S. HRG. 112–707

REVIEWING THE U.S.–CHINA STRATEGIC AND ECONOMIC DIALOGUE

HEARING

BEFORE THE

SUBCOMMITTEE ON
SECURITY AND INTERNATIONAL TRADE AND FINANCE

OF THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDRED TWELFTH CONGRESS

SECOND SESSION

ON

REVIEWING THE U.S.–CHINA STRATEGIC AND ECONOMIC DIALOGUE

MAY 23, 2012

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

Available at: http://www.fdsys.gov/

U.S. GOVERNMENT PRINTING OFFICE

78–503 PDF WASHINGTON : 2013

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

TIM JOHNSON, South Dakota, *Chairman*

JACK REED, Rhode Island
CHARLES E. SCHUMER, New York
ROBERT MENENDEZ, New Jersey
DANIEL K. AKAKA, Hawaii
SHERROD BROWN, Ohio
JON TESTER, Montana
HERB KOHL, Wisconsin
MARK R. WARNER, Virginia
JEFF MERKLEY, Oregon
MICHAEL F. BENNET, Colorado
KAY HAGAN, North Carolina

RICHARD C. SHELBY, Alabama
MIKE CRAPO, Idaho
BOB CORKER, Tennessee
JIM DEMINT, South Carolina
DAVID VITTER, Louisiana
MIKE JOHANNS, Nebraska
PATRICK J. TOOMEY, Pennsylvania
MARK KIRK, Illinois
JERRY MORAN, Kansas
ROGER F. WICKER, Mississippi

DWIGHT FETTIG, *Staff Director*
WILLIAM D. DUHNKE, *Republican Staff Director*

DAWN RATLIFF, *Chief Clerk*
RIKER VERMILYE, *Hearing Clerk*
SHELVIN SIMMONS, *IT Director*
JIM CROWELL, *Editor*

SUBCOMMITTEE ON SECURITY AND INTERNATIONAL TRADE AND FINANCE

MARK R. WARNER, Virginia, *Chairman*
MIKE JOHANNS, Nebraska, *Ranking Republican Member*

SHERROD BROWN, Ohio
MICHAEL F. BENNET, Colorado
TIM JOHNSON, South Dakota

MARK KIRK, Illinois

NATHAN STEINWALD, *Subcommittee Staff Director*
BRIAN WERSTLER, *Republican Subcommittee Staff Director*

C O N T E N T S

WEDNESDAY, MAY 23, 2012

WITNESSES

REVIEWING THE U.S.–CHINA STRATEGIC AND ECONOMIC DIALOGUE

WEDNESDAY, MAY 23, 2012

U.S. SENATE,
SUBCOMMITTEE ON SECURITY AND INTERNATIONAL TRADE AND FINANCE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Subcommittee met at 2:03 p.m., in room SD–538, Dirksen Senate Office Building, Hon. Mark Warner, Chairman of the Subcommittee, presiding.

OPENING STATEMENT OF CHAIRMAN MARK R. WARNER

Chairman WARNER. I would like to call to order this hearing of the Senate Banking Subcommittee on Security and International Trade and Finance entitled "Reviewing the U.S.–China Strategic and Economic Dialogue". I would like to thank our four witnesses, who I will introduce in a moment, for joining us, and my good friend, Senator Johanns, and his staff for assisting in organizing this hearing.

A few weeks ago, as Secretary of State Clinton and Secretary of the Treasury Geithner were heading to Beijing for the latest Strategic and Economic Dialogue, a diplomatic crisis emerged when the civil rights activist Chen Guangcheng escaped house arrest and made his way to the U.S. Embassy. We have all followed that story and his eventual departure for America. But one of the important outcomes of this episode was that both Nations were able to work with one another even though there was this diplomatic incident going on and to continue their economic dialogue.

The U.S. relationship with China is complicated, as we all know, and there are many complex strategic economic and political differences that exist between our countries. However, I believe there is some evidence of progress on this issue and something I hope we are going to hear from our panelists today on, and that is what we are here to discuss.

Obviously, many Americans, and I am glad to see Senator Brown and Senator Merkley joining us, are concerned about Chinese use of trade policy, including controlling the value of its currency, and the impact it has on American firms and workers. Americans look at the large Chinese holdings of American Treasuries and worry. They look at a trade deficit that has seemed to only grow for years and also they worry. I know we also want to hear today from your comments on the recent announcements in terms of China's ability to buy those Treasuries without any intermediary.

I believe these are all important issues and all raise legitimate concerns, but I think that China's continued growth and deepening ties to the U.S. economy mean that there must be ways we can work to identify and work through the real issues that exist between our countries.

We have seen recently China downgrade its growth projections to 8.2 percent—what we would do for 8.2 percent in this country at this point, but as we all know, with that emerging population, they may need that 9 to 10 percent just to stay even. So, again, we hope our panelists will talk about that.

Reforming China's economic policies, modernizing its financial systems, and rebalancing its economy toward greater consumption present real opportunities for U.S. and China's economic relationship. Also, obviously, that would affect most American families, as well.

I am going to turn to my colleague, Senator Johanns, for his opening comment, and then if—do you have openings? We will try to do those, if we could make them relatively short, because I know we have got a bunch of votes this afternoon. Senator Johanns.

STATEMENT OF SENATOR MIKE JOHANNS

Senator JOHANNS. Well, thank you, Mr. Chairman. I appreciate the fact that you have decided to hold this hearing, and we have also appreciated the opportunity to cooperate with you on that.

With the close earlier this month of the fourth Strategic and Economic Dialogue, I value the chance to review the progress that has been made with China over many years, what we must do to make sure that that progress continues and how that progress will eventually help American companies access the world's largest emerging market.

China presents not only extraordinary opportunity, but, I believe, we would all acknowledge it also presents extraordinary challenges. I had the great fortune as Secretary of Agriculture to actually participate in the Strategic and Economic Dialogue process and engaged in bilateral trade negotiations with the Chinese. Our work in developing agricultural trade in goods like soybeans and corn and cotton, that would be one of the success stories of our relationship with China. And, of course, as a Senator from Nebraska, I am eager to figure out ways to expand the opportunities for trade in agricultural products.

As we all know, more Chinese consumers equals more American exports which directly equals more American jobs. Last year, the U.S. exported about $130 billion in goods and services to China, supporting more than 600,000 jobs domestically. There is no reason why, working closely with Chinese to implement some much-needed reforms, last year's level of exports could not be doubled, maybe even tripled.

I am very encouraged by recent news coming out of China that the leadership is beginning to understand the importance of a transition to a consumption-based society and the scope of the efforts necessary to achieve that kind of transition. But we all know that none of this is easy. It is probably not going to happen overnight. But there remain a few issues of major importance that must be worked out.

Currency issues, of course, are always a subject of conversation with the Chinese. Great strides must be taken in even-handed and predictable enforcement of the law, specifically intellectual property rights. The regulatory system must become more transparent and treat entities fairly without regard to nationality.

For example, an issue of great importance to Nebraska, China must stop discriminating against American-grown beef. And to touch on the focus of the hearing today, financial markets must be opened further to allow institutions with innovative new products that will greatly benefit the Chinese to have access to that market.

So again, Mr. Chairman, I thank you. I look forward to hearing from the witnesses.

Chairman WARNER. Thank you, Senator Johanns.

If any other Senator would like to make an opening statement. Senator Brown.

STATEMENT OF SENATOR SHERROD BROWN

Senator BROWN. Thank you, Mr. Chairman, for holding this hearing, and thank you very much to the witnesses, especially Mr. Bergsten. Thank you for your insight and your wisdom and your guidance over the years, especially on currency issues, but on so much more, and I will be brief, Mr. Chairman.

The latest round, as said, concluded earlier this month. It is important this Committee note how these talks are actually addressing or not addressing the imbalances in our trade relations with the People's Republic of China. The Administration and editorial pages argue over and over that China has to alter its economic approach to build domestic consumption, and we know what that would mean for us if they begin to do that better. That is good news in terms of the potential for them to focus on domestic growth rather than sort of a simple ongoing export-led approach. But if we do not get access in terms of our exports for their markets, this may undermine our recovery and undermine job creation here.

For U.S. companies to get access to the Chinese market and to its consumers, they have had to set up operations there, as we know, the way China has done it. And all too often, they do so with joint ventures and technology transfer requirements, which I know mean a lot to Mr. Garfield. Now the Administration has announced a model bilateral investment treaty that in many ways will actually pave the way for more U.S. investment in China. But will that investment treaty actually promote exports from the United States to China and ensure new barriers that do not discriminate—that they do not discriminate against U.S. goods and services, including banking services? Those are some of the questions we need to ask.

I think this is probably the first time in history, I believe, where a business, where a number of companies' business plans have included shutting down production in our country, moving it to another country, producing there, and selling back into our country. I do not think that is a business plan that works long-term for our companies and for our jobs and for our communities in this country and I think it is time we—we clearly are beginning to reexamine that. I think we need to continue that.

Thank you, Mr. Chairman.

Chairman WARNER. Senator Bennet or Senator Merkley?

All right. Let me go ahead. I have got a series of questions, as well, on that same subject that Senator Brown has raised. Let me get to the witness introductions, though, so that we can get to what I hope will be a good conversation.

First, we have Mr. Stephen Roach, who is a Senior Lecturer and Senior Fellow of the Jackson Institute at Yale University. For over 30 years, he has been a highly regarded economist on Wall Street and globally. Just in February, he transitioned to academia—congratulations, I think—and full-time at Yale, following a distinguished career at Morgan Stanley Asia as Executive Chairman and Chief Economist.

As Senator Brown said, a familiar face to many of us, Dr. Fred Bergsten has been Director of the Peterson Institute for International Economics since its creation in 1981. He has advised multiple Presidents on trade, international affairs, and economics since serving under Henry Kissinger at the National Security Council. Again, we thank you for joining us again, Dr. Bergsten.

Mr. John Dearie has been Executive Vice President for Policy at the Financial Services Forum since 2001. He previously spent 9 years at the Federal Reserve Bank of New York and was appointed an officer of the Bank in 1996. Before joining the Federal Reserve, Mr. Dearie was Managing Director of the Financial Services Volunteer Corps, which helped build banking and financial service systems in developing countries.

And then someone who I have had the opportunity to work with on a series of occasions, Mr. Dean Garfield was elected President and CEO of the Information Technology Industry Council in October 2008. Before joining ITI, Dean served as Executive Vice President and Chief Strategic Officer for the Motion Picture Association as well as Vice President of Legal Affairs at the Recording Industry Association. He has helped both industries manage global strategy, intellectual property, policy, and litigation.

Good panel, so let us get to their testimony. Mr. Roach.

STATEMENT OF STEPHEN S. ROACH, SENIOR FELLOW, JACKSON INSTITUTE OF GLOBAL AFFAIRS, YALE UNIVERSITY

Mr. ROACH. Thank you very much, Mr. Chairman. It is a pleasure and an honor to participate in this timely hearing this afternoon. There is no international economic issue that is of greater importance to you in the Senate and to your colleagues elsewhere in Washington than our economic relationship with China.

I have participated in hearings like this for a number of years, as has my friend and colleague, Dr. Bergsten. Yet I have come to a somewhat different conclusion than he has, so we are going to thoroughly confuse you this afternoon, which is always the risk when you invite two economists to comment on anything.

My conclusion is that over the past 7 years, there has been far too much emphasis in this great body on the currency issue as the principal way in which China needs to be addressed in the international economic policy arena. In particular, by focusing on the U.S.–China foreign exchange rate, you are implicitly presuming that there is a bilateral solution to what is really a much broader problem facing the United States. I think this approach has outlived its usefulness, and I think it is incumbent upon you to think of a new framework to address China. So what I would like to do in the next 3 or 4 minutes is simply to demonstrate to you why this approach is the wrong approach and what might be a more productive approach in the years ahead.

First of all, there are four flaws in the Renminbi currency fixation syndrome which many suffer from today. Number one, our trade deficit is multilateral. We have trade deficits with 88 countries. Yes, China is the biggest, 34 percent of the total U.S. multilateral imbalance since 2005. But by higher math, that means there are another 87 countries we that have deficits with. It is a multilateral imbalance in large part because we do not save as a Nation—reflecting our massive budget deficits and a sub-par household savings rate. So if we do not address the sources of our multilateral imbalance and focus solely on the Chinese piece, it is like stepping on a water balloon. The water just goes somewhere else, most likely to a higher cost producer. That would be the functional equivalent of a tax hike on middle-class American workers, which I know none of you would like to see. The bottom line here is you cannot fix a multilateral imbalance with a bilateral exchange rate.

Number two, the currency constituency in the U.S. Senate, led initially by Senators Schumer and Graham in 2005, has been very focused on this ever since they initially demanded a 27.5 percent revaluation of the Renminbi versus the dollar. The last time I checked, the Renminbi is up 31.4 percent against the dollar, so they should go home and declare victory. And, yes, China has done it gradually. Your colleague in the Senate have always wanted it to occur overnight. But it is not clear that the economics suggests that you get to a different place if you do a gradual or a large one-off revaluation. In any case, China is mindful of the horrible mistake that Japan made in listening to similar advice that we offered them in the mid-1980s when they actually did a one-off sharp revaluation of the Yen, Japan has been on its back ever since.

Third, we hear repeatedly that a sharp revaluation of the Renminbi is the answer for global imbalances—that it will address China's trade surplus, America's current account deficit, and global imbalances. I think that view is just wrong. China's current account surplus is diminishing very sharply, from 10 percent in 2007 down to two-and-a-quarter percent this year by the IMF. So you need to update that view.

Similarly, I think the Washington view on China's international imbalance, led by Fed Chairman Bernanke, has been to blame China's surplus savings glut as the source of many problems that the U.S. faces. This year, America's current account deficit of about $510 billion will end up being 2.8 times the size of China's sharply reduced surplus. So the U.S. is actually a much more serious source of global instability today than the so-called savings glut in China.

And then, finally, the idea that China is the world's factory needs to be updated. It is much more the world's assembly line. About 20 to 30 percent of all Chinese exports represents value added is made in China. The balance reflects value added made elsewhere in Asia. Sixty percent of Chinese exports come from Chinese subsidiaries of global multinationals. This is not a currency issue. This is just a manifestation of globalization. Think Apple, for example.

I apologize I have gone over. Let me try to wrap it up in about two more minutes.

I promised you not just to trash the currency constituency but also to stress—and this is my punch line—that you need to come up with a new framework in viewing China—not as a threat but as an opportunity. Several of you did correctly allude to the market access issue in that regard.

I would just make four simple points here. Number one, the jobs in America are not being necessarily squeezed because of currency misalignments in the world. The U.S. dollar, broadly measured by the Federal Reserve Board, is down 25 percent since 2002, and yet our job situation is terrible, as you know. I think that reflects less the currency misalignments and mainly the fact that our major source of aggregate demand, the American consumer, is on ice. Consumer spending, 71 percent of the economy, has grown six-tenths of a percentage point at an annual rate over the last 17 quarters. Without consumption, without demand growth, companies will not hire and they have not.

So that brings me to my second point, which is we obviously need a new source of growth. I would agree with Senator Johanns that exports are at the top of the list. Goods exports are now 10 percent of our GDP, which is a record. But I also agree with you, Senator—we can go a lot higher. China is our third largest and most rapidly growing export market, and with anemic growth of U.S. exports in Mexico and Canada, and, needless to say, a horrible outlook for Europe, we have got to look to China.

And then, third, take a careful look at the "Next China." It is not that they are just talking about changing the model. They have to change the model because an export-led demand growth model in China does not work in a treacherous and weak global environment. So when you think about China, you have got to think of a consumer-led growth model with great opportunity for manufactured goods producers in the U.S., but also for service companies—not just finance but a whole broad array of nonfinancial services in the distribution and transactions processing areas.

So my conclusion is, you are right. Market access is the new issue. Currencies are the old issue. Get off that one. Do not waste your time on that. Do not keep fixating on China's need to revalue the Renminbi. They have done it and they are still doing it. But the next China is what you should be focusing on, not the last China. Take the high road, not the low road.

Thank you very much.

Chairman WARNER. Thank you.

Mr. Bergsten.

STATEMENT OF C. FRED BERGSTEN, DIRECTOR, PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS

Mr. BERGSTEN. Mr. Chairman, it is a great pleasure to be back before the Committee. Congratulations on holding the hearing. For the reasons I will indicate, I think this is very important stuff.

I just want to make three main points. First, the critical need for the Strategic and Economic Dialogue. Second, tangible results to date—has it been worth it, has it been a success. And third, what is the future agenda. I will resist the temptation to get into an extensive dialogue with Mr. Roach about exchange rates. I think he is flogging a little bit of a dead horse for reasons that I will indicate.

First point. I have been proposing for a number of years that the United States and China create an informal G2 to help steer the world economy. The reason is very simple. Progress is impossible on most important global economic issues today without agreement by these two global economic superpowers. Examples include exchange rates in the international monetary system, the world trade regime, climate change. There are many others.

