needs to be done. China is not our key problem. We talked about these issues related to productivity and what needs to be done, and I know there's big problems right there. I think trying to argue that China is an important source of the loss of competitiveness on the U.S. and of the decline in the manufacturing sector, certainly it's had a part to play in it, but I don't think it's the dominant factor.

Likewise, it would simply feed into the Chinese narrative that they are in some sense victims of U.S. and other imperialism, and it could set back reforms there.

So I think a balance needs to be struck. I think the balance is not quite right now. The way you're putting it is more of a confrontational approach, and what we see right now is a very passive approach. I think the balance really has to be somewhere in the middle where the U.S. is much more assertive about its positions, is able to bring the international community to bear pressure on China, and then get the ends which I think will serve the U.S. and China better.

HEARING CO-CHAIR WESSEL: Thank you.

Commissioner Reinsch.

COMMISSIONER REINSCH: Well, I want to thank you both for giving us a dose of realism. We don't always get that, and I appreciate it.

However, I'm compelled to disagree with Dr. Drezner on one peripheral point. I think the history of industrial policy in the United States is actually an impressive one. I'm not going to go off on that rant, which my colleagues have heard before occasionally, but we've actually had an extraordinary record over 150 years of--now I'm doing the rant of selecting and promoting sectors--

HEARING CO-CHAIR WESSEL: We'll give you time. Go ahead.

COMMISSIONER REINSCH: --with considerable success. But I
don't think that's central to the issue, but I would urge you to rethink that point.

I do want to go back to the perception question, which is what a lot of this is about, and I think you've both said very insightful things.

It seems to me that serious problems develop in a relationship when one side or the other misperceives its own strength and position or the other side's strength and position and intentions. So getting our perceptions of ourselves and each other right is very important. Otherwise, we make big mistakes.

Historically, I've tended to find the Chinese fairly realistic, despite what they say at any given moment, about their position in the world and in their region, and their position vis-à-vis us and everybody else.

I do have the feeling, like I think both of you have implied, that their attitude and tone has changed recently. It's sort of like they believe the New York Times, quoting your rhetoric, and I guess my question is why do you think that's happened? Because it seems to me, they have overplayed their hand, as you suggested, and this strikes me as an unusual misstep for them, and I don't quite understand why that's happened. Maybe you can enlighten us.

DR. DREZNER: I'll be happy to talk about industrial policy with you at a later time. I don't want to distract--

COMMISSIONER REINSCH: Good.

DR. DREZNER: --the main tenor of these hearings, but I look forward to that conversation.

In terms of why the Chinese have overplayed their hand, I think it's a combination of two factors. The first is--and this is true, if you think about how countries have done during the Great Recession, China has done remarkably well. You know they maintained their critical above eight percent growth rate in 2009, and if they look around, they certainly seem to have done better than other countries, with minimal pain, at least in the short term, and I think that has probably given them a source of some swagger.

That said, I think you can also argue that a lot of their bluster is actually trying to cover weaknesses rather than strengths in two ways. The first is that China has a fair amount of domestic instability that it's still concerned about.

I think the riots in Xinjiang took them greatly by surprise. I think that the constant concern of trying to maintain a steady employment rate and keep its labor population employed certainly is a factor.

And then finally, as Dr. Prasad talked about, what they've done to stay afloat in terms of their economy, in terms of the Great Recession, has been to double down on a model that I'm not sure can sustain itself.
They've doubled down on trying to expand both exports and their investment, but by expanding investment, they were expanding in sectors where there was already massive overcapacity, and so as a result, I think one of the things that's going on is that we overlook the role in which domestic politics plays in China to explain sometimes while they're articulating foreign policy positions.

I think one of the things that they're trying to do, particularly in issues like Tibet and Taiwan, is try to evoke nationalist credentials that actually gives them some sort of domestic legitimacy because there's going to be pain coming up in terms of dealing with these problems of overcapacity.

So I think part of what's going on is that it's not just a perception of strength; it's a combination of strength and weakness. And I think as a result, the bluster is trying to, in some ways, cover some of that.

