"Rethinking the U.S.-China Economic Agenda"

Testimony of

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Mr. Chairman and members of this important subcommittee, I am delighted to weigh in on an international economic policy issue of enormous importance to the United States. Since its inception six years ago, the Strategic and Economic Dialogue between the U. S. and China has served the very useful purpose of elevating one of the world's most important economic relationships to the high level it deserves. Unfortunately, this dialogue has been misdirected by the combination of bad economic advice, a tough macroclimate bearing down on American workers, and a politically motivated blame game. It is high time to rethink the focus and role of this important framework of engagement.

The United States has long allowed its fixation on China's foreign exchange rate to dominate the debate surrounding its economic relationship with China. Over the past seven years, the U.S. Congress has repeatedly flirted with legislation purportedly aimed at defending hard-pressed American workers from the presumed threat of a cheap Chinese currency. Bipartisan support for such a measure initially surfaced when Senators Charles Schumer (a liberal Democrat from New York) and Lindsey Graham (a conservative Republican from South Carolina) reached across the ideological and party divide to co-sponsor the first Chinese currency bill in 2005. Over the years, the drumbeat has only grown louder in seeking such remedies. By overwhelming bipartisan majorities, the House of Representatives passed a modified version of this bill in September 2010 and you in the Senate followed suit in October 2011. Fortunately, neither bill became law.

Unfortunately, the argument for legislative action against China has become tantalizingly simple. It rests mainly on America's gaping trade deficit, widely thought to be a principal source of the acute pressures bearing down on U.S. jobs and real wages. At one level, that's certainly understandable: A loss of production and market share to foreign competition squeezes America's companies and their workers. The U.S. merchandise trade deficit has, in fact, averaged 4.4% of GDP since 2005 – the largest and most protracted external gap in modern U.S. history. Moreover, China has accounted for fully 35% of the shortfall over this seven-year interval, by far, the largest portion of the overall U.S. trade deficit. The critics claim foul – maintaining that Chinese inroads into American markets are built on a blatant strategy of currency manipulation that is restraining the renminbi, or yuan, from rising to its "fair" market-determined value. The Chinese, insists a broad coalition of politicians, business leaders, and academic economists, must revalue immediately or face punitive compensatory sanctions to level the competitive playing field.

This reasoning resonates with the American public. Opinion polls conducted in 2011 found that fully 61% of the citizens sampled believe that China represents a serious economic threat. Politicians have been quick to respond – and, unfortunately, stoke these fears. Indeed, the currency debate could well loom as a major issue in the upcoming U.S. presidential campaign. President Obama has drawn a line in the sand when he replied, "Enough is enough," upon being queried on the contentious currency issue in the aftermath of his last meeting with Chinese President Hu Jintao. Governor Romney has gone even further – promising to declare China guilty of “currency manipulation” the day he takes office as America’s next president. Nor should this be dismissed as normal election-year politics. As long as conditions remain tough for American workers – more likely than not in the years ahead – pressures for a Chinese fix to our problems will only intensify.

However appealing this logic may appear to be on the surface, it is wrong. Currency adjustments – in effect, altering the relative price structures between nations – are simply not the panacea that most economists used to think they were. According to Federal Reserve statistics, the broadest measure of the U.S. dollar is, in fact down about 25% in real effective terms from its February 2002 peak. Yet over the past decade, the angst of the American worker has only intensified. Contrary to conventional wisdom, shifts in currencies are not the answer for all that ails us. That is particularly true of the foreign exchange rate between the U.S. dollar and the Chinese renminbi. Several reasons come to mind:

First, America’s trade deficit is multilateral: the United States ran deficits with 88 nations in 2010. A multilateral imbalance cannot be fixed by putting pressure on a bilateral exchange rate. It’s like putting pressure on one end of a water balloon. Without addressing the sources of this multilateral imbalance, squeezing one of its bilateral pieces will merely redirect the trade imbalance elsewhere – quite conceivably to a higher cost foreign producer. In other words, this strategy would probably backfire – it would be the functional equivalent of imposing a tax hike on hard-pressed middle-class U.S. families.