The G2 should be completely informal and even unannounced or even acknowledged by the two countries. As the Nike ad says, "Just do it." But they should seek to forge close working cooperation on the whole range of global issues, which is essential for achieving progress on bilateral problems or in implementing their global leadership responsibilities as the world's two largest economies.

Now, the most overt and visible step toward creating a G2 is the very frequent meetings between President Obama and the top leaders of China. Ever since President Obama has been in office, he has met every quarter with either President Hu or Premier Wen, and that is a movement toward a G2 by any name. But the Strategic and Economic Dialogue that we talk about today is by far the most extensive institutionalization of the concept. It brings cabinet officers together once a year. It has launched ongoing dialogue among many groups of officials on many topics.

I, therefore, believe that the S&ED is a crucial component of U.S. foreign policy, national security policy, as well as economic policy. It must be continued and, indeed, strengthened. Its ever expanding agenda of topics and discussion forcing, if not yet action forcing nature, are extremely important. The Administration should be congratulated for the priority it has attached to the dialogue. It should continue and accelerate that focus in the future.

Point two, abstract pursuit of a G2 or a cooperative relationship is unlikely to win widespread support now that it has been operating for 3 years. So the question is, have there been tangible results that suggest beneficial practical payoffs from the exercise?

Now, the dominant issue of this period, though Steve Roach did not like it, has been the extensive currency manipulation for China. For at least 5 years, the Chinese blatantly intervened in the foreign exchange market by buying $1 to $2 billion worth of dollars every single day to keep the price of our currency high and their currency low. That, of course, produced an enormous competitive advantage for China in world trade. It produced a global current account surplus for the Chinese that exceeded 10 percent of its whole economy at its peak 5 years ago and an unprecedented buildup of $3.3 trillion of foreign exchange reserves. So the U.S. has rightly focused on this issue at every meeting of the S&ED as well as in many other contacts with the Chinese.

In recent years, and here I agree with Steve, it has embedded the currency issue in the broader rebalancing question, the need for China to alter its development strategy away from export-led growth in the direction of relying on domestic demand.

My key point, however, is that it is now apparent, as Roach also said, that the U.S. strategy has succeeded to a substantial degree. China's global current accounts surplus has now declined to less than 3 percent of its economy. That is primarily due to the rise of more than 30 percent in the trade-weighted average of the exchange rate since 2005, a rise of more than 40 percent against the dollar. I have attached to my statement an analysis by one of my colleagues, Bill Cline, that shows that if the Chinese continue to permit the currency to rise at the rate of the last 2 years, China's current accounts surplus could actually disappear over the next 2 or 3 years.

So we should, indeed, declare at least an important degree of victory. Now, we have got to remain on the case because we cannot be assured China will let the rate continue rising. In fact, it should rise more to completely eliminate their current account surplus. That would be a desirable thing. But I do believe that the progress on this very difficult and highly contentious issue marks both a major step forward in the U.S.–China economic relationship and a signal achievement for the S&ED itself.

Finally, and very briefly, there are, of course, as Steve said, lots of other very important issues in this relationship. I talk about a couple of global economic issues. No time to discuss them now, the euro crisis and such. I am happy to come back to that later.

But there are many bilateral, including trade, issues that have to be addressed. The S&ED did cover an impressive array of them. It is particularly important that China has agreed to negotiate new international rules on export finance over the next couple of years. This is a major area of international competition and contention. It is a big area of export subsidization. China is not part of the current rules because it is not in the OECD. The commitment to do a new arrangement in this area is very, very important.

But my punch line here is that I think it is going to remain difficult to successfully resolve the large number of our bilateral trade conflicts as long as they continue to be addressed in a purely ad hoc manner. We can take some cases to the WTO, but that is minor stuff. In most cases, we do not have any agreed rules of the road.

Therefore, I will make the breathtaking proposal that the U.S. and China should consider launching negotiations for a bilateral trade agreement to provide a comprehensive framework to deal with the daunting array of economic problems between them, a list that is likely to continue growing as the economic relationship deepens further. Such an effort could even aim to develop a U.S.–China Free Trade Agreement over a period of a decade or so, as has been proposed by some leading U.S. businessmen who have lots of experience in China. Another alternative would be to look for an early occasion to bring China into the negotiations on the Trans-Pacific partnership, which aims to create a Free Trade Area of the Asia Pacific.

Any effort of that type would represent an extension of the G2 concept into the trade policy area, as I believe inevitably must occur at some point. The S&ED could productively begin that conversation, which, of course, carries major foreign policy as well as economic dimensions. So building on its considerable progress to date, I think the S&ED has a rich potential agenda for the years ahead and can be enormously valuable.

Chairman WARNER. Thank you.

Mr. Dearie.

STATEMENT OF JOHN R. DEARIE, EXECUTIVE VICE PRESIDENT FOR POLICY, FINANCIAL SERVICES FORUM

Mr. DEARIE. Senators Warner and Johanns, thanks very much for holding this important hearing. It is vitally important. I very much appreciate the opportunity to be here.

As you have heard already, the rate of China's economic emergence and the impact of its integration into the global economy are unprecedented in the history of the world's economy with profound implications for U.S. economic growth and job creation. But harnessing China's growth and job creation potential requires a number of important structural reforms in China, including financial reform and modernization. In my time with you today, I am going to try to help connect the dots between faster financial reform in China and jobs in the United States.

Since China joined the WTO in December of 2001, U.S. exports to China have increased more than six-fold, growing at seven times the pace of U.S. exports to the rest of the world. China, as you heard earlier, is now America's third largest export market, the largest market for our products and services outside of North America.

For your reference, I have provided in Exhibit A of my written testimony figures that show the growth in exports to China from each of the States represented by Members on this Subcommittee. As an example, Chairman Warner, exports from Virginia to China have increased nearly 800 percent since the year 2000, as compared with growth of just 42 percent in Virginia's exports to the rest of the world. Each of the other States represented on this Subcommittee have posted similarly impressive growth rates in exports to China.

At the Financial Services Forum, we have estimated that if China's citizens were to eventually consume American-made goods and services at the same rate as their neighbors in Japan currently do, U.S. exports to China could grow to as much as $700 billion a year, nearly twice what we imported from China last year, potentially turning a $300 billion trade deficit into a $300 billion trade surplus and creating nearly three million new American jobs. That will not happen overnight, to be sure, but we believe that with the right reforms in place, it will happen over time.

The good news is, as you have heard, is that after three decades of pursuing a manufacturing for export economic model, China's leadership now wisely seeks a more balanced economic model that relies less on exports and fixed investment and more on internal demand, primarily a more active Chinese consumer. But accelerating the shift to a more consumption-based Chinese economy requires a more modern and sophisticated financial sector. Chinese households, as you know, currently depend on their families and private savings to pay for retirement, health care, and the economic consequences of accidents or disasters, with the effect that they save anywhere from a third to even half of their incomes.

Activating the Chinese consumer requires the broad availability of financial products and services, things that we take for granted, personal loans, credit cards, mortgages, pensions, insurance products and services, and retirement security products that will eliminate the need for this precautionary savings on the part of the Chinese and facilitate greater consumption. A recent report by the World Bank called "China 2030," among other findings, confirmed this observation.

The S&ED was created in 2006 in large part to accelerate financial reform in China. Since then, as you just heard from Mr. Bergsten, incremental but meaningful progress has been accomplished. Still, China continues to impose substantial obstacles on U.S. financial institutions operating in China, including caps on investment by U.S. firms in Chinese financial institutions, nonprudential restrictions on licensing and corporate form, arbitrary restrictions on permitted products and services, and arbitrary and discriminatory regulatory treatment.

The fastest way for China to get the modern financial system it needs, and as Mr. Roach indicated, they have already initiated this transition toward a more consumption-based economy, but the fastest way for them to get the financial sector that that shift requires is to open its financial sector to greater foreign participation by foreign financial services firms.

By providing the financial products and services that China's citizens and businesses need to save, invest, insure against risk, raise standards of living, and, therefore, consume at higher levels, foreign financial institutions, including U.S. providers, will help China develop an economy that is less dependent on exports, more consumption-driven, and, therefore, an enormously important and expanding market for American-made products and services.

Thank you very much.

Chairman WARNER. Thank you, Mr. Dearie.

Senator Johanns pointed out that at least for Virginia and Nebraska, while those tremendous export growths were taking place, a certain two Senators were Governors there.

[Laughter.]

Chairman WARNER. Mr. Garfield.

STATEMENT OF DEAN C. GARFIELD, PRESIDENT AND CHIEF EXECUTIVE OFFICER, INFORMATION TECHNOLOGY INDUSTRY COUNCIL

Mr. GARFIELD. Thank you, Chairman Warner, Ranking Member Johanns. Thank you for hosting this hearing on this important issue. It is critically important not only to our companies, but also to the country.

Before I jump into talking about China, I do want to compliment the Committee on the work that it has done on fostering entrepreneurship and innovation. The passage of the Jobs Act is something that we commend, as well as the introduction of the Start Up Act, Start Up 2.0, yesterday, is something that we strongly endorse. I hope those 30 seconds will not count against my time in talking about China.

I would like to focus my testimony on two specific areas: One, our experience in China as it transitioned from a consumer export-driven economy to a more consumer demand-driven economy; and two, solutions for addressing the challenges that we are encountering on the ground in China.

I am very pleased to be here representing the information and communications technology sector, a sector that is transforming the lives of millions of people around the world and that is a real driver for economic growth in the United States. When we saw the first touch screen portable electronic notebook 40 years ago in the movies, most people thought it was simply fanciful. Today, that is a reality that is integrated in all of our lives.

China has been an important part of that innovation story. The large growth in China's GDP has led to a demand for the most innovative products around the world, many of those products that are developed, distributed by our companies. In addition, China, as a number of the panelists have noted, is an important part of the global supply chain, which has resulted in hundreds of thousands of jobs being created here in the United States.

Unfortunately, it has not been a story of straight-line success. As China has transitioned into, or is beginning to transition into more of a consumer-driven economy, they have decided to put their thumb on the scale, particularly as it relates to innovation policy. There have been previous hearings here before on China's indigenous innovation policy, in particular. Through the work of the S&ED, there have been some successes against some of the most blatant offenses, including foreclosing important aspects of the economy related to State-owned enterprises and Government agencies from competition from U.S. and foreign-based companies.

In spite of the success on some elements of indigenous innovation, it continues apace. New movie or same movie with a new title. China has adopted some more sophisticated strategies for its indigenous innovation policies, but it continues apace.

For example, in the fifth—I am sorry, the twelfth 5-Year Plan, China outlined an initiative to focus on advancing strategic emerging enterprises or industries, strategic emerging industries, and intends to do so through a number of means that are completely inconsistent with global norms, for example, advancing China-specific standards or putting in place local testing and regulatory requirements, or simply pumping resources into those strategic and emerging industries. In fact, China has announced a plan to spend $1.6 trillion directed at the industries that it has identified.

And so the question—the challenge is not only what is happening within the borders of China, but the fact that many other major markets that are export opportunities for the United States are now mirroring the model that has been adopted within China. We see in India, Indonesia, Brazil, and all over the—all around the world, other countries adopting similar indigenous innovation policies which are quite problematic and will result in a stalling of job creation here in the United States.

And so the question is, what do we do about it? We have three things to offer.

One is building on what has been successful. As all of the panelists have noted, the Strategic and Economic Dialogues have been quite successful in our advocacy. I also recall in 2010, when the Senate held hearings on these issues, it had a significant impact. And so a unified U.S. position and a forceful position on trade and pushing back around these indigenous innovation policies, not only in China but around the globe, is critically important.

Second is identifying people and agencies within China, and companies, who have a shared interest with the United States. There are a number of players in that market who share our interest, and taking steps to bolster those players is critically important.

Third and final, I think it is important that we take the opportunities that exist, whether it is the G2, as Mr. Bergsten has suggested, or the G20, which is coming up very soon, to highlight these onerous mercantilist policies as it relates to China but more broadly.

Thank you for the time.

Chairman WARNER. Thank you, Mr. Garfield, and I appreciate everybody's testimony.

We will do 5-minute rounds because I want to make sure everybody gets a chance, at least one or two rounds.

I want to actually—I am going to move from some of the macro questions I have, because I am sure some of my colleagues may raise some of them, but I want to actually start where you left off, Mr. Garfield, which is this question of China creating its own standards, I think, in some of the telecom areas they are looking at, such as, a separate Chinese WIFI standard——

Mr. GARFIELD. Yes, WAPI.

Chairman WARNER. ——different from the international standards, which, in effect, almost becomes a competitive barrier for American and other international firms entering into the marketplace. How do we slow that? How do we get them not to use their own national standards as really a trade tool?

And something that has been suggested to me, and I would like your and anybody else on the panel's comments on this, is it has always scratched my head why it seems that China's ability to play off all of the rest of our countries, our EU partners, Japan and others, one against each other, particularly on the private sector side, where we do not seem to have as much unity of purpose. And one thing that was brought up to me is that there are antitrust and other international preconditions that do not allow some of our major partners to actually talk in a coordinated fashion about how they might take on a China that is dealing with not only individual standards, but in certain places State-owned enterprises which are simply clones for their Government policy or State-operated policy. Comments on that? Ideas on that?

Mr. GARFIELD. Yes, I think you have alluded to some of the answers. The issue you identified around standards and the potential that it holds for closing the market to competitors, including competitors that I represent, is a significant problem. I think there are two strategies that immediately jump to mind.

One is doing what we did with the S&ED, which is though we were consistent as a U.S. Government in our opposition with China, we also worked really hard to build a multinational commitment around the problem with indigenous innovation. And so I think it is important that we are consistent in our own advocacy and unified in our position and forceful in our position, but also we have got to work with our multinational partners to make clear that it is problematic.

The second part of it is to realize that China is playing a game of chess, not checkers, and so we may see these standards like WAPI developing within China, but China is using international bodies to advance their same goals. For example, there is a whole discussion going on at the U.N. at the ITU around standards and what is the proper approach for establishing standards. It is important that the United States take a firm position there, but it is one person, one vote, and so we, again, have to collaborate with our international partners to push back against that kind of an effort.

Chairman WARNER. I want to make sure we get to everybody else weighing in on the panel on this. I also think your point—right before we were coming over here, we were hearing from the IT industry about India trying, not with standards but with other tools, to try to basically emulate China's restrictions. Does anybody else want to add in on this, particularly are there antitrust provisions? Somebody has raised this with me. I do not know if it is a valid concern or not.

Mr. BERGSTEN. I do not know about that. I want to make two quick observations, though. You are absolutely right. The use of national standards to affect competitive positions is the protectionist device de jour. It is no longer tariffs, quotas. That is the kind of thing. That is why I am arguing we need to get China into some kind of trade agreement with us. Those things are not covered by the multilateral rules effectively.

They will be included, to an important extent, in the TransPacific Partnership. That is one of the U.S. goals in that 21st century agreement. And I think it would be strongly in our interest to find a way to bring China into a trade agreement where we could debate explicitly those kinds of rules of the road. It would be tough. There are lots of aspects to it. But that is one of the main reasons I propose that.

On your question about the Chinese playing off the other countries, exactly right. It is our own stupidity. We talk all the time about intensifying trans-Atlantic relations. The U.S. and Europe should be getting together. If the U.S. and Europe should be getting together on anything, it is this, a common threat toward Europe. But what happens? When the European leaders go to Beijing, they want to sell Airbuses. When our leaders go, they want to sell Boeings. It is a competition rather than a cooperation. Now, with a little subtlety, you can do both, but we certainly should be coordinating with our allies.

I think it is right. One of the reasons that at least the first version of the National Indigenous Innovation Policy was rolled back a bit was because it was a pretty coordinated approach from main trading partners of China coming in to harangue them on the issue. It can be done and we are simply short-sighted not to do it.

Chairman WARNER. I want to be sensitive to my colleagues' time, so maybe in a second round I will get Mr. Dearie's and Mr. Roach's comments on that.

Senator Johanns.

Senator JOHANNS. Well, let me thank each of you for being here, some excellent testimony.

I am going to start with you, Mr. Bergsten. I find your proposal on a trade agreement sort of approach an interesting approach, but let me, if I might, offer a dimension to that and then maybe another approach that I would like your thoughts on.

The dimension I would offer is that, as you know, trade agreement negotiations are painstakingly slow. They typically extend over many, many years. The world is changing so fast. This is an economy we want to access now as aggressively as we can. And then at the end of the day, they are hard to get passed. There are strong differences of opinion about the value of any trade agreement, and then you have individual interests that weigh in. So this gets to be a complicated process.

It should not dissuade you. I support trade. I think I have supported every trade agreement in the last 20 years. But let me offer another thought, another approach, maybe, and again, I would like each panel Member's kind of quick comment on this.

I thought the Strategic and Economic Dialogue actually worked quite well. I happened to be there at the meeting with the President when Secretary Paulson proposed it. It kind of caught my attention. I saw it come to fruition, participated in some of that. It actually worked well.