COMMISSIONER REINSCH: On this point, I think we agree, but Dr. Prasad, do you want to add anything or dissent?

DR. PRASAD: China is a $5 trillion economy with a per capita income that's about one-tenth that of the U.S., and they're getting used to being the heavyweight on the block. I think as they try to find their tone, it sometimes comes out as aggression, and as Dr. Drezner pointed out, despite the economic success, they're on a high wire. They have enormous imbalances in the economy.

They have enormous disparities that they're dealing with within their economy, and in that sense, these nationalistic ways of putting things actually helped them a lot in terms of controlling the domestic politics because they know they have a lot to deliver, and feeding into that domestic narrative of us against the world I think actually serves them very well right now.

COMMISSIONER REINSCH: I'm out of time, but I think both points are very well-taken, and I encourage us to get into the question of how Chinese domestic politics play into their foreign policy decision-making because I think you're right. It's a critical element.

Thank you.

HEARING CO-CHAIR WESSEL: Commissioner Blumenthal.

COMMISSIONER BLUMENTHAL: Yes. Actually I was hoping to have you repeat your statement about industrial policy for the record without it getting muddied up by, you know, Commissioner Reinsch.

COMMISSIONER REINSCH: Then I'd get to repeat mine.

COMMISSIONER BLUMENTHAL: I wanted to make sure everyone had heard that.

But my question is if you can put a few things together which you've done so nicely, both of you, for us economic idiots amongst us. So this statement you made about trade policy, which I think is very
important, if you could put that together with—right—so we haven't ratified the South Korea FTA. I agree with your statement now on how important trade policy is inside Asia.

So if you stacked it up, and you said China has a series of FTAs, many more, or least ones that are going forward. It is making different sounds about the dollar as a reserve currency, although I take your point, Dr. Drezner, that it's just a hedge, it's not real, but let's say if you could put the following together for us in terms of maximizing U.S. welfare, where would we want our dollar to be?

There was some talk earlier in the day about not wanting the dollar to be the reserve currency. We had testimony on that beforehand. But, so if you wanted to put us in the maximizing the welfare position, where would you have us on the status of the dollar, the status of the dollar, weakness, strength, reserve currency of the dollar, the liberalization of trade inside of Asia?

I'd like both of your opinions on this—how that might apply to our debt situation as well with China? I think they're related. I'm not sure exactly how. But I think that the dollar, the exchange rate and the trade issue is actually quite intertwined in a way that you've alluded to.

DR. DREZNER: You take this one first.

DR. PRASAD: Okay. That's a very comprehensive question, and thanks for prefacing that by generously referring to economic idiots because I think these days it's more that economists are considered idiots. So that's very generous of you to say that. I was talking about myself then.

Let's start with the last part, the status of the dollar. If the dollar were to depreciate in value for any reason, including Chinese actions, it could actually help the U.S. economy in the short term for a couple of reasons. It would make exports more competitive and, of course, it would paradoxically lead to a wealth gain in the U.S. because in terms of most of our liabilities are in U.S. dollars, most of our assets are in foreign currency, so we'd make a net wealth gain.

But if that fall in the dollar was because there were serious concerns about the U.S. debt sustainability, that would lead to a very sharp increase in interest rates. It would mean less availability of financing of the debt, both domestically and from abroad. So that could have very negative consequences in terms of U.S. growth because if you are dealing with the reality of the deficit, it's going to mean very significant expenditure reductions and/or tax increases. Without that, there is no way you can bring the deficit down.

So the deficit financing is going to increase, and that's going to have implications for U.S. growth and U.S. productivity.

In terms of trade, the Chinese have been signing a lot of free trade
agreements in the Asian area. I think this is again a natural consequence of the fact that there is substantial amount of integration of supply chains, and the U.S. and countries of Western Europe still remain very important export markets.

The big question is whether China and the other countries in the region are going to be able to adopt policies that increase their domestic demand rather than still keeping them export dependent. I think when one thinks about Chinese policies, including currencies, that's the real crux of it because if Chinese currency policy stays where it is, their very imbalanced economy is going to become even more unbalanced, as Dr. Drezner has just pointed out.