It’s no dark secret as to the primary sources of our multilateral trade imbalance – an unprecedented shortfall of national saving. America’s so-called net national saving rate – the combined depreciation-adjusted saving of individuals, businesses, and the government sector – fell into negative territory in late 2008 and has remained near or below zero ever since. This is unprecedented in the annals of modern global history. Never before has the world’s leading economic power run a negative net national saving rate. Lacking in saving and wanting to grow, the U.S. must them import surplus saving from abroad – and run massive current account and multilateral trade deficits in order to attract the foreign capital. That’s where China and our other 87 trade deficits enter the U.S. macro equation.

Yet you in the political arena choose to blame others for our sins – specifically, sins arising from outsize budget deficits and sharply reduced personal saving that have forced the United States to turn to foreign saving as a source of domestic growth. Pointing the finger at China merely deflects attention away from the heavy lifting that must be done at home. Scapegoating may be politically expedient but it won’t work in addressing the fundamental problems of a saving-short U.S. economy. In this vein, America’s major threat is from within. If we don’t want trade deficits – with China or with anyone else – we must face up to our chronic shortfall of saving. If we don’t want to save – and many believe (myself excluded) that’s the last thing post-crisis America needs – then we have to accept trade deficits as a steep price to pay for our profligacy.

Second, the renminbi has now appreciated 31.4% against the dollar since mid-2005, when China started to reform its foreign exchange regime. That's well in excess of the 27.5% increase called for by the original Schumer-Graham bill. In other words, the currency hawks have pretty much gotten what they wanted all along. But, as underscored above, the problems bearing down on American workers have only become worse. You would think that might provide pause for thought in continuing to agitate for further Renminbi appreciation. But the periodic attempts of you in the Congress to enact anti-China currency legislation say otherwise.

The advice from many leading academics – advice, I might disappointingly add, that has been well received in Congress – is that China should have moved quickly with a large one-off adjustment to bring its currency to fair value. While it is debatable as to whether the time path of any currency shifts makes much of a difference in the long run, the Chinese have long viewed a large one-off revaluation with understandable trepidation.

And with good reason. Mindful of the painful lessons of Japan – especially its disastrous concession on sharp yen appreciation that was the centerpiece of the so-called Plaza Accord of 1985 – the Chinese have opted, instead, for a gradual revaluation. Significantly, the endgame is not in doubt. Recent moves toward the offshore internationalization of the renminbi, a more open capital account, and significantly wider currency trading bands leave little doubt that China is committed to establishing a market-based, fully convertible renminbi.

Third, the currency hawks have long maintained that it is in the world's best interest for China to reduce its outside current account imbalance and use the currency lever to accomplish that critical task. They also believe that global imbalances – an ever-present threat to the world economy for the past couple of decades – have been largely made in China. The Washington consensus has been especially adamant in making this case, stressing that China's saving glut has been a major source of global instability. [1] Without a sharp renminbi revaluation, they argue, the world will never come to grips with its dangerous imbalances.

Here as well, the political expedience of the blame game has hijacked this important element of the debate. First of all, the good news is that there has now been significant improvement in China's external imbalance. The International Monetary Fund estimates that China's current-account surplus will narrow to just 2.3% of GDP in 2012, after peaking at 10.1% in 2007. Unfortunately, it's hard to say the same for any meaningful improvement in America's gaping external imbalance. By the IMF's reckoning, the U.S. current-account deficit is likely to be about $510 billion this year – fully 2.8 times greater than China's surplus (see Figure 1 on page 13, "A Tale of Two Deficits"). Far from blaming China as a major source of global instability, you in the Congress should take a long and hard look in the mirror as to the role that America's persistent and outsize external imbalance is playing as a major source of global instability. Far from being a responsible steward of global economic

[1] See the March 10, 2005 speech by then Fed governor, Ben Bernanke, "The Global Saving Glut and the U.S. Current Account Deficit."

prosperity, an unbalanced U.S. economy has been a major source of instability in a crisis-prone world.