If I had one concern about it, there was a tremendous amount of time and effort and preparation put into that on both sides, Chinese and the United States. You would have this 2-day meeting effort. Everybody would get their item on the list. We would talk through those items, work through it. But then you would not get back together again for a while.

I often wondered if it was—as an addition to it, do an approach that basically said, look, there are certain areas—it might be telecom, it might be agriculture, it might be financial services—and literally have subsets of that that kind of filled in that interim period of time, where you could literally work through these issues like Mark has raised and then bring that back to the economic dialogue so you did not lose track as the months passed of these very, very significant items that could be make or break items for a given industry.

Let me start with you. What is your reaction to that? And then if I could just go around the panel quickly.

Mr. BERGSTEN. I think you are absolutely right, and that has, in fact, been the evolution of lots of international institutions over the years, as you know. G20 was preceded by G7, preceded by G5. They originally started with a single annual meeting, but then created sherpas to implement the process over the course of the year, set up subgroups of the type that you suggest.

So I think that would be a natural evolution, would be highly desirable. It would go very much in the direction of my G2 because it would then foster habits of cooperation, channels of communication in which an official in Beijing could pick up the phone, call here when she or he had a concern and vice-versa, and you develop that thick network of collaboration.

We have that to a large extent with the European countries from having worked with them for so many decades. We need now to foster it with China, and your route, I think, would be a very promising one to pursue.

Senator JOHANNS. Mr. Roach, what are your thoughts?

Mr. ROACH. I think that the collaborative network between U.S. and Chinese officials, of which I have actually been privileged to speak to senior officials on both sides for a number of years, is really gaining momentum. Under the auspices of what was initially the Strategic Economic Dialogue, now the Strategic and Economic Dialogue, the momentum is continuing.

I think one of the most important things that has occurred over the last, now, 11 years with respect to China and the world has been China's accession to the rules-based WTO framework which is a means of accountability that we can now rely on. The Chinese will protest from time to time, as will we, if charges are brought against them or us. But the rules-based framework that Fred has alluded to is a powerful one.

I think, however, the politics and many of the reasons that you raise, Senator Johanns, on the pragmatic aspects of going for an FTA would really rule that option out. It is just not a realistic goal for the foreseeable future. Maybe someday we will get there, and I would be very much in support of that. But formalizing more of a secretariat type of arrangement where there is constant and formalized accountability of agreements that have been reached at various bilateral meetings would be a more productive avenue to pursue. I think it would be a very important and positive contribution.

Mr. DEARIE. Senator, I agree. As a general matter, I am in favor. As a general matter, I am very supportive of the ambitious ideas that Fred put on the table. I recognize some of the political practical issues that Mr. Roach is talking about. But any kind of high-level consistent engagement with China, I think, works entirely in our favor.

I think that you make a very, very good point that that engagement also needs to be coordinated with Europe. There is very little doubt, based on my observation, that China does, or has in the past, played a, or pursued something of a divide and conquer strategy. And to the extent that we and the Europeans can coordinate our pressure and our demands on China, not only does that make more sense logically, but it has worked in the past, as Mr. Bergsten just described, in terms of some of the other problems in the past.

So as a general matter, more areas of high-level engagement with China, coordinated with the Europeans, work very much in our favor.

Your specific comment on the S&ED, I think, is also well taken, and I would point out—I am sure you know this—the original SED, Strategic Economic Dialogue, Number One was very focused on economics and finance, financial reform and economic reform in China, and it was twice a year. When the Obama administration came into office, they expanded the dialogue to be the Strategic and Economic Dialogue and included into the dialogue a lot of other issues, strategic issues, military issues, environmental issues, human rights issues. I am not quibbling with that. This bilateral relationship is very complex, to be sure. And then they reduced the number of meetings to once a year. And so the practical effect of expanding the range of issues on the table and limiting or cutting in half the number of times that you meet every year just has the practical effect of limiting, I think, or slowing down some of the progress that can be made.

Clay Lowery, who served in the Treasury Department when the dialogue was the Strategic Economic Dialogue, happened to testify last week before the House Financial Services Committee and he spoke to this in very eloquent terms, and he spoke specifically about having a twice-a-year high-level engagement creates a much more of a momentum and puts firm markers out there on a more frequent basis in terms of when deliverables have to be accomplished. And then, just as importantly, you see the people on the other side of the table more often. And this element of trust, personal trust and personal engagement and getting to know your counterpart on the other side of the table, particularly in the context of our engagement with the Chinese, is very important.

Mr. GARFIELD. Can I——

Chairman WARNER. I am going to have to call on Senator Merkley.

Senator MERKLEY. Thank you, Mr. Chair. I have to go preside, so I am just—I had wanted to explore an issue. Unfortunately, I am just going to be able to raise it. Maybe my colleagues will explore it.

After the group of 10 Senators, bipartisan delegation, went to China last year, and we heard a lot of insights from our foreign diplomatic personnel, economic analysts, our companies doing business there, it gave me a more comprehensive picture of the tilted playing field, and I would categorize that in really four components: The weak enforcement of labor and environmental laws; currency manipulation; direct subsidies; and nontariff barriers.

And many of those pieces have been mentioned here. We have talked about technical standards that Senator Warner raised, nontariff barriers, indigenous innovation, which fits into that category. Not a lot of discussion of the direct subsidies. We did in the course of last year around the trade treaty debate raise the issue of the direct subsidy that China is supposed to report under the WTO. It has only done so only once in 10 years.

Shortly after we raised that and raised the concept of a bill that would require our Trade Representative to do counternotification as authorized under the treaty, our Trade Representative went ahead and did counternotification, raised a list of 200 subsidies that China does directly to its companies, items for export, and it was a fascinating list. If I could stay, I would get your insights on that list. But the fact that it revealed a huge energy strategy, a paper strategy, a famous brands strategy, all of which have not been raised or discussed in this conversation and really merits exploration. Take these four areas together and all the subcomponents and China has a comprehensive approach.

And as we look out across America, we see a loss of millions of jobs over the last 10 years, and if we do not make things in America, you really do not have a middle class. And so we have to wrestle with this in a comprehensive fashion. Unfortunately, my Committee Members are going to continue pondering that along with all of you, and thank you very much.

Chairman WARNER. Thank you, Senator Merkley.

Senator Bennet.

Senator BENNET. Thank you, Mr. Chairman, and thank you for holding the hearing, and thank you for your excellent testimony. It really has been a fascinating discussion.

Mr. Garfield, I wanted to start with you on your second proposed solution, as I recall, which was the notion that we should be finding companies in China that have, as I understood it, aligned self-interests with some of the things that we want. I wonder if you could say a little more about that. I guess that might be actors that want a strong IP regime or—is that what you have in mind?

Mr. GARFIELD. Exactly. It actually connects with the point that the Ranking Member was making earlier about doing a side dialogue. As it turns out, in the innovation hearing that is occurring, and the way that it is happening is with expert to expert around innovation, the challenge we have is when you only have China at the table, it is hard to bring international pressure or additional pressure beyond the United States.

One of the things that I have identified and we have found generally as a sector in operating in China is that it is a huge country and a huge bureaucracy, if you will, and there are agencies and provinces that have ambition of driving innovation and driving growth, but doing it in a way that is consistent with global norms. And so identifying those emergent companies as well as those emergent players within the country, I think, is important, an important part of our strategy.

Senator BENNET. Are there—putting the geography aside for a second, although that is a very interesting insight—are there particular industries that you think we could go farthest fastest with in terms of creating a regime that actually would work better?

Mr. GARFIELD. I think one is certainly our sector because of the opportunities globally. The other thing about our sector is it evolves so quickly——

Senator BENNET. Right.

Mr. GARFIELD. ——and so players in China see the global opportunity and they are also adversely impacted, not on a grand scale, but there are some companies within China that are impacted by the policies that are put in place that are intended to promote and advance those sectors. And so I would say that our sector is one to look at as an opportunity for finding aligned interests.

Senator BENNET. I wanted to follow up on one of the implications of Jeff Merkley's question, since he had to leave, and I wanted to do it in the context of solar panels. There are two interesting sides to this argument. The Commerce Department, I think, recently announced that it was raising tariffs on solar panels because it found the Chinese were dumping them into the global market. I have observed over the last couple years that our largest single export from the United States is the aircraft, $30 billion a year. I think the solar panel exports from China is about $15 billion a year. That is not trivial. It is half of our largest single export.

And you have people that look at this and say, well, this is good because this is going to mean that our manufacturing sector is now going to be able to manufacture solar panels again, which some of us believe were actually invented not just in the United States but in the great State of Colorado. But then there are other people that say, you know, if the Chinese are willing to subsidize this to this degree and our interest really is in trying to move into alternative sources of energy and be able to do better conservation and be able to do the sorts of retrofits in our buildings, that is where the jobs really are and that is where the wage growth really is.

I wonder if you have a perspective, just as a—not necessarily on that case or solar panels, even, but how we as policy makers should think about this relationship with China in the context of wanting to create jobs here in the United States, wanting rising wages here in the United States, and wanting to recouple our own economic growth with job growth and wage growth.

Mr. ROACH. Can I just tackle that, because it is a critical issue. I will comment briefly, and I will do it at the macro level. I am sure my fellow witnesses can bore in on a little bit more specifically.

You are talking here really about two totally different systems of economic organization. We protest a lot about, as Senator Merkley said, about the subsidies, the plan, the energy plan. China is in the midst, as several of us have said, of their twelfth 5-Year Plan. This is a Soviet-style structure that was first developed in the early 1950s. The first four or five of these 5-Year Plans were total unmitigated disasters. It was not until the late 1970s with, I believe, the fifth 5-Year Plan that was formulated by Deng Xiaoping in the aftermath of the Cultural Revolution, when China was on the brink of total failure as an economic system, that they got their act together.

In the subsequent six or seven 5-Year Plans, they have moved their model forward to what they call a socialist market-based system, and the twelfth 5-Year Plan is far more market-based, far more consumer-based, and, therefore, far more in our interest as an exporter than China has ever been.

They have done an extraordinary job of taking an economy that was on the brink of failure 32 years ago to what is today the world's second-largest economy, but they have got miles to go. Their per capita income is 10 percent of ours. They still have got 600 million people living in relatively impoverished levels in the rural countryside.

So is their system wrong for them? It is not our system. It is not right for us. But the question that Senator Merkley seemed to be alluding to is that we should take tremendous exception at the system that they have put in place to drive economic development. With all due respect to the Senator, I think that system has worked extremely well for them in getting to this point, but it will not work that well in the future. The Chinese have said that. They know that. They are changing.

And that goes back to the comments that I made at the outset. We have got to look at where China is going and gear our own strategy, whatever that is, to thinking strategically about how we can really take advantage of the growth opportunities and the job opportunities that we can derive from where China is headed—not from where it has been.

Mr. BERGSTEN. I would like to give a simpler but complementary answer to your question. Economists agree on very few things. You can see it here today. But practically all economists agree on the virtues of free trade. And the answer to your question, the tradeoff between getting cheaper goods for our consumers versus avoiding an unlevel playing field, really goes to that fundamental truth. Free trade is good for our economy, but when the other country cheats, you want to counter it because that violates the very principles of free trade, and that is the need, then, for international rules of the game, the WTO, but it does not cover a variety of these subsidies we are talking about today.

So I think the presumption, in answer to your question about solar panels or anything else, is that we want to have maximum openness of trade, but if the other country is cheating, through manipulating the currency or subsidized credit or any of a variety of practices which are an inherent part of the Chinese system, as Steve outlines, then you have got to counter that, and over time, try to get to systemic changes to rectify it.

Mr. GARFIELD. I also think when the other country is cheating, we cannot do things to shoot ourselves in the foot. And so there are a number of initiatives that are on the docket for this Congress that could help to make the U.S. more competitive, whether it is tax reform, immigration reform where we educate our best and brightest and then ask them to leave the country or make it very difficult for them to do, cyber security and making our systems more secure. And so we do not have to look very far to see a list of policy priorities that can make the U.S. a lot more competitive.

Mr. BERGSTEN. If I could just add one more sentence, there is a well known theorem in economics called the Theory of the Second Best. If the other guy is subsidizing and you cannot get him to stop, there is a very strong case for your subsidizing to match him. That is the issue of export credits. We do not really love, I think, having an Export-Import Bank or other procedures that subsidize our export finance, but since the other guys do it, you have to match. And, in fact, if you do not match, then there is no way of getting them to desist. So you want to have a two-track strategy. You want to match, but then you want to use that leverage to try to get them to roll back, and that is the case across the board and you have to implement it item by item. But those are the basic principles, I think, that need to apply. Thank you.

Mr. ROACH. And just for the record, I strongly object to the word "cheat" to characterize China's behavior as a developing economy.

Mr. BERGSTEN. I want to reiterate it.

Chairman WARNER. That would be where I want to start the second round, and again, the witnesses have all got great information. I would ask you to please—we have got——

Mr. DEARIE. I will be brief.

Chairman WARNER. We are interested questioners and we would really appreciate if you could try to keep your answers a little briefer.

I do think it is curious that some of what Senator Bennet and others were talking about kind of falls under the rubric of industrial policy, and some of our colleagues who abhor any notion of America having an industrial policy then say, and look how we are getting beat by China. An interesting contradiction.

I want to come back, because I probably more fall closer to Dr. Bergsten than Mr. Roach on some of these issues, because I do have concerns and I would like to give Mr. Dearie and Mr. Roach an opportunity to answer the last question. Are we missing opportunities for American enterprises to collaborate with Europe, Japan, others, in having an organized approach vis-a-vis China?

I would like, as well, then, as others answer in on this, I will try to get all my questions into one, because I know you all even with that admonition are going to go longer on your answers. The whole notion—and one of the things that Treasury recently announced that State-owned enterprises in China are about to increase their dividends. What does that mean for Chinese consumers? Will that move, again, a good sign toward consumption, or does it mean that this is again playing on an unlevel playing field because the State-owned enterprises are getting additional support systems?

And one thing that has been touched on by Dean briefly but not really hit on, and this is where, Mr. Roach, I will take exception to your characterization, because whether it is State sanctioned or quasi-State sanctioned, the amount of intellectual property theft and cyber attacks that are being generated by China, I think, are outrageous and in direct opposition to any kind of ascension to world standards.

So let us start with Mr. Dearie and Mr. Roach, and with the admonition that I have only got 3 minutes before Senator Johanns is up.

And I also want to add, I think Senator Johanns's comments, and we are talking already about seeing how we might formalize some of those efforts to make sure the S&ED becomes this ongoing process. I think you raised an excellent point.

Mr. Dearie and Mr. Roach first.

Mr. DEARIE. I will be as brief as I can be because I understand the time constraint. I think that your point about greater international cooperation vis-a-vis the Chinese is an excellent one. I would note very specifically with regard to the U.S. Strategic and Economic Dialogue with China, Europe has its own similar Strategic Economic Dialogue. I think they call it the High Level Dialogue or something to that effect. I am not sure if I have the words correct, but still, it is modeled after our S&ED and so they have an independent line and format of negotiation.

There certainly must be opportunities for greater coordination between we and the Europeans and potentially even the Japanese, as you suggest. I do not have any specific ideas about how we might accomplish that. I will give that some thought and get back to you——

Chairman WARNER. Are there any things that are precluding that cooperation at this point?

Mr. DEARIE. I do not——

Chairman WARNER. Anything that is formalized?

Mr. DEARIE. I am not aware of anything that would preclude it, no, except for the inherent complexity associated with doing a multilateral approach, but we have done that before. So I will give that some thought, and if we come up with ways that we can accomplish that, we will certainly share those with you.

In terms of your specific question with regard to the higher dividends being paid by State-owned enterprises, we actually think that that is a good thing. There is a tremendous amount of money that is locked up in the State-owned enterprises in China. This is part of what has been called a financial repression of the Chinese consumer. Interest rate regulations are part of that, as well. But certainly as the State-owned enterprises begin to increase their dividends, begin to pay out a lot of this money out to Chinese consumers who might be shareholders in State-owned enterprises, it will certainly be a step in the right direction in terms of increasing consumer consumption.

Chairman WARNER. Mr. Roach.

Mr. ROACH. Just a couple of quick things: One, rightly or wrongly, the Chinese feel that over the last 150 to 200 years, they have been maligned severely by the West. This goes back to the Opium Wars of the mid-19th century. I think the idea that we should forge a grand coalition between ourselves and Europe and gang up on the Chinese probably would not go over very well in that respect. There are international forums like the WTO that are very appropriate for addressing the Chinese.

Second, the Chinese are doing this pro-consumption transformation. They need enormous help, and that help is our opportunity. If there is one thing that we know how to do in the United States, it is how to take a consumption model to excess. We are the world's greatest consumers, unfortunately, to a fault. We have gone well beyond what economic fundamentals suggest we should have done. But we have built up industries and systems in goods and services that could be of enormous benefit to the Chinese.