And that could have potentially important complications for global financial stability and for the U.S. It's going to look great in the short run because the U.S. will continue taking the exports, we'll continue getting our deficits financed again, like I said, a repeat of 2007, but it's going to make circumstances much more fragile, both in the short term and long term.

COMMISSIONER BLUMENTHAL: Dr. Drezner, where would you want us to be on each one of these comments?

DR. DREZNER: First, on having the dollar as a reserve currency, I think the answer is yes, I think you still want the dollar to be the reserve currency. It gives the United--I've seen arguments by Fred Bergsten and others saying, you know, the U.S., by having the dollar as a reserve currency has not been able to impose fiscal discipline.

As someone who studies international relations, I generally like having more autonomy rather than less so, in this instance, I disagree respectfully with Dr. Bergsten. I understand why he wants to go in that direction, but I don't think it would necessarily--I think the adjustment would be relatively harsh, not to mention we would give up the benefits of seigneurage, which are not insignificant. We're talking about, you know, upwards of 50 or $60 billion a year.

In terms of where the dollar should be, I agree with Dr. Prasad. You do want to see a depreciation of the dollar. The dollar is overvalued vis-à-vis the renminbi, in particular. And I think that if the appreciation of the renminbi was handled well, it would translate into economic gains for the United States.

Furthermore, this is a propitious time to do that because one of the downsides potentially of a depreciation of the dollar is potentially higher inflation because imports would become more expensive.

I don't think inflation is a concern right now in terms of the U.S. economy, as anyone who has looked at the core inflation rate recently would agree. So this is actually a propitious time to do that.

I think it would also help China, and I think this is one of the
arguments that needs to be made, which is one of the ways you can presumably expand Chinese consumption is if you make Chinese imports or imports to China cheaper, which is what would happen if you had that kind of appreciation.

On the trade liberalization front, I will, I don't disagree with anything Dr. Prasad said. I would point out that one of the comparative advantages that the United States does have when it negotiates free trade agreements is that its FTAs tend to be much more comprehensive in scope and deal with just about every sector of the economy in terms of the bilateral relationship, and often furthermore deal with non-trade areas such as services or investment as well.

And, if you look at the Chinese bilateral trade deals with ASEAN and other countries, those are much more circumscribed because of the supply relationship. So in that respect, an FTA with the United States still does represent the sort of gold standard of FTAs.

HEARING CO-CHAIR WESSEL: Commissioner Videnieks.

COMMISSIONER VIDENIEKS: Good afternoon, gentlemen.

A year or so ago, maybe a couple of years ago, Secretary Paulson testified that our trade relationship and the resultant deficit is with the region, not just with China.

So my question is twofold. To what extent is China still an assembler of goods, wherever we are in the technology spectrum, and are the exports to the U.S. basically going through a funnel type of thing, which is China, huge, okay, compared to its neighbors, and is the money flowing back the same way? But for some reason not stopping in China? That's basically my question.

Maybe both of you gentlemen could comment on that.

DR. PRASAD: So it used to be true until about 2004 that, in fact, if you took the U.S. trade deficit with all of emerging Asia, that was relatively stable and the composition was changing away from non-China Asia towards China.

Since 2005, the picture has changed. The U.S. bilateral deficit with China has become the dominant factor. The overall U.S. deficit with Asia has increased. Now the interesting thing is that in terms of the importance of the U.S. market to China, that figure has remained relatively stable at about 18 to 20 percent.

So it's not like the Chinese, prima facie, rely much more on the U.S. market, but the reality is that a lot of trade within Asia is still part of the supply chain, and the share of processing trade accounted for by Chinese trade has gone down from about 55 to 60 percent to about 45 percent. So there is more trade that is originating in China with a little more value added.

It's not hugely up the value-added chain still. So in terms of final
demand, my perception is that the U.S. and Europe still remain very important export markets for China even though the raw numbers don’t seem to show it.