Finally, China's role in the global economy has changed considerably over the past 30 years. Specifically, it has evolved from the so-called world's factory to more of an assembly line. Research shows that no more than 20% to 30% of Chinese exports to the US reflect value added inside China. Moreover, roughly 60% of Chinese exports represent shipments of "foreign invested enterprises" – in effect, Chinese subsidiaries of global multinationals. This raises important questions about the intrinsic identity of the fabled Chinese export machine: Is it them, or us? Think Apple. The supply-chain logistics of globalized production platforms distort bilateral trade data between the U.S. and China, and have little to do with the exchange rate.

In short, the Chinese currency is not the corrosive problem that you in the Congress have been led to believe over the past seven years. By having the wool pulled over your eyes, you have missed a far more important story. Rather than vilifying China as the principal economic threat to America, the relationship needs to be recast as an opportunity. That's especially the case in a weak U.S. growth environment, plagued by unacceptably high levels of unemployment and underemployment. We need to spend far more time in trying to come up with new and creative solutions to this daunting growth problem. Related to that is the need to think of how China can become an important part of this solution.

For starters, this requires an honest assessment of our own problems. Due to the recent crisis – and the years of excess that preceded it – America's growth calculus has been turned inside out. Over most of our modern history, we have relied on internal demand as the sustenance of economic growth and prosperity. That approach is now in tatters. The largest component of U.S. aggregate demand – the consumer – is on ice. With households focused on the post-crisis repair of severely damaged balance sheets, inflation-adjusted private consumption has expanded at an anemic 0.6% average annual rate over the past 17 quarters. Moreover, consumer deleveraging has only just begun, suggesting these headwinds are not about to subside. The U.S. is in desperate need of new sources of economic growth and job creation.

Exports top the list of possibilities – a view underscored by Nobel Prize winning economist, Michael Spence, in a recent comprehensive study of America's job challenge.[2] There are grounds for encouragement that an adaptable U.S. economy may already be rising to the challenge. Merchandise exports have now risen to a record of nearly 10% of our GDP – up dramatically from the 6.5% share prevailing a decade ago (see Figure 2 on page 14, "America's Opportunity: The Export Revival"). The Obama Administration has set the ambitious goal to double U.S. exports in five years. But with trend export growth to our largest external markets – Canada and Mexico – hovering at close to 3% over the past five years and stagnation long

[2] See Michael Spence and Sandile Hlatshwayo, "The Evolving Structure of the American Economy and the Employment Challenge," a Council on Foreign Relations working paper, March 2011.

evident in Japan and now likely in crisis–torn Europe, America's export-led growth agenda will need to turn to new markets.

China could well hold the key in meeting this challenge. It is now America's third largest and most rapidly growing export market. There can be no mistaking its potential to fill a growing portion of the void left by U.S. consumers. As such, Chinese domestic demand – not its currency – should be featured as a prominent element of America's new growth agenda. Yet congressional enactment of anti-China currency legislation could backfire in this regard – undoubtedly triggering retaliatory moves by China that would immediately choke off shipments to America's third largest export market. You in the Congress must be vigilant in guarding against this risk.

The key to realizing the opportunities of America's new export-led growth agenda lies in market access – specifically, access to China's future sources of economic growth. This is precisely the time to focus on this issue – as China's own growth imperatives shift away from exporting into weakened U.S. and European consumer markets toward sourcing the demand for its own pro-consumption rebalancing. Unlike Japan, modern Asia's first growth miracle, China is far more likely to satisfy this incremental consumption growth from foreign production. Chinese imports have been running at 28% of GDP since 2002 – nearly three times Japan's 10% import ratio during its high-growth era (1960-1989). As a result, for a given increment of domestic demand, China is far more predisposed to draw on foreign production.