And I would stress here services in particular—retail trade, wholesale trade, domestic transportation, supply chain logistics. The infrastructure in those areas in China is tiny compared to the scale of their economy. These are opportunities of enormous scope and scale that could be hugely beneficial to us in taking advantage of this transformation.

Chairman WARNER. Thirty seconds, only, Dr. Bergsten and Mr. Garfield, on State-owned enterprise, dividend policy as well as any brief comment on IP or some of the cyber issues.

Mr. BERGSTEN. Yes. I think the dividend policy is a big step forward. The State-owned enterprises are still largely retrograde dinosaurs. To the extent that they keep their own profits and keep reinvesting them in things they should not be investing them in, it makes it harder to rebalance the economy.

Conversely, when those very large amounts of money do get transferred to the central Government, it gives them more resources to do the kind of rebalancing, building of safety nets, that will help reduce the reliance on heavy investment, export-led growth. So I think that is something we at my Institute have called for for quite a long time. We are very pleased that it is now moving that way.

Mr. GARFIELD. I will simply comment on the multinational coalitions and say that no one is really focused on ganging up on China. It is more working with multinational partners much in the way that we did in 2010 around indigenous innovation to get China or convince China that acting consistent with global norms is completely consistent with its overall goals domestically.

Chairman WARNER. Senator Johanns.

Senator JOHANNS. Again, thanks to each and every one of you for being here. I am starting to pay attention to the clock because I, myself, have a meeting that I have to get to here pretty quickly. So let me, if I might, end my participation in the hearing with just a thought or two.

I am fascinated, Mr. Roach, by your description of a new China, a China that is based upon a consumer approach. The more China ties itself and its future to an export market, the more you have to realize that that market is going to be fickle at times. It is going to ebb and flow and that is going to have an impact on your economy. Their movement in that direction, I think, does provide great opportunities for us to try to meet some of the needs. We are already seeing in some areas, like food, they are very happy to buy our food and we are happy to sell it.

The second point I wanted to make today is that as that relationship continues to expand and grow, it does occur to me that there is a need for yet another step. We started with the Economic Dialogue. Then it became the Strategic and Economic Dialogue. I had no problem with that. I think that makes sense. But I think there is a next step out here, and here is why.

You know, if you think about China, it was not all that long ago in human history that this was a closed society. We did not do business with China. We did not go to China. There was not really a relationship with China until Nixon took a bold step and said, we need to create this relationship.

What has happened since then is that the Chinese are especially entrepreneurial and that economy has taken off, and my impression has been that it has grown faster than the ability of the Government to manage that. So you do run into these kinds of irritating trade issues, like why are you not buying Nebraska beef, and there are so many of those kinds of things that you run into. But part of the challenge they have is growing their infrastructure fast enough to manage good trade policy.

The final point I will make about that, though, is that that in itself creates a remarkable opportunity for cooperation with the United States, I believe. It seems to me that we have the ability to partner with them, and I am not talking about foreign aid or anything like that, but I am talking about technical expertise from the United States and from China sitting down and working through these issues in a way that is positive in terms of opening up markets and hopefully avoiding those problems before they develop, because there is—it just seems there is always a long list of irritants that—and they really are. They are irritants that we need to work our way through.

Now, again, because of time, I cannot go around to each person, but if you would, call us on the phone or write us a letter. I would love to hear your thoughts on that.

And I will end by just saying how much I appreciate really, really provocative testimony, very thought provoking information that you have provided. Thank you very much.

Mr. ROACH. Thank you.

Mr. BERGSTEN. Thank you.

Mr. DEARIE. Thank you.

Mr. GARFIELD. Thank you.

Chairman WARNER. Thank you, Senator Johanns. Let me also—I am getting close on the time constraint, too, so I want to make a couple of final comments, as well, echoing a lot of what you said, Mike, and agree that we have got to figure out a way to get this right, this relationship right. The notion of formal or informal—probably better informal, Dr. Bergsten—of a G2 idea, I think, makes enormous sense.

I want to again thank the panel, as well. It has been a really provocative hearing. I particularly appreciate, Mr. Roach, some of the comments you made at the outset in terms of, I think, outlaying where we have gone on this currency discussion. It is a helpful point that needs to be made, and I did not even see Fred kind of—I even think I heard him agree with you on parts of that.

[Laughter.]

Chairman WARNER. You know, what I am concerned about is some of these efforts, and again, I may be a little too industry-specific, but that China—we have a potential, still, to blow this relationship, and China, as they try to move toward, I think we all agree, toward this consumption-based approach. My sense is, and this is—I may actually ask a quick response on this—I have a sense that a number of not just American-based companies but other companies, international large brand companies, went into China with stars in their eyes in terms of access to a huge, huge market, in certain times may have made sacrifices on their own standards and procedures as the price of entry of getting into that market. They have now been there for, most of them, a decade-plus, continue to sink in enormous amounts of resources, and have not seen the ability to necessarily either take back profits made or have found real challenges on some of the joint ventures, but rather see the Chinese regime and Government being less than a level playing field, kind of sucking sometimes out the intellectual content of property and then setting up either State-owned or other competitors that do not allow, again, a level playing field. I think we are seeing it on standards. I think we have seen it on intellectual property. I think we are starting to see it on an enormous up ramp on cyber.

And as someone—and I will take Mr. Roach's view of this is an extraordinarily important relationship. How do we make sure we do not get it wrong? How do we make sure that we continue to press the Chinese to be full active partners? They are an emerging Nation, but at some point, it seems like they are playing as an emerging Nation when the circumstances fit or a first-tier Nation with the economic clout that they bring to bear, and I just would like, again, with the request for some level of brevity, if anybody has got a response to either Senator Johanns's or my—and since he left, I am more interested in a response to my point—you know, that this is still a relationship in transition and that, we could get it wrong, but the Chinese could get it wrong, too. What if these enterprises that continue to invest in China do not feel they are playing on a level playing field? I think Mr. Dearie's numbers were revealing to me. I know they had gone up, but I did not appreciate how much that export opportunity had risen. So how do we get it right? And again, we will just go down the panel.

Mr. ROACH. Yes, just briefly. I think, Senator Warner, your concern about the fact that this relationship could still be blown is, I think, a very important and a very legitimate concern. We have one of the candidates for Presidency who has made a solemn promise to the American public that on the day that he is sworn in, he will declare China guilty of currency manipulation. That underscores your risk.

I would just like to second, and I believe it was Mr. Dearie's comment, that one of the risks here is that we have gone from holding the Strategic Dialogue with China twice a year to once a year. As such, it has become an exercise in event planning. Both sides breathe a great sigh of relief when each meeting ends, and they do not have to do it again for another year. I actually think the more frequent the meetings are, the greater the degree of engagement and the less the risk that we will blow it. So I would be very much in favor of going back to the former frequency of at least twice a year—and possibly even more.

Mr. BERGSTEN. Just two quick points. Just to underline your fear that we could still blow it is the fact that China is a sui generis, unique global economic superpower. It is the first global economic superpower in history that is at the same time a poor country, does not have a market economy, and is not a democracy. And so on the one hand, we have to treat it and act with it like a more or less equal global economic power. On the other hand, it has got these profound differences. And so finding a way to relate to it, very different from the Europeans in the past or the Japanese now.

That is why I think two things that have been discussed today are of uppermost importance. One is to use the multilateral system. I mean, the Chinese are responsive to external advice and even pressure. But if it looks like they are responding to external pressure, then they get their backs up and, in fact, it is counterproductive. So the way in which you do it is critical. Using the multilateral institutions, as Steve said, where they are a full member, full participant, is absolutely crucial to the strategy. Now, that, of course, raises the weakness of the multilateral institutions, the IMF on currency, the WTO does not cover a lot of things, but you have to use them as much as possible.

But then my second point, you have got to go beyond that, and particularly the U.S. as the other big superpower has to go beyond it, and that is why I am calling for a G2. Informal, yes, not intended to substitute for the G20 let alone the IMF or WTO, indeed, to make them work better, but by developing really thick networks of cooperation between us and the Chinese. Not easy. Not easy for them. Not easy for us. But I really think if we are going to meet the main challenge of this century, that has got to be a central part of it.

Chairman WARNER. Mr. Dearie.

Mr. DEARIE. Very quickly, to your point about the possibility of blowing it, I think the possibility exists on both sides. There is absolutely no question that certainly within the financial space that there is profound frustration at not being able to operate on a level playing field. We have already seen a couple of large financial institutions either reduce substantially or, in fact, unwind their operations in China. There is still tremendous interest in being there. I mean, it is the second-largest economy in the world, the fastest growing economy in the world. But they want to be there on a national treatment basis.

On the Chinese side, I think that there are still large elements of—certainly at the senior political level in China and even at the senior commercial level in China, there is still—and I think this gets to what Mr. Roach was talking about, about China not wanting—culturally and historically, very sensitive to being seen as being pushed around and being influenced by foreigners. John Huntsman, our recent Ambassador to China, had an op-ed in the *Wall Street Journal* just recently in which he described China as being profoundly insecure in a sense, and there are elements in China that I think still see the U.S. and China relationship as something as a zero-sum game, that what is in our interest is not in their interest and vice-versa.

So there is a lot of work to be done on the trust front, explaining and getting to know and learning more about each other, and that is why more frequent—more and more frequent high-level engagement with China is so important.

The good news here, though, is that engagement works. If you look back over the last, you know, since 1979 and how we have engaged with China, sometimes it seems like it is not working because progress is always, you know, it is terribly incremental, the Chinese move at a pace that seems very unsatisfying. But if you look back in retrospect and look at what the United States and China have accomplished together since 1979, it is incredible. It is very important to understand, and I think this sort of threads through a number of our testimonies today, there is a happy alignment right now between U.S. interests and Chinese interests in terms of the economic space. They want to go where we want them to go, and so there is an enormous opportunity here.

Last, Congress has an enormously important role to play. China cares about Congressional sentiment. They monitor Congressional sentiment very, very closely in terms of statements, in terms of hearings like this, and I would encourage this Committee, this Subcommittee, and Congress in general to bring the same kind of intensity and pressure that they have brought in recent years on the currency to these issues of engagement and expanded market access. Thanks.

Chairman WARNER. Mr. Garfield.

Mr. GARFIELD. Two quick points. One, the relationship thus far, I think, both for the tech sector as well as the country, has been a net positive, but we are always recalibrating and a number of the issues we have talked about today moves it closer to being a close call on whether it continues to be a positive.

Two, I think we have to continue to be consistent and clear in our opposition to the types of policies that we have been discussing, and the point that Mr. Dearie made about the role that Congress and the U.S. Government can play generally in spotlighting these issues and being clear about our opposition to policies that are inconsistent with global norms is critically important.

Chairman WARNER. Great. Well, thank you all very much. A very fascinating hearing. And with that, the hearing is adjourned.

[Whereupon, at 3:30 p.m., the hearing was adjourned.]

[Prepared statements supplied for the record follow:]

PREPARED STATEMENT OF SENATOR MIKE JOHANNS

Thank you, Mr. Chairman, I appreciate you holding this hearing today. With the close earlier this month of the fourth Strategic and Economic Dialogue, I value the chance to review progress that has been made with China, what progress must continue, and how that progress will eventually help American companies access the world's largest emerging market. To be sure, China presents not only extraordinary opportunity, but also extraordinary challenges.

I had the great fortune, as Secretary of Agriculture, to participate in the Strategic Economic Dialogue process and engage in bilateral and multilateral trade negotiations with the Chinese. Our work in developing agricultural trade in goods like soybeans, corn, and cotton is one of the great success stories of our relationship with China, and I am eager to see our successes expand.

As we all know, more Chinese consumers equals more American exports, which directly equals more American jobs. Last year, the U.S. exported nearly $130 billion in goods and services to China, supporting more than 600,000 jobs here domestically. There is no reason that, working closely with the Chinese to implement some much needed market reforms, last year's level of exports could not be doubled or tripled.

I am very encouraged by recent news coming out of China that the leadership is beginning to understand the importance of a transition to a consumption-based society, and the scope of the efforts necessary to achieve such a transition. None of this is to say that reforms will be easy, or will come quickly.

There remain issues of major importance that must be worked out. Great strides must be taken in even-handed and predictable enforcement of law, specifically intellectual property rights. The regulatory system must become much more transparent, and treat entities fairly, without regard to their nationality. For example, an issue of great importance to Nebraska, China must stop discriminating against American-grown beef. And, to touch on the focus of the hearing today, financial markets must be opened to allow institutions with innovative new products to access an ever-growing consumer base.

I look forward to hearing from the witnesses, and to discussing their thoughts on the future of the U.S.–China relationship.

PREPARED STATEMENT OF STEPHEN S. ROACH

SENIOR FELLOW, JACKSON INSTITUTE OF GLOBAL AFFAIRS, YALE UNIVERSITY

MAY 23, 2012

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 6 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 7 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 cosponsor 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 percent of GDP since 2005—the largest and most protracted external gap in modern U.S. history. Moreover, China has accounted for fully 35 percent of the shortfall over this 7-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 percent 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 percent 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 then 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 postcrisis 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 percent against the dollar since mid-2005, when China started to reform its foreign exchange regime. That's well in excess of the 27.5 percent 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 percent of GDP in 2012, after peaking at 10.1 percent 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 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 percent to 30 percent of Chinese exports to the U.S. reflect value added inside China. Moreover, roughly 60 percent 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 7 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 postcrisis repair of severely damaged balance sheets, inflation-adjusted private consumption has expanded at an anemic 0.6 percent 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 chal-

---

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

lenge.[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 percent of our GDP—up dramatically from the 6.5 percent 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 5 years. But with trend export growth to our largest external markets—Canada and Mexico—hovering at close to 3 percent over the past 5 years and stagnation long 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 percent of GDP since 2002—nearly three times Japan's 10 percent 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 percent 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 percent 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 out-

[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.

weigh the misperceived perils of the currency threat. The time has come to deemphasize 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

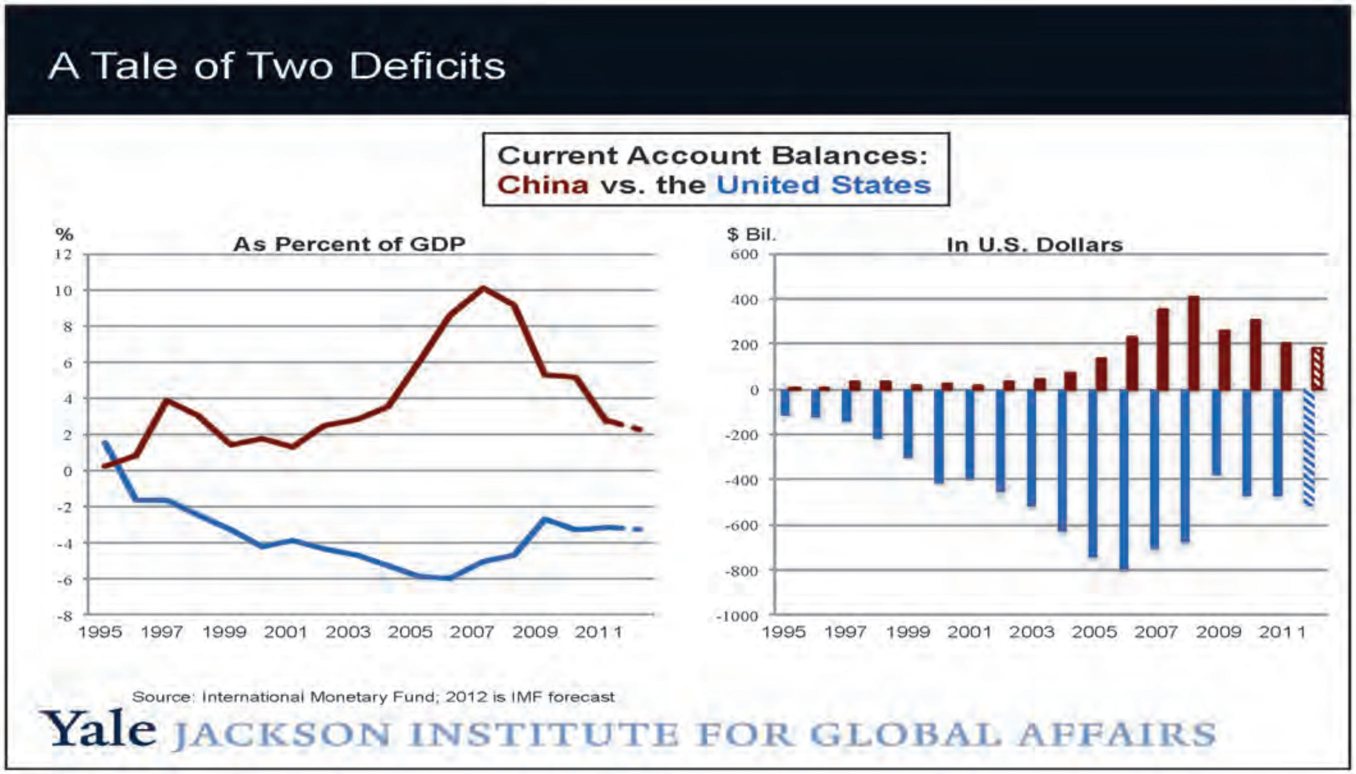
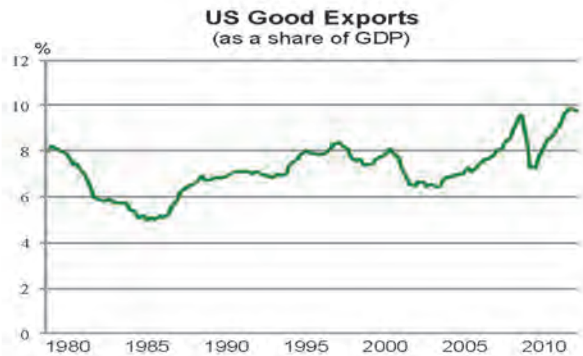