COMMISSIONER VIDENIEKS: And they do have these trade agreements with their neighbors, but proportionately are they, what would they proportionately be compared to the size of the U.S. market or the European market?

DR. PRASAD: So Chinese import demand for final goods has increased. So the Chinese income levels have been rising very, very fast. So the sheer size of the Chinese market means that higher value-added goods are being imported from the rest of Asia into China plus, of course, commodity imports are playing a very important role here, and this notion of very investment-led growth means that they do import a lot of commodities, intermediate goods, and so on.

But the trade with the rest of the world is still very important for China in terms of the final demand.

COMMISSIONER VIDENIEKS: Sir.

DR. DREZNER: I would just add, I mean I agree with everything Dr. Prasad has said, and I think one of the interesting trends is that as China starts moving into more higher-value-added exports, that is causing, I think, a small but perceptible shift in its relationship with ASEAN and the other Pacific Rim economies, which is they're suddenly much more concerned about China having a similar comparative advantage profile to their economies.

So, in fact, countries like Indonesia have been much slower in implementing the China-ASEAN Free Trade Agreement precisely because they're concerned as well about China's currency politics. And so, as a result, again, I think this is an opportunity for the United States to actually engage with these countries, both through the Trans-Pacific Partnership in terms of trade and also perhaps through more multilateral consultations in terms of currency.

COMMISSIONER VIDENIEKS: Thank you.

HEARING CO-CHAIR WESSEL: Commissioner Shea.

COMMISSIONER SHEA: Thank you both for being here.

Let's get back to the issue of Chinese domestic public opinion on Chinese foreign policy, international economic policy. I just have a couple of questions. Help me understand this. How closely is the status of China's reserves and foreign investments monitored by the average Chinese person, by the Chinese public? I know there's quite a bit of stir in the Chinese blogosphere about CIC's loss in Blackstone.

So if you have a sense of do people in China study how the reserves are being deployed?

Secondly, I assume there's an understanding that this process of
managing the exchange rate cannot continue forever. Do you have a sense of how domestic public opinion in China, and as you point out, the GDP there is one-tenth that of the United States--they have tremendous problems in China--could domestic public opinion be brought to bear to suggest that the economics of the managed exchange rate policy is no longer in China's interests?

DR. DREZNER: Yes. I would say the Chinese public in this respect corresponds roughly to the American public, which is there's a small section of the population that pays a great deal of attention to the bilateral relationship, and there's a larger part of the population that only periodically pays attention to the relationship.

I can tell you that Chinese public opinion surveys suggest that, in fact, the majority of Chinese do expect a new Cold War with the United States. These are surveys that were conducted in 2009. So, in this respect, the Chinese public opinion I think somewhat corresponds to American public opinion.

I think part of the problem here is that because of China's political regime, one of the issues they have is that they do try to obviously repress certain elements of public opinion that might demand things like, I don't know, political liberalization within China.

Now, in the process of doing that, they can't suppress all public opinion, so I think one of the things this does is it actually artificially inflates the sort of nationalist voice within the Chinese public because that's actually one of the few legitimate areas where you can express an opinion.

So one of the problems we have, and I think there should be further research into this area, is just how powerful is Chinese nationalism or is, in fact, this sort of an artificially inflated effect?

DR. PRASAD: So with the caveat that you're asking for a non-Chinese perception of a Chinese perception, let me say that, in fact, Chinese leaders are very pragmatic, and I can tell you, as was mentioned earlier, if you speak to them, they are very candid about the constraints they face and what sort of delicate balancing act they face domestically.

There is a fairly widespread perception in China that China is financing the U.S. Like I said, much of the other part of the equation gets left out in this debate, and there is a perception that U.S. is not sufficiently acting beholden to China even though China is very generously financing the U.S. deficit, and that perception is very important.

And this actually in some part explains the sort of aggressive approach you see by the Chinese in their public statements because, as I said, the Chinese are locked into U.S. Treasuries. Eventually they are going to take a loss on those holdings when the renminbi appreciates,
and the worst thing for them is to act like they were blindsided by that.