As the Chinese consumer emerges, demand for a wide variety of U.S.-made goods – ranging from new-generation information technology and biotech to automotive components and aircraft – could surge. And this plays very much to America's competitive strengths: Capital goods and motor vehicles products currently account for 42% of total U.S. goods exports – the largest category of overseas demand for American-made products. The key for U.S. trade negotiators is to make certain that American exporters in our leading industries have fair and open access to these new and potentially enormous Chinese markets.

A similar opportunity is available in services. At just 43% of GDP, China's services sector is relatively tiny when compared with other major economies in the world (see Figure 3 on page 15, "The Potential in Chinese Services"). Services are, in many respects, the infrastructure of consumer demand, and the Chinese services share of its economy will only grow in the years ahead. By contrast, the United States is the world's quintessential services-based economy, with much in the way of process design, scale, and managerial expertise to offer China. There is enormous scope for America's global services companies to expand and partner in China, especially in transactions-intensive distribution sectors – wholesale and retail trade, domestic transportation, and supply-chain logistics, as well as in the processing segments of finance, health care, and data warehousing. The recent Strategic and Economic Dialogue made significant progress in opening up Chinese financial services to increased foreign investment. Attention now needs to be turned to nonfinancial services, as well.

The U.S.-China trade agenda must be refocused toward expanded market access in these and other areas – pushing back when necessary against Chinese policies and government procurement practices that favor domestic production and indigenous innovation. Some movement has occurred, but more is needed – for example, getting China to sign the World Trade Organization's Government Procurement Agreement. At the same time, the U.S. should reconsider antiquated Cold War restrictions on Chinese purchases of high technology-intensive items.

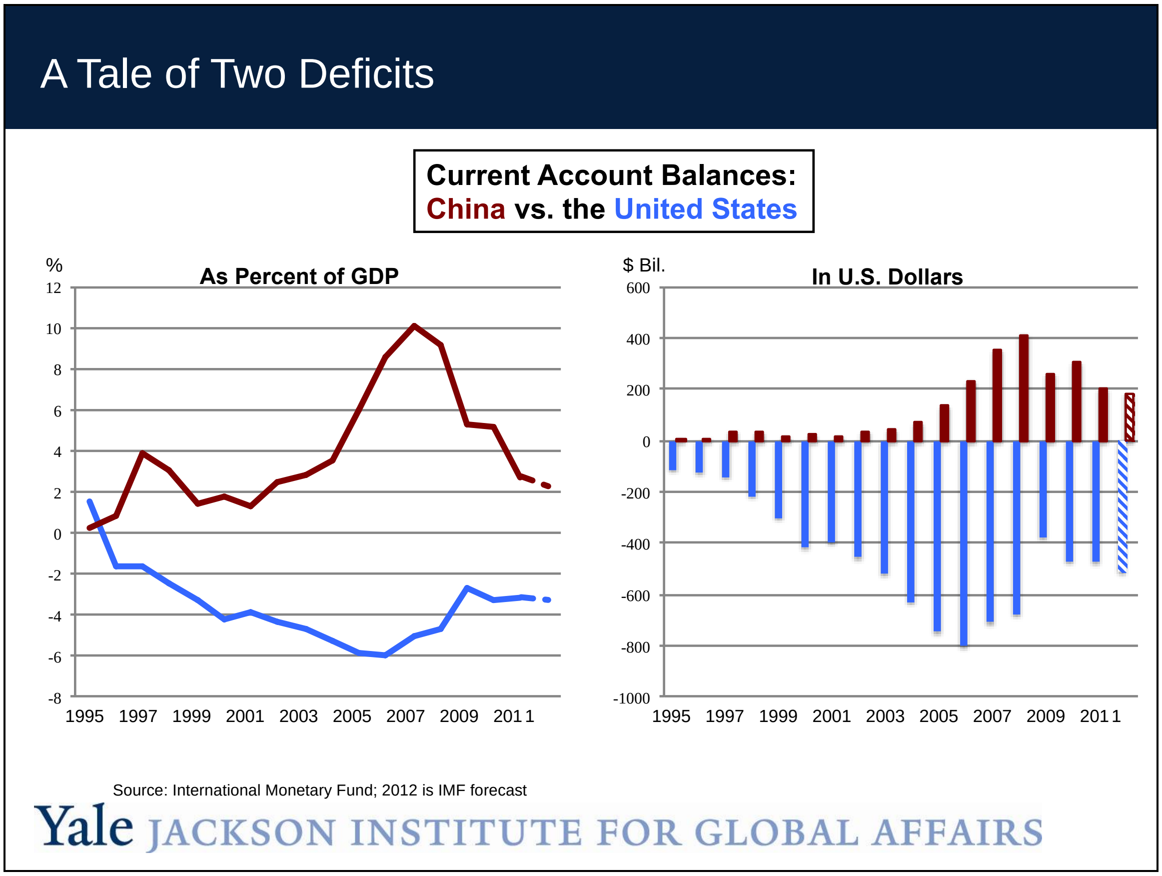
The good news is that important progress was made on both of these counts at the just completed May 2012 Strategic and Economic Dialogue with China. As such, the focus must now shift to follow-through, implementation, and enforcement. Both of these breakthroughs have potentially important implications for the Chinese piece of America's export-led growth and employment agenda.