A Tale of Two Deficits
Current Account Balances:
China vs. the United States
%
As Percent of GDP
12
10
8
6
4
2
0
-2
-4
-6
-8
1995 1997 1999 2001 2003 2005 2007 2009 2011
$ Bil.
In U.S. Dollars
600
400
200
0
-200
-400
-600
-800
-1000
1995 1997 1999 2001 2003 2005 2007 2009 2011
Source: International Monetary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

Figure 2

America's Opportunity: The Export Revival



Top 10 Markets for U.S. Exports

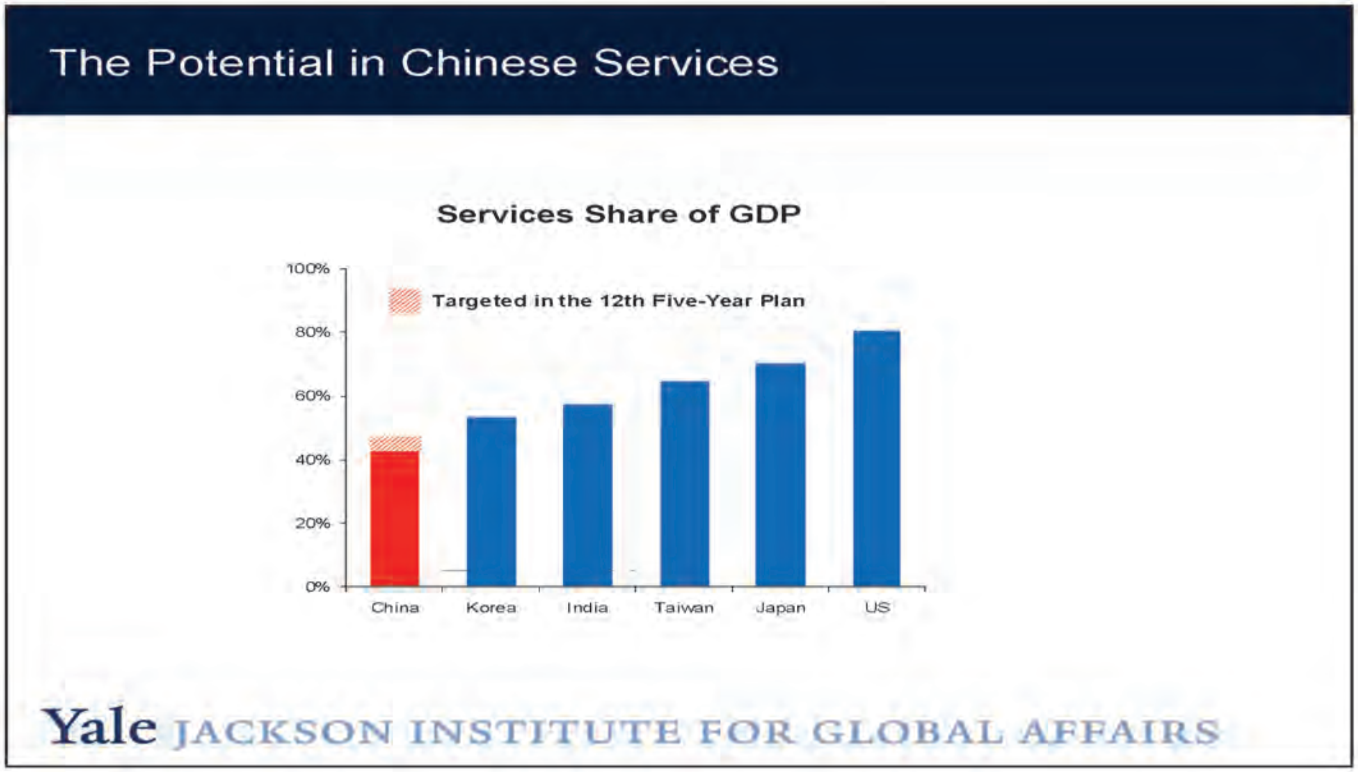
	$ Value: 2011 (bil.)	5 Year growth*
1. Canada	280.9	2.4%
2. Mexico	197.5	3.7
3. China	103.9	15.6
4. Japan	66.2	0.4
5. U.K.	56.0	6.0
6. Germany	49.1	7.9
7. Korea	43.5	2.8
8. Brazil	42.9	15.3
9. Netherlands	42.8	6.9
10. Singapore	31.4	n/a

* Average annual export growth: 2005-09

Source: U.S. Department of Commerce, BEA

Yale JACKSON INSTITUTE FOR GLOBAL AFFAIRS

Figure 3



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

PREPARED STATEMENT OF C. FRED BERGSTEN

DIRECTOR, PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS

MAY 23, 2012

Toward a G2

I have proposed since 2004 that the United States and China create an informal G2 to help steer the world economy. The reason is simple: progress is impossible on most important global economic issues without agreement by these two global economic superpowers. Examples including exchange rates and the international monetary system, the world trade regime and climate change. (The one notable exception is financial regulatory reform, where China is not yet an important player so most decisions remain with a subset of the membership of the Financial Stability Board.)

There are now three global economic superpowers, the European Union along with China and the United States. But Europe, or even the more integrated eurozone, speaks with a single voice on very few issues. Moreover, its current economic weakness limits its influence on most topics. So a G2 is the only practical possibility for achieving effective global economic leadership.

A number of other countries, including a growing number of emerging markets, are of course important as well. The G2 is not intended to replace the G7, G20 or the formal multilateral institutions like the International Monetary Fund and World Trade Organization. Its goal is in fact to make all of them work better. But even the G20 is too large to function effectively so a smaller steering committee is needed.

The G2 should be completely informal and indeed unannounced, or even acknowledged, by the two countries. As the Nike ad says: "Just do it!" They should forge close working cooperation on the whole range of global economic issues, which is essential for achieving progress either on bilateral problems or in implementing their global leadership responsibilities as the world's two largest economies.

The most overt and visible step toward creation of a G2 is the very frequent meetings between President Obama and the top leaders of China, President Hu Jintao and Premier Wen Jiabao, who have gotten together on average every quarter since President Obama took office. But the Strategic and Economic Dialogue (S&ED), following its predecessors, the Strategic Economic Dialogue and Senior Dialogue of the Bush administration, is by far the most extensive institutionalization of the concept. The S&ED brings cabinet officers together once a year and has launched ongoing dialogue among many groups of officials on many topics. They are learning who to call in each other's capital to address key problems, and how to deal with those officials, a central ingredient in international economic cooperation that has long ago been accomplished across the Atlantic and to a degree across the northern Pacific to Tokyo.

I thus believe the S&ED is a crucial component of U.S. (foreign and national security as well as economic) policy and must be continued and indeed strengthened. Its ever-expanding agenda of topics and discussion forcing, if not yet action forcing, nature are extremely important. The Administration should be congratulated for the serious attention and priority it has attached to the Dialogue, and it should continue and accelerate that focus in the future. Any successor Administration should do so as well.

The Currency Issue

Abstract pursuit of a G2, however important, is unlikely to win widespread support, however, now that the S&ED has been operating for 3 years. Have there been tangible results that suggest beneficial practical payoffs from the exercise and from the associated U.S. policy initiatives toward China?

The dominant economic issue of this period has been the extensive currency manipulation by China. For at least 5 years, the Chinese authorities blatantly intervened in the foreign exchange market by buying $1–2 billion every day to keep the price of the dollar high and the price of their renminbi (RMB) low. This produced an enormous competitive advantage for China in international trade, a current account surplus that exceeded 10 percent of its GDP in 2007 and an unprecedented buildup of almost $3.3 trillion of foreign currency (largely dollar) reserves.

The United States has thus rightly focused on this issue at every meeting of the S&ED as well as in many other contacts with the Chinese, both bilaterally and in multilateral forums. In recent years, it has correctly imbedded the currency manipulation per se in the broader context of the need for China to rebalance its development strategy away from export-led growth, featuring unprecedented investment levels (almost 50 percent of GDP) and repressed domestic financial markets, in the direction of relying on domestic demand (especially consumption and services).

It is now apparent that the U.S. strategy has succeeded to a substantial degree. China's global current account surplus has declined to less than 3 percent of its GDP. This is primarily due to the rise of about 30 percent in the trade-weighted value of the RMB since 2005, including its climb of more than 40 percent against the dollar. My colleague William Cline's new analysis (attached) suggests that China's current account surplus could even disappear over the next few years if it permits the RMB to continue strengthening at the pace of the last 2 years since upward appreciation recommenced in June 2010 after a hiatus during the global recession.

I believe that the S&ED has played a very useful role, and added an important pressure point, in persuading the Chinese authorities to gradually reduce their beggar-thy-neighbor currency policy. China of course had to come to believe that such a change was in its national interest but the S&ED, and related U.S.–China discussions, have been extremely important in at least two respects: convincing the Chinese of the (very powerful) case that a stronger exchange rate was in their own economic interest, and emphasizing constantly that China's (exceedingly important) relationship with the United States would be significantly affected by their behavior on this issue.

The S&ED thus passes the critical test from the U.S. standpoint of having achieved, at least to a substantial degree, major progress on a clearly articulated central goal of the exercise. They will have to remain on the case because we cannot be assured that China will let the RMB continue rising, which is required to avoid recrudescence of the problem, and the rate has in fact remained essentially flat for the last 6 months. Moreover, it would be desirable for the currency to rise enough (and China to rebalance more broadly enough) to fully eliminate the current account surplus and indeed convert it into a modest deficit. There remains the vexatious, if economically irrelevant, issue of China's continuing large bilateral surplus with the United States—which (on our numbers) exceeds their total global surplus (on their numbers) but is particularly misleading because only a small fraction of the value of exports recorded as coming to the United States from China is actually added in China itself. But I believe that the progress on this very difficult and highly contentious issue marks both a major step forward in U.S.–China economic relations and a signal achievement for the S&ED.

Other Issues

There are of course a number of other important economic issues that the S&ED should help resolve. A true G2, for example, would play a central role in addressing two of the key macroeconomic issues now facing the world economy:

- resolution of the euro crisis and, specifically;
- creation of additional lending capacity at the International Monetary Fund to reinforce the efforts of the Europeans themselves in financing adjustment programs in the eurozone and to help other countries that are sideswiped by the euro crisis.

China, as the world's largest holder of foreign exchange reserves and a major surplus country, should be a large (probably the largest) contributor to such enhanced lending capability at the IMF. I believe the United States, as the world's largest deficit and debtor country, is correct not to contribute to that facility itself. But the United States should be pushing hard for the creation of a maximum "firewall," in light of its own huge interest in a stable resolution of the crisis, so should be urging China to lend at least $500 billion to the Fund (and offering support for a corresponding increase in China's role in that institution).

There are fleeting references to these issues in the fact sheet on the S&ED distributed by the Treasury Department. However, there is no indication that they received major attention and Under Secretary Brainard did not mention them in her report of May 16 to the House Financial Services Subcommittee on International Monetary Policy and Trade. Surely the world's two major economies should seriously address these pivotal global issues in their economic dialogue.

Many bilateral, including trade, issues must be addressed as well. The S&ED apparently covered an impressive array of such topics. It is particularly important that China has agreed to negotiate new international rules on export finance by 2014. This is an important aspect of global competition that is often distorted by national subsidies and China is not a party to the current international agreement that is centered on the OECD because it is not a member of that organization.

It will remain difficult to successfully resolve the large number of bilateral trade conflicts between the United States and China, however, as long as they continue to be addressed in a purely ad hoc manner. There are some cases that can be taken to the dispute settlement mechanism of the WTO, as both countries have done, but most of the trade issues cited in the S&ED fact sheet are not subject to agreed rules of the road. Disagreements are thus likely to fester, eroding both the bilateral relationship and, in light of the leading global position of the two countries, the international trading system as a whole.

I thus believe that the United States and China should consider launching negotiations for a bilateral trade agreement to provide a comprehensive framework to deal with the daunting array of economic problems between them—a list that is likely to continue growing as the economic relationship deepens further. Maurice R. Greenberg, the long-time CEO of AIG (long before its collapse in 2008) and one of this country's keenest and most experienced observers of China, has proposed that such an effort could aim to develop a U.S.–China free trade agreement over a period of a decade or so. Another alternative would be to look for an early occasion to bring China into the TransPacific Partnership, with its high standards for governing trade and investment in the Asia–Pacific region.

Any such effort would represent an extension of the G2 concept into the trade policy area, as inevitably must occur at some point. The S&ED could productively begin that conversation, which of course carries major foreign policy as well as economic dimensions. It is already addressing possible components of a broader trade agreement such as a Bilateral Investment Treaty, Government procurement and reform of State-owned enterprises in China. Building on its considerable progress to date, the S&ED has a rich potential agenda for the years ahead.

Peterson Institute for International Economics

Policy Brief

NUMBER PB12-7 APRIL 2012

Projecting China's Current Account Surplus

William R. Cline

William R. Cline *has been a senior fellow at the Peterson Institute for International Economics since its inception in 1981. During 1996–2001, while on leave from the Institute, he was deputy managing director and chief economist of the Institute of International Finance. He is the author of 24 books, including* Financial Globalization, Economic Growth, and the Crisis of 2007–09 *(2010). He is the coeditor of* Resolving the European Debt Crisis *(2012).*

Note: The author would like to thank Joseph Gagnon and John Williamson for comments on an earlier draft, and Yimei Zou for research assistance.

For several years China has run persistent current account surpluses that have been widely seen as the most serious single source of global imbalances on the surplus side, and mirrored by persistent systemically large US current account deficits on the other side. In recent years, however, both imbalances have shown moderation (figure 1). China's surpluses have posed questions of international policy rules, because they have reflected in part an unwillingness to allow the exchange rate to appreciate sufficiently to act as an effective equilibrating mechanism. Exchange rate intervention resulted in a massive buildup of international reserves, which rose from $615 billion at the end of 2004 to $3.2 trillion at the end of 2011 (IMF 2012a).

EXCHANGE RATE TRENDS

As shown in figure 1, in 2009 and again in 2011 there were substantial reductions in China's current account surplus. Although many had dismissed the 2009 reduction as solely the consequence of a collapse in global demand caused by the global recession, Cline (2010) estimated that a substantial part of the reduction in the surplus reflected a lagged effect of the real effective appreciation of the renminbi that took place from mid-2005 to mid-2008.

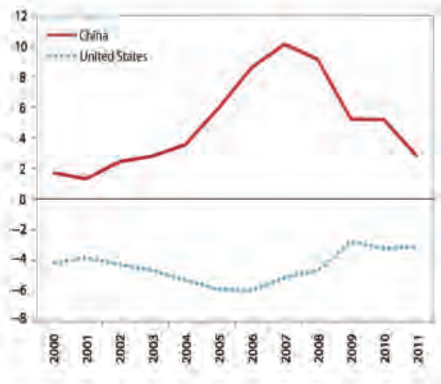
As shown in figure 2, the real effective exchange rate rose by nearly 20 percent from 2005 to August 2008 when the government suspended the policy of gradual appreciation. Because the safe-haven effect boosted the dollar in late 2008 through early 2009, the renewed tie of the renminbi to the dollar resulted in still further real effective appreciation through the first quarter of 2009. Thereafter the dollar eased again and the renminbi fell along with it. By mid-2010, Chinese authorities once again removed the fixed tie to the dollar and began to allow gradual appreciation. As indicated in the figure, there was a new phase of effective appreciation that went modestly further than the peak of early 2009. By February 2012, the effective rate stood 27.4 percent above its 2005 full-year average.

When figures 1 and 2 are viewed together, and if allowance is made for lags from the exchange rate to trade outcomes, there is a strong implication that the rise in the real effective rate of the renminbi after 2005 contributed to the decline in the current account (as a percent of GDP) after 2007.