As you pointed out, the losses by the CIC have already hurt them domestically politically so at least if they say, look, we told the U.S. that this is a problem, we acted aggressively, but the U.S. did what it did, and we're going to have to eat some of these losses, that plays much better, and that I think, in fact, explains some of the aggression you'll see on this issue.

Now, could the Chinese continue with this exchange rate policy? One of the reasons they've been able to do it is that they have a very repressed financial system, and actually the costs of the exchange rate policy, to some extent, are hidden in the financial system. It translates into very low interest rates paid to households that put a lot, that save a lot, put a lot of their deposits in the banking system.

But it's a very nicely spread-out cost so you don't see it. So as long as you control the financial system, so long as you have at least moderately effective capital controls, it is actually possible for them to keep this exchange rate going, but again, they are very realistic that this is imposing costs on them.

They want to get out of this, but it's a little difficult for them to do this in an abrupt way. They're only willing to do it incrementally, and doing it incrementally is actually somewhat harder.

COMMISSIONER SHEA: It sounds a little bit as if the United States has the same problem with our fiscal spending. We're both sort of addicted to it. We're addicted to the fiscal spending. The Chinese are addicted to purchasing U.S. debt. We realize it can't continue on forever, but we're unwilling to take the steps, the immediate steps, to remediate the situation.

DR. DREZNER: I think it was Saint Augustine who said, "Lord, show me the error of my ways but not just yet."

And that pretty much captures both countries, I think.

COMMISSIONER SHEA: Thank you.

HEARING CO-CHAIR WESSEL: Commissioner Cleveland.

HEARING CO-CHAIR CLEVELAND: It is hard to follow Augustine. We focused mostly on the Chinese-U.S. relationship, and I take your point, Dr. Drezner, that the Chinese have not been able to exercise "compelling" power when it comes to their interests, but rather it's "deterrent" power and you also point out they are unlikely to be able to create a cartel of creditors.

You've done a piece in International Security and talked a fair amount about the Chinese relationships and their approach to emerging markets, and I wonder if the dynamic is the same, particularly in the ASEAN countries, when it comes to "compelling" versus "deterrence"? What kind of relationships are evolving in the Asia-Pacific area?
DR. DREZNER: I would say the relationship is different. Obviously, China has much more significant market power vis-à-vis each of the individual ASEAN countries than it does vis-à-vis the United States.

So obviously China is a more powerful actor and would potentially have greater compellence power vis-à-vis each of these countries individually.

One of the reasons that ASEAN exists in the first place is that it was originally organized as a hedge against what at the time was considered Maoist China, and so in some ways ASEAN has actually managed to leverage its organizational status remarkably effectively because if you take a look, it's sort of the regional institution building in the Pacific Rim. It's all through ASEAN.

So, in some ways, they've actually been able to come up with institutional hedges against China, but I don't doubt that the China has more influence probably vis-à-vis the individual countries that see China as a more important market than the United States. There is no doubt about that, and I think I had said something to that effect in my testimony.

HEARING CO-CHAIR CLEVELAND: Since you have identified - the G20--as an important forum for resolution of these issues, a forum which helps to get away from the bilateral tit-for-tat in terms of currency exchange, how would you see the dynamics of pressure within Asia and ASEAN playing out in the G20? Either one of you.

DR. DREZNER: I believe ASEAN is represented by Indonesia in the G20. So the ASEAN opinion, such as it is, will have voice within the G20. I don't think they're going to feel marginalized. I think one of the advantages of the G20 mechanism, in particular, is that the one thing China does not like to be is isolated or alone.

As a result, if they discover that other countries believe or agree with the United States that China is also part of the problem with regard to issues such as macroeconomic imbalances, they're eventually going to realize that they're going to have to do something on this.

I think you can argue, and I agree with Dr. Prasad on this, that one of the small virtues of the Great Recession is that the United States has realized that it can't sustain policies of the past, and it's going to have to change.

The question is whether China realizes that yet. I think to date the answer is no, they have not. And I think it's possible through the G20 mechanism that they can realize that, in fact, the handwriting is on the wall.