The bottom line for a growth-starved United States: Insofar as America's economic relationship with China is concerned, the opportunities of market access far outweigh the misperceived perils of the currency threat. The time has come to de-emphasize the latter and focus on the former. The long-dormant Chinese consumer is about to be unleashed, providing new markets for all the world's major exporters. This plays to one of America's greatest strengths – our zeal to compete and win share in new markets. Shame on us if we squander this extraordinary chance. This is not the time to dig in our heels and cling to the same timeworn approach in our trade relationships with China. We need to return to the high road of economic engagement and avoid the low road of the blame game.

Accordingly, it is also time to rethink the basic thrust of our Economic and Strategic Dialogue with China – the subject of this important hearing today. Specifically, we need to recast this exchange as an integral piece of America's new growth agenda. The emphasis should be placed on opportunities – not on hollow threats. With respect to China, my recommendations are simple: End the currency fixation. Focus on market access as the key to U.S. growth and jobs.

Thank you very much.

**Figure 1**


A Tale of Two Deficits
Current Account Balances:
China vs. the United States
%
As Percent of GDP
12
10
8
6
4
2
0
-2
-4
-6
-8
1995 1997 1999 2001 2003 2005 2007 2009 2011
$ Bil.
In U.S. Dollars
600
400
200
0
-200
-400
-600
-800
-1000
1995 1997 1999 2001 2003 2005 2007 2009 2011
Source: International Monetary Fund; 2012 is IMF forecast
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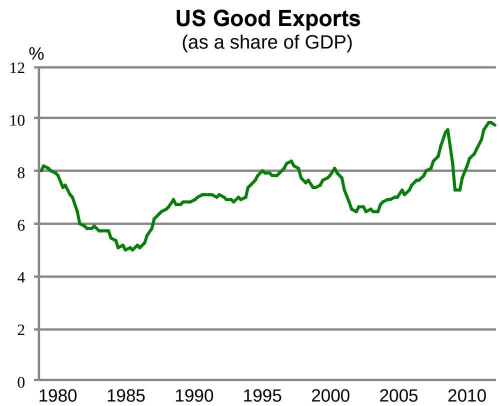
## Figure 2

# America's Opportunity: The Export Revival




**Top 10 Markets for U.S. Exports**

| | $ Value: 2011 (bil.) | 5 Year growth* |
|---|---|---|
| 1. Canada | 280.9 | 2.4% |
| 2. Mexico | 197.5 | 3.7 |
| 3. China | 103.9 | 15.6 |
| 4. Japan | 66.2 | 0.4 |
| 5. U.K. | 56.0 | 6.0 |
| 6. Germany | 49.1 | 7.9 |
| 7. Korea | 43.5 | 2.8 |
| 8. Brazil | 42.9 | 15.3 |
| 9. Netherlands | 42.8 | 6.9 |
| 10. Singapore | 31.4 | n/a |