TRENDS IN OIL TRADE

Another factor that seems to have played a role, however, is the value of net oil imports. As shown in table 1, the value of China's net oil imports rose from 1.1 percent of GDP in 2003 to 2.23 percent in 2007. The total current account surplus rose from 2.8 percent of GDP to 10.1 percent, or by 7.3 percent of GDP, so the non-oil current account surplus rose by even more, 8.4 percent of GDP. With high prices in 2008, net oil imports reached 2.79 percent of GDP. In that year, the rise in the oil deficit by 0.56 percent of GDP accounted for about one-half of the reduction in the overall surplus (from 10.1 percent of GDP to 9.1 percent.) With the return of high prices in 2011, net oil imports were once again back up to 2.76 percent of GDP, and once again the rise in the oil import

Figure 1 Current account balance as percent of GDP: China and the United States



Source: BEA (2012), SAFE (2012).

bill coincided with a reduction in the overall surplus. Overall, from 2007 to 2011 the rising oil import bill contributed about one-half percent of GDP to the reduction in the current account surplus. Although this influence was modest, it was not inconsequential.

CAPITAL SERVICES

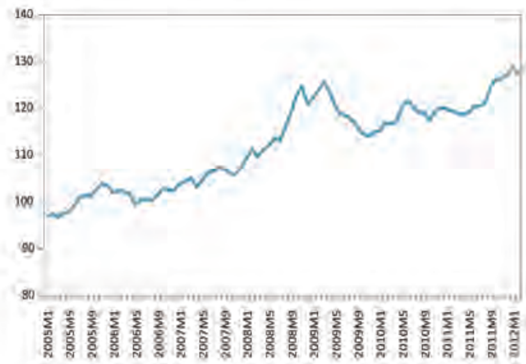
Just as the oil sector may cause divergences in the current account from trends that might otherwise be expected based on the exchange rate and growth, for China it would be expected that there should be a rising trend in net capital services as the economy has increasingly built up net foreign assets. As table 2 shows, from the early 2000s until the end of the decade there was an upswing in the capital services account from a deficit of about 1.3 percent of GDP (2000–01) to a small surplus (+0.16 percent average in 2007–10). However, there was a swing back into deficit in 2011, as payments on liabilities surged to about $155 billion while earnings on assets fell slightly to $128 billion. The table also reports year-end stock levels of international assets and liabilities, as well as the implied average rates of return. The decline in the return on foreign assets, from 4.5 percent in 2007 to 3.1 percent in 2011, reflected the decline in US and other international interest rates associated with the global recession. It is also evident that the return on China's external liabilities has systematically exceeded that on its assets, reflecting the dominance of direct investment in liabilities versus government bonds (US Treasuries) in assets. China has the mirror image of the favorable asymmetry that the United States enjoys in higher returns on its external assets (where direct investment and portfolio equity dominate) than on its liabilities (where debt dominates).

STATISTICAL ESTIMATES

The separate determinants of oil trade and net capital services suggest that a useful approach in explaining China's current account balance is to model the current account stripped of these two components, and then to add in the effects of oil and capital income. Table 3 reports time series on the real exchange rate; domestic and foreign growth; and the non-oil non-capital services current account as a percent of GDP (NONKCA). The table also shows world growth at market exchange rates (the proper concept when measuring effective international demand) and domestic growth for China.

Following Cline (2010), the dependent variable for the external balance, in this case NONKCA, can be regressed on the lagged real effective exchange rate and a variable that captures world demand growth and (in principle) domestic demand growth, as well as on a time trend. An initial test indicated, however, that the coefficient for a demand variable that includes both world and Chinese growth turned out to

Figure 2 Real effective exchange rate, renminbi (2005=100)



Source: IMF (2012a). CPI–deflated.

Table 1 China's oil trade

	Volume: imports (million barrels per day)	Values (billions of US dollars)				**Net imports** (percent of GDP)
		Imports	**Exports**	**Net imports**	**GDP**	
2000	1.477	14.8	2.1	12.7	1,198	1.06
2001	1.477	11.7	1.4	10.3	1,325	0.78
2002	1.662	12.8	1.3	11.5	1,454	0.79
2003	2.031	19.8	1.7	18.2	1,641	1.11
2004	2.769	33.9	1.3	32.6	1,932	1.69
2005	2.954	47.9	2.7	45.2	2,257	2.00
2006	3.323	66.4	2.7	63.7	2,713	2.35
2007	3.692	79.7	1.7	78.0	3,494	2.23
2008	3.877	129.0	3.0	126.0	4,520	2.79
2009	4.246	88.9	2.2	86.7	4,991	1.74
2010	4.800	134.96	1.6	133.3	5,878	2.27
2011	5.354	195.1	1.9	193.2	7,300	2.76

Source: EIA (2011a), Customs (2012).

Table 2 Capital services account (billions of US dollars and percent)

	Income	Payments	Net	Percent of GDP	Assets	Liabilities	RORA	RORL
2000	12.3	26.5	–14.2	–1.18				
2001	9.1	27.7	–18.61	–1.40				
2002	7.7	22.3	–14.67	–1.01				
2003	14.8	22.8	–8	–0.49				
2004	18.5	22.7	–4.15	–0.21	933	653		
2005	35.6	53.2	–17.6	–0.78	1,229	816	3.81	8.15
2006	50.3	57.7	–7.4	–0.27	1,690	1,050	4.09	7.07
2007	76.2	72.7	3.5	0.10	2,416	1,228	4.51	6.92
2008	92.5	81.2	11.3	0.25	2,957	1,463	3.83	6.61
2009	99.4	99.3	0.1	0.00	3,457	1,946	3.36	6.79
2010	131	112.8	18.2	0.31	4,126	2,335	3.79	5.80
2011	128	154.9	–26.9	–0.37			3.10	6.63

RORA = rate of return assets (percent); RORL = rate of return liabilities (percent)

Source: SAFE (2012), IMF (2012a).

Table 3 Influences on the current account excluding oil and capital services, 2000–11

	CA	NONKCA	R*	R*L	gw	gc
	(percent GDP)		(index)		(percent)	
2000	1.71	3.96	108.53	111.61	4.3	8.4
2001	1.31	3.49	113.20	108.51	1.6	8.3
2002	2.44	4.23	110.58	110.87	1.9	9.01
2003	2.80	4.39	103.32	111.89	2.7	10.0
2004	3.55	5.46	100.54	106.95	3.9	10.1
2005	5.94	8.72	100.00	101.93	3.5	11.3
2006	8.58	11.20	101.57	100.27	4.0	12.7
2007	10.13	12.26	105.58	100.79	4.0	14.2
2008	9.12	11.66	115.29	103.58	1.5	9.6
2009	5.23	6.97	119.21	110.44	–2.3	9.2
2010	5.19	7.15	118.67	117.25	4.0	10.3
2011	2.80	5.78	121.88	118.94	3.0	9.5

CA = current account balance as percent of GDP; NONKCA = non-oil non-capital-services current account as percent of GDP; R*= real effective exchange rate; R*L = lagged R*; gw = world growth at market exchange rates; gc = China's growth

Source: Tables 1 and 2, IMF (2011), IMF (2012a).

be extremely small and insignificant.[1] A better econometric result was obtained when only world growth is included. The estimated equation is:

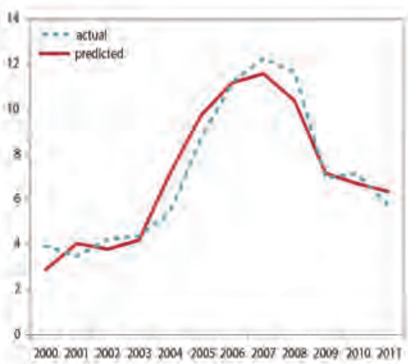
$$1)\ NONKCA = \underset{(8.4)}{46.82} \underset{(-8.0)}{-0.410}\, R^*L + \underset{(1.6)}{0.269}\, gw + \underset{(7.0)}{0.621}\, T;$$

Adj. $R^2 = 0.896$

where *NONKCA* is the non-oil non-capital-services current account balance as a percent of GDP, R^*L is the lagged

1. The variable was: *gc–gw*, the difference between world growth and Chinese growth.

Figure 3 Actual and predicted non-oil non-capital-services current account surplus as percent of GDP



Source: Authors calculations.

exchange rate (average of prior two years), *gw* is the IMF (2011) estimate of world growth with GDP weighted at market exchange rates, and *T* is a time variable starting at 1 in 2000 and rising to 12 in 2011. The adjusted R^2, or degree of explanation adjusted for degrees of freedom, is high at 89 percent, as reflected in the relatively close overall fit of the predicted value to the actual value for the non-oil current account balance (figure 3). The *t*-statistics in parentheses indicate that the coefficient on the lagged real exchange rate is highly significant, as is the coefficient on the time trend.[2] The coefficient on foreign growth falls short of the usual 5 percent level for significance, but has the right sign, is of a plausible magnitude, and is significant at the 15 percent level.

The exchange rate coefficient indicates that on average over the period, an increase by 1 percent in the lagged real exchange rate had an impact on the non-oil non-capital-services current account balance of 0.44 percent of GDP.[3] This impact estimate may be on the high side (the corresponding parameter used in Cline and Williamson, 2011a, is 0.30). For foreign growth, a 1 percentage point increase translates to 0.27 percent of GDP increase in the (non-oil non-capital-services) current account surplus. Considering that exports of goods and services were an average of 31 percent of GDP over the period (IMF 2012a, 2011, SAFE 2012), this estimate is approximately consistent with an income elasticity of unity for foreign demand for Chinese exports.

The time trend of an increase in the non-oil non-capital-services current account surplus by 0.62 percent of GDP annually is smaller than the 0.78 percent estimate in Cline (2010). This trend is still substantial, and reflects the Balassa-Samuelson effect, whereby the rising relative productivity of tradable goods in an emerging market economy means that its trade surplus will tend to increase over time if not offset by trend appreciation of the real exchange rate. More specifically, evaluated with the 2011 level of the lagged exchange rate index as the base, the time trend of 0.62 percent of GDP per year implies the need for the real effective exchange rate to appreciate by 1.3 percent annually to avoid an increase in the current account surplus relative to GDP.[4]

DECOMPOSING THE SURPLUS REDUCTION

Equation 1 and tables 1 and 2 provide a basis for identifying the components of the reduction in the current account surplus from its peak in 2007 to its much more moderate level in 2011. As set forth in table 4, the total reduction in the current account surplus amounted to 7.3 percent of GDP. The rise in the oil deficit contributed 0.53 percent of GDP. The main estimates of the table apply equation 1 to estimate the impact of the exchange rate and foreign growth. When the coefficient on the exchange rate, –0.410, is applied to the change in the (lagged) real exchange rate index by 18.16 index points (from 100.8 to 118.9), the result is an estimated contribution of 7.45 percent of GDP reduction in the current account surplus. World growth at market exchange rates was higher by about 1 percentage point in 2007 (at 3.97 percent) than in 2011 (at 2.96 percent), and applying the coefficient from equation 1, the consequence would have been a reduction of 0.27 percent of GDP in the surplus. From table 4, net capital services ironically contributed a downswing of 0.47 percent of GDP, an aberration from the long-term trend in the opposite direction caused by the decline in return on

2. For 13 observations, the threshold for significance at the 5 percent level is a *t*-statistic of 2.16. Application of White's test suggests that heteroskedasticity is not a problem, and robust *t*-statistic tests confirm significance of the exchange rate and time variables.

3. The average for R*L over the period was 108.6, so a 1 percent change amounted to 1.086 units on the lagged exchange rate index. Multiplied by the coefficient 0.410, this change translates to a change in the non-oil current account by 0.44 percentage points.

4. That is, with the 2011 R*L index at 118.9, a 1 percent real appreciation represents 1.189 units on the index. Applying the exchange rate coefficient in equation 1 (–0.41), the result is a reduction in the current account surplus by 0.487 percent of GDP. To offset the upward drift of 0.62 percent of GDP per year thus requires annual appreciation by 0.62/0.49 = 1.27 percent per year.

Table 4 Composition of the reduction in the current account surplus from 2007–11 (percent of GDP)

	Equation 1	Alternate
Surplus, 2007	10.13	
Surplus, 2011	2.76	
Change in surplus	–7.37	
Impact of balance on oil	–0.53	
Impact of real renminbi appreciation	–7.45	[–5.4]
Impact of world growth	–0.27	[–3.0]
Impact of capital services	–0.47	
Impact of time trend	2.48	
Subtotal, impacts:	–6.24	[–6.92]
Unexplained	–1.13	[–0.45]

Source: Author's calculations.

assets from the international boom year of 2007 to the weak-recovery year of 2011. For its part, the time-trend raised the surplus by an estimated 2.48 percent of GDP over the four-year interval. In the main estimates, the net influence of these five influences amounts to –6.24 percent of GDP, a reduction that is smaller than the total observed reduction by an unexplained 1.13 percent of GDP. This unexplained change equals the (absolute) sum of the discrepancies between the predicted and actual outcomes in 2007 (underpredicted) and 2011 (overpredicted) observable in figure 3.

Table 4 also includes a set of alternative estimates for the impact of the exchange rate and foreign growth, shown in brackets. In this case, the exchange rate impact parameter is set at –0.3 percent of GDP for a 1 percent real effective appreciation, the parameter used in Cline and Williamson (2011a). The 18 percent rise in the lagged real exchange rate variable from 2007 to 2011 thus generates a reduction of 5.4 percent of GDP in the current account surplus, about three-fourths as large as in the main estimate.

With respect to foreign growth, the reduced-form specification of this influence in equation 1 may fail to capture the cumulative effect of several years of slow world growth, because only the foreign growth rate for the year in question is included. Real growth of world product at market exchange rates was an average of 3.24 percent annually in 2000–07 but only 1.54 percent annually in 2008–11 (IMF 2011). Cumulating the annual reduction of 1.7 percent over four years, world output was 7 percent lower in 2011 than it would have been if growth had continued at its 2000–07 rate. Applying a plausible income elasticity of 1.5 for world demand for China's exports, in 2011 the level of exports would have been 10.5 percent higher than the actual outcome, an increment that amounts to $219 billion (goods and services) or 3 percent of 2011 GDP. The alternative estimate is thus much larger than the equation estimate in the case of the impact of the slowdown in global growth. The amount of the surplus reduction left unexplained is smaller than in the main estimates.

Overall, table 4 indicates that the largest source of the decline in China's current account surplus has been the appreciation of its exchange rate. Sluggish world growth also played a role, estimated to be only modest in the estimates based on equation 1 but a bit over half as large as the exchange rate impact in the alternative estimate. To a much smaller degree, a rising oil import bill has also played a role, and in 2011, so did the unusually low return on foreign assets.

The influence of the exchange rate also implies that there is more adjustment in the pipeline. The final exchange rate signal underlying the predicted outcomes in figure 3, because

Overall, table 4 indicates that the largest source of the decline in China's current account surplus has been the appreciation of its exchange rate.

of the lag, is the average for 2009–10, an index of 118.9. The rate rose further to 121.9 in 2011 and, not shown in the table, to 128.1 in the first two months of 2012. So there is another 7.7 percent effective real appreciation in the pipeline for the lagged real exchange rate even if the renminbi remains unchanged at its effective level of early 2012. Given the parameters discussed above, the consequence would be the further narrowing of the surplus by some 2 to 3 percent of GDP. This lagged influence would be working against the time trend that increases the surplus, and against the likely reversion to higher earnings on foreign assets, but would be reinforced by any trend toward higher oil imports.

PROJECTING THE CURRENT ACCOUNT

China's current account balance can be projected using equation 1 for the non-oil non-capital-services current account (NONKCA) and then adding in separate projections of oil trade and the capital services balances.

Table 5 Projection of the non-oil non-capital-services current account (NONKCA)

	GDP (billions of US dollars)	**R*L** (real exchange rate index 2005 = 100)	**gw** (percent)	**NONKCA:** (percent GDP)	(billions of US dollars)
2011	7,300	118.9	2.96	6.36	464
2012	8,089	120.3	2.46	6.30	509
2013	8,993	125.0	3.05	5.14	463
2014	9,986	128.1	3.87	4.71	471
2015	11,080	128.1	3.97	5.36	594
2016	12,305	128.1	4.01	5.99	731
2017	13,082	128.1	4.00	6.61	865

R*L = lagged R*; gw = world growth at market exchange rates; NONKCA = non-oil non-capital-services current account

Source: Author's calculations. See text. (Corrected May 14, 2012).

Table 6 Projected net imports of oil, 2011–17

	Consumption (million barrels per day)	**Production** (million barrels per day)	**Imports** (million barrels per day)	**Price** (US dollars)	**Value** (billions of US dollars)	Percent GDP
2011	10	4	6	102.1	193	2.65
2012	10	4.1	5.9	102.5	191	2.36
2013	11	4.1	6.9	110.6	241	2.68
2014	11	4.1	6.9	116.8	254	2.55
2015	12	4	8	122.5	309	2.79
2016	13	4.1	8.9	122.3	343	2.79
2017	13	4.1	8.9	126.8	356	2.72

Source: EIA (2011b), EIA (2012), SAFE (2012).

Excluding Oil and Capital Services

Table 5 reports elements of a projection through 2017 of the NONKCA. The table first shows the dollar value of China's GDP, based on the actual outcome for 2011 (NBSC 2012) and then applying the proportionate growth path for dollar GDP in the September 2011 International Monetary Fund (IMF) *World Economic Outlook* (and simply extrapolating to 2017 from 2016; IMF 2011).