DR. PRASAD: Yes. The economic entanglements between each
of the ASEAN economies and China is very, very strong, both in terms of trade and increasingly through finance so it's a little difficult for China's neighbors to stand up and speak out on this issue even though they are being quite significantly affected by Chinese currency policies.

So the question is who is going to speak up? One could argue that a country like India, which has more limited trade relations with China, could do it, but there again India is a little concerned about standing out in front by itself.

The idea of a parallel dialogue that is going to be set up with India, I understand, in the next couple of months, will probably give India a little more of a say in these matters, especially in the context of the G20, and the U.S., I think, is sensibly trying to use India as a bit of a bulwark against China.

But you can see the influence, as I mentioned, even in the context of Brazil, which is being hurt by the currency policy of China, but given its entanglements made some peeps about Chinese currency policy, but relatively muted ones. So the question is who is going to organize this group, and here again I think the U.S. has a fairly important role in the G20 or the IMF may be the mechanism through which to do it.

HEARING CO-CHAIR CLEVELAND: And do you see, as the witnesses this morning indicated, that the G20 might succeed where the IMF has been unable to succeed?

DR. DREZNER: I would say yes simply because, among other reasons, the G20 has more flexibility in terms of how it's going to go forward on these processes than the IMF. It's not a treaty body. There are emergent norms being established. Furthermore, one of the advantages of the G20, actually from the U.S. perspective, is that it's a less Eurocentric institution.

If you think of international relations as a set of networks, one of the interesting things about the G20 is the U.S. really is at the center of almost every other country out there in a way that it wasn't necessarily in just the G7. That there was a sufficient European counterweight to that. So there are ways in which the U.S. is actually better placed in the G20 than it was in older institutions to try to influence China.

DR. PRASAD: Yes, I agree with that assessment. I think the G20 is a much more natural forum. However, the G20 has chosen the IMF as its Secretariat, and the IMF is supposed to conduct many of these assessments. It's a little difficult for the G20 because it doesn't have the institutional structure or the knowledge to conduct the assessments. So it has to take the analysis from the IMF, and then make policy decisions or policy judgments based on those assessments, and the question is whether the IMF can actually deliver effective assessments, and that remains to be seen.
HEARING CO-CHAIR CLEVELAND: I agree. Thank you.

HEARING CO-CHAIR WESSEL: Vice Chairman Bartholomew.

VICE CHAIRMAN BARTHOLOMEW: Thank you.

I want to go back to the distinction between perception interpretation and perception management.

For example, Dr. Drezner, I don't know that we really know how well China has actually done in this economic crisis. We know how well they are saying that they have been doing in this economic crisis, but because they are not transparent, there's not the release of a whole lot of data. We don't actually know.

There are some people who say if you go and you look at power consumption, in some of these months where they reported that they were doing really well, it turns out that the power that they used doesn't reflect the output that they say that they've been doing. So there's a piece there.

I also at the risk of alienating some of the journalists who cover this body, I wanted to just mention our crack staff sent around an article that was filed at 8:45 this morning on this hearing, which started at nine, and the headline is "U.S.-Sino Tensions Dangerous Game U.S. Panel Told."

The sub-headline is "China Might Aggressively Sell U.S. Assets If Provoked," which is a continuation of the narrative, and, in fact, you might want to take a look at this.

Dr. Prasad, your written testimony is quoted in here, and I don't know that it actually reflects the narrative that's been told by people as we've gone through this.

I go back to that question of how much of this perception is actively being shaped for example by the Chinese government or people who are interested in doing business with the Chinese government? And how much of it is a more passive thing that's happening?

This narrative goes deep, and I would argue that it probably goes back to the time of the MFN debates, if not earlier. I've been thinking this through actually as we've been sitting here. At the time, it was sort of the myth of Chinese power. Dr. Prasad, we don't have that about India, and India has just as many potential consumers as China does. So something different has happened over the course of the past 20 years.

Do you have any sense of how much of that might have been active Chinese perception management of this narrative, the creation of the narrative, and as it's unfolding?