* Average annual export growth: 2005-09

Source: U.S. Department of Commerce, BEA

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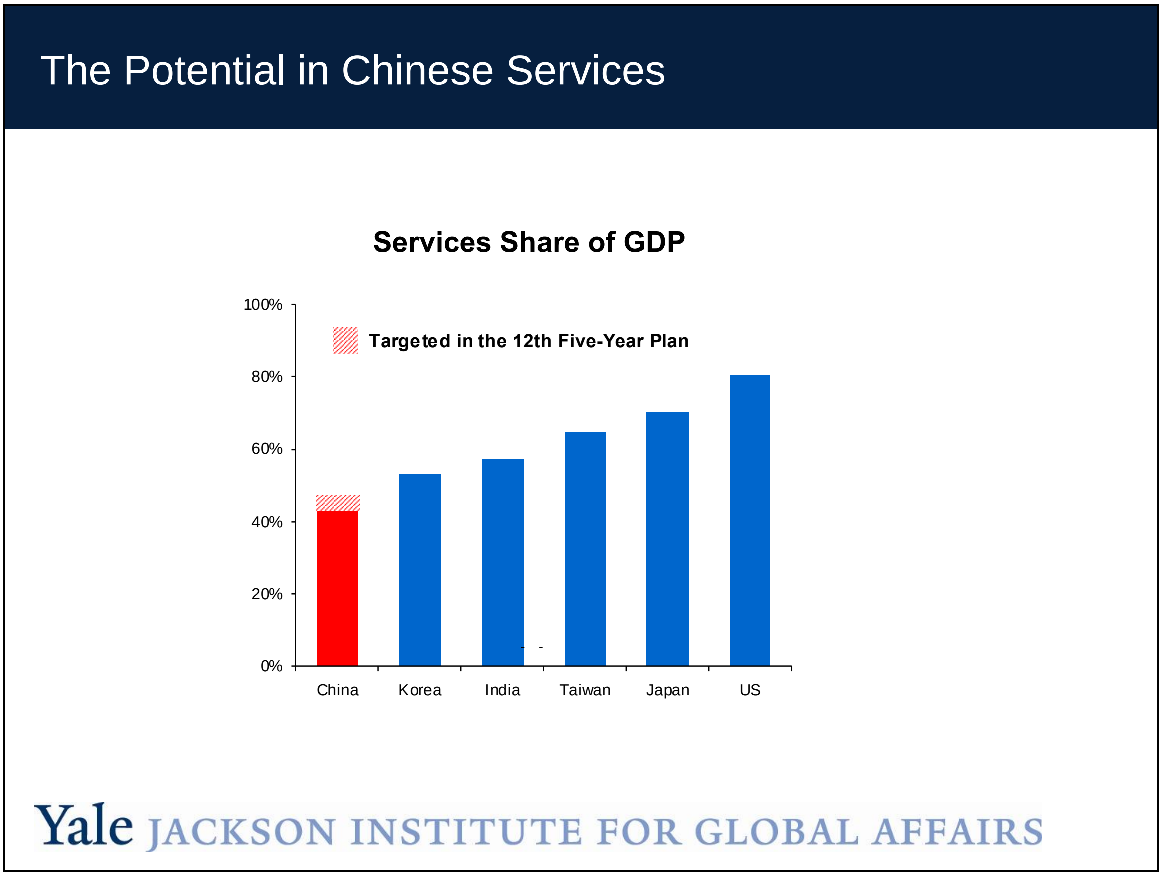
**Figure 3**


The Potential in Chinese Services
Services Share of GDP
Targeted in the 12th Five-Year Plan
100%
80%
60%
40%
20%
0%
China
Korea
India
Taiwan
Japan
US
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