The lagged real exchange rate variable assumes that there is no further change in the real effective rate from the average in the first two months of 2012. World growth at market exchange rates is from IMF (2011) except that the estimates are reduced by 0.7 percent in 2012 and 0.6 percent in 2013 based on the more recent WEO update (IMF 2012b).[5]

There is a decline in the NONKCA by about 1.6 percent of GDP from the 2011 model-based estimate to 2014, before this surplus rises back slightly above the 2011 percent of GDP by 2017. The causes of this path are the further appreciation in the lagged real exchange rate (the pipeline effect noted above), on the one hand, versus the time trend, on the other. For the period as a whole the two approximately offset each other.

5. Note also that the time variable for equation 1 begins at 12 for 2011 and reaches 18 in 2017.

Oil Trade

The US Energy Information Agency (EIA 2011b) has projected the oil production and imports for China shown in table 6. Imports are expected to rise from 6 million barrels per day in 2011 to 8.9 million barrels per day by 2017. The agency also projects the average price of imported oil for the United States, which is applied here as indicative of the world price (EIA 2012). This price is expected to remain unchanged at \$102 per barrel in 2012 and then rise to \$127 by 2017. Multiplication of the average price by the number of barrels per year yields an import value that is modestly higher than the actual net import value for 2011 (\$224 billion rather than \$193 billion). The value series shown in the table adjusts the product of import volume times price downward by this ratio (193/224) to obtain the estimate of China's net oil import value through 2017.

There is a striking constancy in the resulting estimate of the ratio of net oil import value to GDP, at slightly over 2.5 percent of GDP throughout the period. Even though oil import volume rises almost 50 percent over the period, and the price rises 24 percent, the value of China's GDP rises so rapidly that there is no change in the ratio of the net import value to GDP. Thus, the nominal dollar value of GDP rises almost 80 percent from 2011 to 2017 (table 5).

Capital Services

Projection of the elements of table 2 above provides a basis for projecting the balance on capital services. The end of year foreign liabilities equal the prior year value as adjusted for inflation, plus the inflow of direct investment. The inflation adjustment applies 4 percent annual inflation to the share of equity (direct investment and stock) in external liabilities, which stands at 72 percent.[6] For external assets, the end-year figure equals the previous year's level adjusted for inflation (this time with only a 9 percent share), plus the current account surplus, plus the excess of inward direct investment over outward direct investment.[7]

With estimates of the stock of foreign assets and liabilities in hand for the prior year, the capital services for the current year are obtained by multiplying the stocks by the rates of return. It is assumed that by 2014 the return on assets abroad returns to 4 percent, and that for liabilities the rate of return remains at the recent level of 6.7 percent.

Ironically, China's capital services account remains in small deficit through 2017, despite the growing net international investment position

Ironically, China's capital services account remains in small deficit through 2017, despite the growing net international investment position (NIIP). The NIIP rises from \$1.89 trillion at the end of 2011 to \$2.59 trillion at the end of 2017. However, the adverse differential rate of return leaves net earnings persistently negative, although at small amounts.

Current Account

Table 8 reports the resulting projections of the current account deficit as a percent of GDP, for 2011 through 2017. Figure 4 displays the same projections, with the actual outcome shown for 2011. Overall the current account surplus remains in a range of 2 to 4 percent of GDP.

The projections show a persistently lower current account surplus than in the period of 2005–10. Even so, at least the 2012 forecast may be on the high side, considering that the model over projects the 2011 outcome by about 0.6 percent of GDP. The low point in the projection, about 2 percent of GDP in 2013–15, reflects the completion of the lagged influence of the exchange rate appreciation. The increase to about 4 percent of GDP by 2017 reflects the resumption of the dominance of the trend term.

SHORT-TERM TRENDS

In 2012, the current account surplus could be substantially lower than the level projected in table 7, in view of a simple "momentum" calculation extrapolating recent trends. For the two quarters 2011:4 and 2012:1, exports of goods and services rose 11.1 percent above the level a year earlier, while imports of goods and services rose 13.5 percent. If these two rates are applied to the full-year 2011 base levels (\$2.09 trillion exports, \$1.90 trillion imports), the result is an expected surplus on goods and services amounting to \$164 billion. For 2003–11, the average ratio of the surplus on goods

6. At the end of 2010, foreign direct investment (FDI) in China was \$1.48 trillion and equity securities were \$206 billion, with total liabilities at \$2.34 trillion. Chinese FDI abroad was \$310.8 billion and equity securities abroad were \$63 billion, with total foreign assets at \$4.13 trillion (IMF 2012a).

7. Suppose that the current account is zero and inflation is zero. Foreign liabilities rise by the amount of inward direct investment. The inflow builds up reserves. Foreign assets rise by the amount of outward foreign investment. The reserve buildup from FDI inflow is cut back by the amount of reserves needed to finance the outward direct investment.

Table 7 Projected capital services (billions of US dollars)

	Income	Payments	Net	Assets	Liabilities	RORA	RORL	Direct investment: Inward	Direct investment: Outward
2011	128	155	–26.9	4,513	2,622	3.1	6.6	220.1	49.7
2012	154	176	–22.2	5,003	2,933	3.4	6.7	234.5	57.6
2013	185	196	–11.4	5,414	3,267	3.7	6.7	249.8	66.8
2014	217	219	–2.3	5,836	3,627	4.0	6.7	266.1	77.4
2015	233	243	–9.6	6,326	4,015	4.0	6.7	283.5	89.8
2016	253	269	–16.0	6,926	4,433	4.0	6.7	302.0	104.1
2017	277	297	–20.0	7,640	4,882	4.0	6.7	321.7	120.7

RORA = rate of return assets (percent); RORL = rate of return liabilites (percent)

Source: Author's calculations.

Table 8 Projected current account balance

	NONKCA	Oil	Capital services	Total	Level (billions of US dollars)
	(percent of GDP)				
2011A	5.78	–2.65	–0.37	2.76	201.7
2011M	6.36	–2.65	–0.37	3.34	243.9
2012	6.30	–2.36	–0.27	3.66	296.4
2013	5.14	–2.68	–0.13	2.34	210.7
2014	4.71	–2.55	–0.02	2.14	214.1
2015	5.36	–2.79	–0.09	2.48	275.3
2016	5.99	–2.79	–0.13	3.07	378.3
2017	6.61	–2.72	–0.15	3.74	489.0

NONKCA = non-oil non-capital-services current account; A = Actual; M = Model

and services to the overall current account surplus was 85.8 percent. Applying this ratio, the "momentum" estimate for the 2012 current account surplus would be \$191 billion or 2.36 percent of GDP, lower than the table 8 projection by 1.3 percent of GDP. Consensus private forecasts have recently placed the 2012 current account surplus at \$236 billion, or 2.9 percent of GDP, also lower than the table 8 projection of 3.66 percent of GDP (Blue Chip 2012). On the basis of recent trends, then, the projected surplus path in table 8 and figure 4 is more likely to err in the direction of overstatement than understatement (at least in the near term).

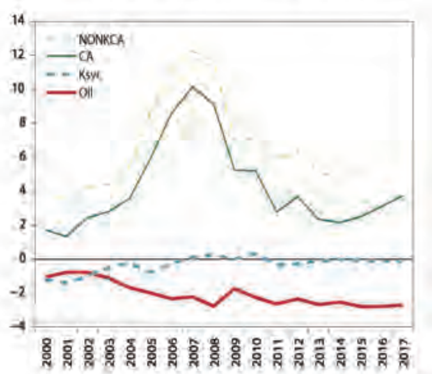
ALTERNATIVE SCENARIOS

It is useful to consider two types of alternatives to the main projections. The first is an alternative based on the more conservative parameter for the exchange rate impact used in Cline and Williamson (2011a).[8] The second is an alternative premised on a continued commitment in Chinese exchange rate policy to allow gradual real appreciation. From June 2010 when the government once again allowed the exchange rate to move, until December 2011, the real effective exchange rate appreciated by 4.5 percent (IMF 2012a). This pace amounts to an annual rate of 3 percent.

Table 9 and figure 5 report the resulting current account projections as a percent of GDP for these alternative scenarios. Whereas the baseline estimate using equation 1 projects a return to a surplus of almost 4 percent of GDP by 2017 ("Base" in the figure), applying the more conservative exchange rate impact parameter results in a higher surplus at 5.37 percent of

8. The alternative parameter, –0.3 percent of GDP change in current account for 1 percent real effective appreciation, translates to a change of the exchange rate coefficient in equation 1 to –0.252, as well as a change in the constant term to 28.11, for consistency with the 2011 predicted level of NONCKA.

Figure 4 Current account balances as percent of GDP: oil, capital services, non-oil non-capital-services, and total 2000–11 actual and 2012–17 projected



NONKCA = non–oil non–capital–services current account; Ksvc = capital services; CA = current account balance as percent of GDP

Source: Author's calculations, SAFE (2012), Customs (2012).

GDP in 2017 ("Alt1"). In sharp contrast, if the exchange rate coefficient in equation is applied but it is assumed that the real effective exchange rate remains at its January-February level for the rest of 2012 and then appreciates at an annual pace of 3 percent per year, then the current account swings into deficit by 2016, and the deficit reaches about 2 percent of GDP by 2017 ("Alt2").[9] Finally, when both variants are combined (more conservative exchange rate parameter, continued appreciation of the renminbi), by 2017 the current account remains in surplus but at a considerably lower level than in the baseline, at only 1.68 percent of GDP. Both the table and the figure also indicate the "momentum" projection for 2012 discussed above, as a reminder that the surplus for 2012 could be significantly smaller than in the model-based projections.

CONCLUSION

In the September 2011 issue of the IMF's *World Economic Outlook* (WEO), the Fund projected that China's current account surplus would decline to no lower than 5.2 percent of GDP in 2011 and thereafter would rise again to 7.2 percent of GDP by 2016 (IMF 2011). Although lower than the peak level of 10 percent of GDP in 2007, this range remained sufficiently high to be likely to cause continued policy confrontation about China's exchange rate practices involving intervention to prevent appreciation of an undervalued exchange rate. The actual outcome in 2011, a surplus of only 2.8 percent of GDP, was thus a significant policy surprise. A central question is whether the unexpected reduction was transitory or whether instead a new and lower range for the trajectory of the current account surplus is likely to remain more permanent. When the IMF issues its spring WEO in late April 2012, analysts and policymakers will learn whether and by how much the Fund has downscaled its estimate of the future path of China's current account surplus.

This note has sought first to explain the reduction in the surplus, and second to project the medium-term path for the current account. The statistical model relating the current account excluding oil and capital services provides a basis for decomposing the sources of the reduction of the surplus from 2007 to 2011. The lion's share of the reduction came from the substantial real appreciation of the exchange rate. More modest contributions also came from higher world oil prices, slower world growth, and an erosion in the capital services account

9. The January-February real effective rate was already 5.1 percent higher than the average for 2011.

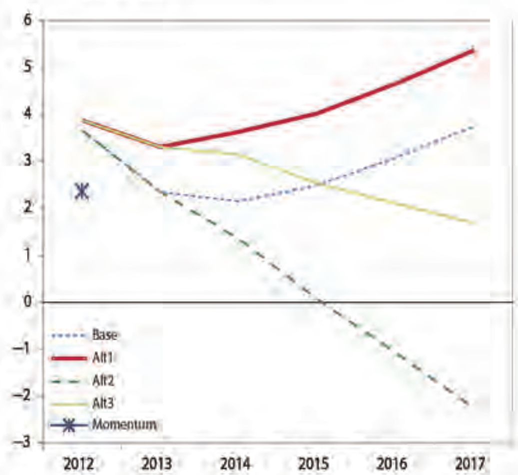
Table 9 Alternative current account projections (percent GDP)

	Base	Alt1	Alt2	Alt3	Momentum
2012	3.66	3.88	3.66	3.88	2.36
2013	2.34	3.30	2.34	3.30	
2014	2.14	3.63	1.36	3.14	
2015	2.48	4.02	0.07	2.53	
2016	3.07	4.65	–1.07	2.10	
2017	3.74	5.37	–2.25	1.68	

Base = baseline; Alt1 = lower exchange rate coefficient; Alt2 = continued renminbi appreciation. Alt3 = both effects combined; Momentum = recent-trend forecast

Source: Author's calculations.

Figure 5 Current account balance under alternative scenarios (percent GDP)



Base = baseline; Alt1 = lower exchange rate coefficient; Alt2 = continued renminbi appreciation; Alt3 = both effects combined; Momentum = recent-trend forecast

Source: Author's calculations.

associated with the decline in foreign interest rates (table 4). When special projections of the oil import bill and capital services are combined with projections of the statistically estimated model under the assumption of a constant real exchange rate at the level of early 2012, the result is that there does indeed seem to be a lasting reduction in the current account surplus, which now seems likely to remain within a range of 2 to 4 percent of GDP over the next six years, far below the range of about 5 percent to 10 percent in the period of 2005–10.

Application of the more conservative exchange rate impact coefficient in Cline and Williamson (2011a) yields a moderately higher current account surplus of 5.4 percent by 2017. A reasonable range for the current account by that time would thus be a surplus of about 4 to 5 percent of GDP (in the absence of further exchange rate change), following reductions to about 2 to 3.5 percent in 2013–14. The policy experiment in which the real effective level of the renminbi continues to rise at 3 percent annually shows that the result would be shift China into approximate current account balance by 2017 (in a range of ±2 percent of GDP, depending on the exchange rate impact parameter used).

Some would argue that the presence of exchange intervention and reserves build-up by a major surplus country remain contrary to the spirit of international financial cooperation, even if the surplus is considerably smaller relative to GDP than in earlier years. In particular, although Cline and Williamson (2011b) apply a threshold of 3 percent of GDP as the perimeter designating whether a currency is at its fundamental equilibrium rate or instead is undervalued (3 percent surplus) or overvalued (3 percent deficit), others have argued that China should not be running a surplus at all (see e.g., Goldstein and Lardy 2006). Moreover, the fact that China's GDP is rising rapidly as a share of the world economy means that even at just 3 percent of GDP its surplus could be large relative to global imbalances.[10] These considerations suggest that an exchange rate path continuing the pace of real effective appreciation begun in June 2010 would go a long way toward reducing the problems for global imbalances posed by China's current account surplus.

POSTSCRIPT

After this policy brief was completed, the IMF released its spring *World Economic Outlook*, which included estimates placing China's current account surplus at 2.3 percent of GDP in 2012, 2.6 percent in 2013, and 4.3 percent in 2017, a range consistent with the analysis here. IMF (2012c, 211).

10. Thus, by 2016 China's GDP is projected in IMF (2011) to amount to 12.9 percent of world product at market exchange rates. By running a surplus of just 3 percent of GDP at that time China would thus be posing the need for all other countries to run offsetting deficits averaging 0.44 percent of GDP, a large consequence from the actions of a single nation.

REFERENCES

BEA (Bureau of Economic Analysis). 2012. *US Economic Accounts*. Washington: US Department of Commerce. Available at: www.bea.gov (accessed April 6, 2012).

Blue Chip. 2012. *Blue Chip Economic Indicators*. New York: Aspen Publishers.

Cline, William R. 2010. *Renminbi Undervaluation, China's Surplus, and the US Trade Deficit*. PIIE Policy Brief 10-20. Washington: Peterson Institute for International Economics.

Cline, William R., and John Williamson. 2011a. *Estimates of Fundamental Equilibrium Exchange Rates, May 2011*. PIIE Policy Brief 11-5. Washington: Peterson Institute for International Economics.

Cline, William R., and John Williamson. 2011b. *The Current Currency Situation*. PIIE Policy Brief 11-18. Washington: Peterson Institute for International Economics.

Customs. 2012. General Administration of Customs of China. (Trade data accessed via the ISI Emerging Markets CEIC Database.)

EIA (Energy Information Agency). 2011a. *Country Analysis Briefs: China*, May 2011. Available at http://www.eia.gov/cabs/china/Full.html (accessed April 6, 2012).

EIA (Energy Information Agency). 2011b. *International Energy Outlook 2011*, September. Washington: Department of Energy.

EIA (Energy Information Agency). 2012. *Annual Energy Outlook 2012 Early Release*, January. Washington: Department of Energy.

Goldstein, Morris, and Nicholas Lardy. 2006. China's Exchange Rate Dilemma. *American Economic Review* May: 422–26.

IMF (International Monetary Fund). 2011. *World Economic Outlook Database September 2011*. Washington.

IMF (International Monetary Fund). 2012a. *International Financial Statistics*. Washington.

IMF (International Monetary Fund) 2012b. *World Economic Outlook Update*, January 24. Washington.

IMF (International Monetary Fund). 2012c. *World Economic Outlook: Growth Resuming, Dangers Remain*, April. Washington.