DR. PRASAD: First of all, on the growth numbers, my sense is that on average they're reasonably accurate. I mean there are problems with gathering the data, as there are in every country, but I don't think there is a systematic attempt to fudge the data at the national level.
If you look at the numbers we've been talking about, of about 13 percent of GDP credit going out from the banks in 2009, that can almost directly, if it goes into investment, even half of it, translate into the sort of growth rate we've seen. So I think the bigger concern is not whether they're growing at eight percent or six percent, but what is behind the growth?

It is the balance of growth, which was tilting more towards exports, which is now tilted towards investment, but it's going to need even more export dependence. That is the serious concern.

In terms of perception, first of all, there is an order of magnitude difference between, not quite an order of magnitude but a significant difference between the scale of the Chinese and Indian economies in terms of their growth, and so on, and that I think has had an important implication.

The Chinese have been much more effective at deploying their power strategically. Like I said, they've created these economic entanglements, partly as a matter of policy and partly just as a matter of their being able to provide the right sort of infrastructure and other conditions that created these entanglements.

And they have been guiding perceptions. Again, part of it is to guide the internal debate, but part of it is also responding to internal pressures, as I said. So at one level I think there is a concerted attempt to guide this debate, but what the pressures are that are driving it, whether it's more internal or whether it's more external, I think it's hard to tell.

I think we're all trying to figure out how China might use its power, and the sheer numbers, $2.4 trillion, whatever it is, gives you a lot of power. So I think we're all in this position of wondering what the Chinese are going to do with it. So many of the overhyped stories you see might simply be concerns being expressed in the form of those hypotheses.

VICE CHAIRMAN BARTHOLOMEW: Dr. Drezner.

DR. DREZNER: I would say two things on this. The first is it's always convenient how the Chinese officials that talk about the prospect of using this financial power as a foreign policy tool have absolutely zero influence whatsoever over China's financial holdings.

So I think one of the things that's going on is that if you have, let's say, a PLA official threatening to, saying we should dump U.S. dollars, well, that's obviously going to make headlines. It's a great good juicy story, and that should without question make the press, and I think one of the answers is the media does need to actually have a better perception of how the internal workings are within China.

So I don't think China is consciously doing this. I just think that
if you actually have officials saying these things, that it is going to get reported.

I think there's a second issue, however, which we haven't really talked about. I would say with respect to the Commissioners, they are all old enough to remember what the Cold War was like. My students are not, and it's a bit of a frustration for me personally trying to explain this to them, but for those of you who might recall the Cold War was a balance of terror.

It was a system of mutually assured destruction, and as in some ways existentially draining as that was, there was also a source of stability to it. There was the recognition in retrospect, we can say, of course, the Soviets were not going to launch a nuclear strike against the United States because that would have meant the end of their system.

Similarly, the United States was not going to do the same to the Soviet Union. I think Larry Summers coining of the term "balance of financial terror" does apply to the current bilateral economic relationship.

So this is actually, on the one hand, a source of stability, but on the other hand, it's clearly a source of anxiety, and I think that also is driving some of this discussion, which is the United States is not used to the idea that other countries might actually have deterrent power.

As I said before, I think we've gotten a little lazy in our days of hegemony.

VICE CHAIRMAN BARTHOLOMEW: Thank you.

HEARING CO-CHAIR WESSEL: Commissioner Mulloy.

COMMISSIONER MULLOY: Thank you, Mr. Chairman. I want to salute you and the Vice Chair, or the two chairs of this hearing, for putting it together. You did a great job.

I want to thank the witnesses for that very thoughtful testimony. I don't agree with all of it. Mr. Drezner, you might want to read Alexander Hamilton's Report on Manufacturers.

DR. DREZNER: I have.

COMMISSIONER MULLOY: Okay. Good. So we have had an industrial policy in this country. Here's what I want to ask about. It came up earlier today about China's growth of green technologies and the amount of money they're putting into trying to grow green technology leadership, and they're putting like--what was it--$280 billion, and we're putting 80 billion or something. How does the accumulation of foreign currency reserves translate into China's ability to subsidize particular industries in China? How does that happen? Is there a connection?

DR. PRASAD: That's a slightly tricky issue because for instance, if they were to use that money internally, it would work against what
they're trying to do, which is to maintain the value of the currency. If, however, they use some of it for imports, then it would not affect the value of the currency so they could achieve these multiple objectives.

But the Chinese have been very virtuous in terms of their fiscal policy until the crisis hit their fiscal deficit in explicit terms, ignoring all the contingent liabilities in the banking system and so on. The explicit budget deficit was basically zero. They've got a very good revenue generation program in place, and they've been fairly cautious about expenditures. So they have room. They had a lot of room to use fiscal stimulus, and they have a lot of room to act on fiscal policy.

Now, of course, a lot of this is being hidden through the banking system. So the $2.4 trillion definitely helps, but I don't think they are really relying on that for green technology.

The bigger question is how they are, again, using, to some extent, industrial policy to very effectively give their green technology sector a leg up in the international race, and I think that's the key concern. If the U.S. cannot invest in those sorts of technologies, if it cannot use government policy to aid the process, maybe not directly invest, but it cannot provide the right sort of incentives for the private sector to do this, then China could take on a leadership role.

DR. DREZNER: I would just add, I agree with everything Dr. Prasad, the first part of what Dr. Prasad said. China's primarily used its foreign holdings in terms of anything beyond just keeping the currency undervalued primarily for resource acquisition and long-term investments in other parts of the globe.

I would also add, to some extent, it's been used, and this has actually caused some blow back, as a jobs program, which is if they engage in long-term investment in places like, let's say, the Democratic Republic of the Congo or Sudan or Zimbabwe, they'll certainly engage in those foreign direct investments, but they also love this because they then export Chinese workers to those countries as a way for them to do all of the infrastructure work and so forth.

This has caused, as you can imagine, a fair degree of resentment in those countries who assumed that the foreign direct investment was going to translate into domestic jobs, and it hasn't.

So I agree that the only way this could be used to accelerate their industrial policy would be acquire firms, you know, based outside of China that were seen as possessing strategic technology, but to date, they haven't really engaged in that practice all that much.

COMMISSIONER MULLOY: Well, one other thing on that. The underpriced currency has attracted foreign investors into China.

DR. DREZNER: Yes, but mostly as a speculative bet that eventually the currency will appreciate.
COMMISSIONER MULLOY: I mean manufacturers, which move manufacturing from here.

DR. DREZNER: I would argue that a billion Chinese consumers is what's attracted foreign direct investment into China, not the undervalued currency.

COMMISSIONER MULLOY: Has the undervalued currency been part of the attractiveness?

DR. PRASAD: It's attractive, as Dr. Drezner pointed out, because there is a sense that if the currency appreciates, you make a gain on that.

DR. DREZNER: Yes.

DR. PRASAD: But if you look at the magnitudes involved, it's not--gross FDI flows into China have been on the range of 60 to $70 billion a year, and that's peanuts in a $5 trillion economy where bank lending is a huge amount. So the amount of foreign direct investment has certainly helped serve as a catalyst in the exporting sector, and to small and medium-sized enterprises that are not well served by the domestic banking system, it's important.

But just in terms of orders of magnitude, foreign flows are really not what is boosting Chinese investment.

DR. DREZNER: I would also add on this that Chinese behavior towards foreign direct investors has changed somewhat over the last year. We can think about the arrest of the officers from Rio Tinto, and obviously Google comes to mind as well.

So it will be interesting going forward to see whether or not those FDI flows maintain their level.

COMMISSIONER MULLOY: Thank you both again.

HEARING CO-CHAIR WESSEL: Thank you to our witnesses, both on this panel and previous panels. Thanks to our staff, Nasos-Athanasios Mihalakas, Paul Magnusson and Nargiza Salidjanova, for all their great help in setting this up today. We stand adjourned until our next hearing.

Thank you.

[Whereupon, at 2:30 p.m., the hearing was adjourned.]