NBSC (National Bureau of Statistics of China). 2012. Statistical Communiqué on the 2011 National Economic and Social Development. Available at http://www.stats.gov.cn/was40/gjtj_en_detail.jsp?channelid=1175&record=45 (accessed on April 6, 2012).

SAFE (State Administration of Foreign Exchange of China). 2012. *Balance of Payments 2000–2011*. Annual balance of payments tables available at http://www.safe.gov.cn/model_safe_en/tjsj_en/tjsj_list_en.jsp?ID=30304000000000000&id=4 (accessed on April 6, 2012).

The views expressed in this publication are those of the author. This publication is part of the overall programs of the Institute, as endorsed by its Board of Directors, but does not necessarily reflect the views of individual members of the Board or the Advisory Committee.

PREPARED STATEMENT OF JOHN R. DEARIE

EXECUTIVE VICE PRESIDENT FOR POLICY, FINANCIAL SERVICES FORUM

MAY 23, 2012

Introduction

Chairman Warner, and Ranking Member Johanns, thank you for the opportunity to participate in this important hearing regarding the recent round of the U.S.–China Strategic & Economic Dialogue (S&ED) and the need to expand foreign access to China's financial sector.

My name is John Dearie and I currently serve as Executive Vice President at the Financial Services Forum, a financial and economic policy group comprised of the chief executive officers of 20 of the largest financial institutions with business operations in the United States. The Forum works to promote policies that enhance savings and investment and that ensure an open, competitive, and sound global financial services marketplace.

The Forum also leads Engage China—a coalition of 12 financial services trade associations united in support of high-level engagement between the United States and China, with a particular emphasis on accelerated financial reform and modernization in China.

Today's hearing is both timely, given the recent round of the S&ED in Beijing—and enormously important. The rate of China's economic emergence and the impact of its integration into the global economy are unprecedented in the history of the world's economy—with profound implications for U.S. economic growth and job creation.

Importance of Growing China to U.S. Growth and Job Creation

As you will recall, China's economy has grown at an annual rate of nearly 10 percent for more than two decades. The world's 7th largest economy in 1999, China recently surpassed Japan to become the world's 2nd largest economy.

Since China's joined the World Trade Organization (WTO) in December of 2001, U.S. exports to China have increased more than six-fold-growing at seven times the pace of U.S. exports to the rest of the world. China is now America's third largest export market, and the largest market for U.S. products outside of North America. According to a recent *Washington Post* article, exports to China from almost every U.S. State and Congressional district have grown dramatically in recent years. [1]

For your reference, I have provided in Appendix A figures showing the growth in exports to China from each of the States represented by Members of this Subcommittee. [2] As an example, Chairman Warner, exports from Virginia to China have increased 787 percent since 2000, as compared to growth of just 42 percent in Virginia's exports to the rest of the world. Each of the other states has posted similarly impressive growth. Clearly, fair and competitive access to China's fast-growing middle class and business sector represents an enormous commercial opportunity for American manufacturers, services providers, and farmers.

Let me give you a quick sense of what an expanding China can mean for U.S. economic growth and job creation. Last year, U.S. exports to Japan totaled $66 billion, while U.S. exports to China totaled $104 billion. But China's population is 10 times that of Japan. If China's citizens were to eventually consume American-made goods and services at the same rate as the Japanese do, U.S. exports to China would grow to about $700 billion annually.

That's seven times what America exported to China last year, an amount equivalent to nearly 5 percent of U.S. GDP, and nearly twice what we imported from China last year—potentially turning a $300 billion trade deficit into a $300 billion surplus.

Perhaps more importantly, if we apply the Commerce Department's metric of 5,000 new American jobs for every $1 billion in additional exports, increasing exports to China to $700 billion a year would create some 3 million new American jobs. Now, that won't happen overnight. But we believe that with the right reforms in place, it will happen over time.

Critical Importance of Financial Sector Reform in China

In our view, one of the most fundamental and important reforms necessary for the United States to harness the job-creation power of a rapidly growing China is modernization of China's underdeveloped financial system.

[1] "U.S. Exports to China Boom, Despite Trade Tensions", Keith B. Richburg, *The Washington Post,* March 11, 2012.

[2] Export statistics provided by the U.S.–China Business Council.

Capital is the lifeblood of any economy's strength and well-being, enabling the investment, research, and risk-taking that fuels competition, innovation, productivity, and prosperity. As the institutional and technological infrastructure for the mobilization and allocation of investment capital, an effective and efficient financial system is essential to the health and productive vitality of any economy.

As a financial sector becomes more developed and sophisticated, capital formation becomes more effective, efficient, and diverse, broadening the availability of investment capital and lowering costs. A more developed and sophisticated financial sector also increases the means and expertise for mitigating risk—from derivatives instruments used by businesses to avoid price and interest rate risks, to insurance products that help mitigate the risk of accidents and natural disasters. Finally, the depth and flexibility of the financial sector is critical to the broader economy's resilience—its ability to weather, absorb, and move beyond the inevitable difficulties and adjustments experienced by any dynamic economy. For all these reasons, an effective, efficient, and sophisticated financial sector is the essential basis upon which the growth and vitality of all other sectors of the economy depend.

Unfortunately, the world's second largest and fastest growing economy is currently supported by one of the world's least developed and inefficient financial systems. Like a world-class athlete with cardiovascular disease, China runs an ever-mounting risk of catastrophic breakdown even as it continues to turn in robust economic growth performances.China's financial sector challenges are many. For example:

- China's financial system is very bank-centric, with banks intermediating more than three-quarters of the economy's total capital, compared to about half in other emerging economies and less than 20 percent in developed economies.
- Meanwhile, China's equity and bond markets remain comparatively small and underdeveloped. More fully developed capital markets would provide healthy competition to Chinese banks and facilitate the development and growth of alternative retail savings products such as mutual funds, pensions, and life insurance products. And by broadening the range of funding alternatives for emerging companies, more developed capital markets would greatly enhance the flexibility and, therefore, the stability of the Chinese economy.
- Noncommercial lending—or "policy lending"—to State-owned enterprises continues.
- As a result, the stock of nonperforming loans on banks' balance sheets remains high.
- China's banks are undercapitalized and lending practices, risk management techniques, new product development, internal controls, and corporate governance practices remain inadequate.
- Prudential supervision and regulation of the financial sector remains opaque, is applied inconsistently, and lags behind international best practices.

Simply stated, China's underdeveloped financial sector presents substantial risk to the continued growth and diversification of the Chinese economy—and, therefore, to the U.S. and global economies as well. [3]

China's Commitment to Financial Reform

In its twelfth 5-Year Plan, approved by the National People's Congress last March, China's leadership acknowledged that its manufacturing-for-export economic model of the past three decades has left it vulnerable to slow-downs in external demand. China's leadership now wisely seeks a more balanced economic model that relies less on exports and more on internal demand—primarily, a more active Chinese consumer.

A more consumption-based Chinese economy is very much in the interest of the United States. As I noted earlier, a more active Chinese consumer will dramatically expand demand for U.S.-made products and services.

But accelerating the shift to a more consumption-based Chinese economy requires a more modern and sophisticated financial sector. Chinese households currently save as much as half of their income, as compared to single-digit savings rates in the United States and Europe. This pronounced propensity to save is related to the declining role of the State, and the fact that most Chinese depend on their families and private savings to pay for retirement, health care, and the economic consequences of accidents or disasters.

[3] *See,* "Why Financial Reform Is Crucial for China's Growth", Arthur R. Kroeber, The Brookings Institution, March 19, 2012.

Activating the Chinese consumer requires the availability of financial products and services—personal loans, credit cards, mortgages, pensions, insurance products and services, and retirement security products—that will eliminate the need for such "precautionary savings" and facilitate consumption.

This observation was recently confirmed by an important report entitled "China 2030," jointly issued on February 27th by the World Bank and China's Development Research Center. The report emphasized that achieving China's macroeconomic goal requires a number of urgent reforms, including "commercializing the banking system, gradually allowing interest rates to be set by market forces, deepening the capital market, and developing the legal and supervisory infrastructure to ensure financial stability and build the credible foundations for the internationalization of China's financial sector."[4]

Given the unique and critical role an effective and efficient financial sector plays in any economy, reform of China's financial sector is a prerequisite to China achieving its own economic goals.

Fortunately, China's leadership recognizes the connection between faster financial reform and a more consumption-based economy. In a March 5th speech opening the National People's Congress, Premier Wen Jiabao confirmed that China seeks more balanced and sustainable development, stating "we will move faster to set up a permanent mechanism for boosting consumption." Importantly, as part of the restructuring strategy, Wen also appeared to endorse further reform of China's financial system, stating: "We will improve both initial public offerings . . . and ensure better protection of return on investors' money and their rights and interests."[5]

The same day, Guo Shuqing, Chairman of the China Securities Regulatory Commission commented to reporters: "Market risk is concentrated in the banking system. Developing equity financing . . . can reduce the burden on the Government, and open new investment channels to funds and wealthy citizens."

On March 21st, Zhou Xiaochuan, Governor of the People's Bank of China, wrote in China Finance magazine: "Currently conditions for market-oriented interest rate liberalization are basically ripe. The People's Bank of China will actively push forward [with such reforms]."[6]

The fastest way for any developing economy to acquire the modern financial sector it needs is to import it—that is, to allow foreign financial institutions to establish in-country operations though the establishment of branches and subsidiaries, joint ventures with domestic institutions, and cross-border mergers and acquisitions. Foreign institutions—including U.S. institutions—bring to China world-class expertise and best practices with regard to products and services, credit analysis, risk management, internal controls, and corporate governance.

The U.S.–China Strategic and Economic Dialogue

To enhance the management of the growing bilateral relationship, President George W. Bush and President Hu Jintao established the U.S.–China Strategic Economic Dialogue (SED) in September of 2006. The SED—led by then-Treasury Secretary Hank Paulson and Chinese Vice Premier Wang Qishan—created an unprecedented channel of communication between Cabinet-level U.S. and Chinese policy makers, and provided an overarching framework for the examination of long-term strategic issues, as well as coordination of ongoing bilateral policy discussions (*e.g.,* the Joint Commission on Commerce and Trade, the Joint Economic Committee). A central focus of the SED was accelerating financial reform in China.

Upon taking office, the Obama administration renamed the Dialogue as the "Strategic & Economic Dialogue," broadening the talks to include other issues such as human rights, environmental issues, and diplomatic cooperation.

Limited but significant progress has been made by way of the Dialogue:

- China has agreed to allow qualified foreign companies to list on its stock exchanges by issuing shares or depository receipts;
- China has expanded its Qualified Foreign Institutional Investor (QFII) program and reduced the initial "lock-up period" for certain investors, creating new opportunities for foreign mutual funds and money managers to invest in China;
- China has agreed to allow nondeposit taking foreign financial institutions to provide consumer financing;

[4] "New Push for Reform in China", Bob Davis, *The Wall Street Journal,* February 23, 2012.
[5] "China Premier Backs Blueprint for Financial Reform", Dinny McMahon, *The Wall Street Journal*, March 5, 2012.
[6] "Conditions Ripe for China Interest Rate Reform—Central bank Chief Zhou", Kevin Yao, Reuters, March 21, 2012.

- China has agreed to ease qualifications for foreign banks to issue yuan-denominated subordinated bonds, which will allow foreign banks to raise capital in China;
- China has issued regulations specifying requirements to allow insurance companies—including foreign-owned companies—to invest assets overseas; and,
- Since July of 2005, the yuan has appreciated against the U.S. dollar by more than 25 percent in nominal terms and almost 40 percent in real terms. China also recently announced that it would widen its trading band to allow market forces to play a greater role in setting the exchange rate. [7]

Additional progress was achieved at the most recent S&ED meetings in May:

- China now has amended its regulations to implement last year's S&ED commitment to allow U.S. and other foreign insurance companies to sell mandatory auto liability insurance in what is the world's largest market for automobiles.
- China committed that foreign and domestic auto financing companies—currently dependent on China's State-owned banks for funding—will be able to issue bonds regularly, including issuing securitized bonds. This will help boost the competitive edge in China of U.S. auto firms, which are global leaders in auto financing.
- China committed to increase the total dollar amount that foreigners can invest in China's stock and bond markets under its Qualified Foreign Institutional Investor (QFII) program from $30 to $80 billion. This will reduce restrictions on the free flow of capital and increase opportunities for U.S. pension and mutual funds and other investment management firms.
- China committed to allow foreign investors to take up to 49 percent equity stakes in domestic securities joint ventures, going beyond China's WTO commitment of 33 percent. China also agreed to shorten the waiting period (seasoning period) for securities joint ventures to apply to expand into brokerage, fund management, and trading activities that are essential to building competitive securities businesses.
- China agreed to allow investors from the U.S. and other economies to establish joint venture brokerages to trade commodity and financial futures and hold up to 49 percent of the equity in those joint ventures; and,
- China reaffirmed its intention to promote more market-based interest rates, which will allow Chinese households to earn a higher return on their savings, supporting greater household consumption.

U.S. Institutions Still Confront Major Restrictions

Despite such important progress, U.S. financial institutions continue to face a number of substantial obstacles in China:

- Investment by U.S. firms in Chinese financial institutions is limited to minority interests and is capped. For example, foreign investment in Chinese banks remains limited to 20 percent ownership stakes, with total foreign investment limited to 25 percent. Foreign ownership currently amounts to less than 2 percent of the Chinese banking system. According to Department of Treasury data, as of December 2011, only eight U.S. banks were operating in China with a total of just 76 branches.

  Foreign-owned securities and asset management firms are limited to joint-ventures in which foreign ownership is capped at 49 percent. Meanwhile, foreign life insurance companies remain limited to 50-percent ownership in joint ventures and to 25-percent equity ownership of existing domestic companies.

  While these caps were agreed to in the course of WTO accession negotiations, the limitations are among the most restrictive of any large emerging market Nation and stand in the way of a level playing field for financial service providers. More importantly, they limit access to the products, services, know-how, and expertise that China needs to sustain high rates of economic growth, and that China's businesses and citizens need to save, invest, and create and protect wealth.

  Such investment caps also stand in stark contrast to the Federal Reserve's recent decision to approve Industrial & Commercial Bank of China's acquisition

[7] "The Outlook for China's Currency", Laura D'Andrea Tyson, *The New York Times,* May 6, 2011. Also see "China Bashing Is Popular But Could Do More Harm Than Good", Editorial, Bloomberg, April 25, 2012.

of the Bank of East Asia's U.S. banking subsidiary, [8] the Bank of China's application to expand its U.S. operations to Chicago, [9] and the application by Agricultural Bank of China Ltd. to establish a branch in New York. [10]

As strong proponents of cross-border trade and investment, the U.S. financial services industry applauds the Fed's decision—but also calls on China to lift remaining restrictions to U.S. investment in China's financial system.

Other remaining barriers to U.S. activity in China include:

- Nonprudential restrictions on licensing and corporate form;
- Arbitrary imitations of permitted products and services; and,
- Arbitrary and discriminatory regulatory treatment.

While China may be compliant with the letter of its WTO obligations, such restrictions and regulations—and the manner in which they are enforced—violate the spirit of China's WTO obligations by creating artificial and arbitrary barriers to greater foreign participation.

With these problems in mind, U.S. effort within the S&ED and other bilateral exchanges should focus on:

- the critical importance of open commercial banking, securities, insurance, pension, and asset management markets to promoting the services- and consumption-led economic growth that China's leaders seek;
- the clear benefits to China of increased market access for foreign financial services firms—namely the introduction of world-class expertise, technology, and best practices—and the importance of removing remaining obstacles to greater access;
- nondiscriminatory national treatment with regard to licensing, corporate form, and permitted products and services;
- nondiscriminatory national treatment with regard to regulation and supervision;
- regulatory and procedural transparency; and,
- increasing institutional investors' participation in China's capital markets by further expanding the Qualified Foreign Institutional Investor (QFII) and Qualified Domestic Institutional Investor (QDII) programs.

For a more detailed discussion of the U.S. financial services industry's priorities in China, please see Appendix B.

Conclusion

Mr. Chairman, the fastest way for China to develop the modern financial system it needs to achieve more sustainable economic growth, allow for a more flexible currency, and increase consumer consumption is to open its financial sector to greater participation by foreign financial services firms.

By providing the financial products and services that China's citizens and businesses need to save, invest, insure against risk, raise standards of living, and consume at higher levels, foreign financial institutions—including U.S. providers—would help China develop an economy that is less dependent on exports, more consumption-driven and, therefore, an enormously important and expanding market for American-made products and services. In doing so, U.S. financial services firms can help China become a more stable and responsible stakeholder in the global economy and trading system.

It is importance to emphasize that Congress has an important contribution to make toward expanding market access generally, and encouraging faster financial reform in China specifically, by bringing the same kind of attention and pressure to these issues as it has to the relative value of China's currency. Chinese policy makers care what members of Congress think and carefully monitor the content of statements, speeches, and hearings as they gauge the state of the bilateral relation-

[8] The subsidiary has assets of $780 million and 13 branches in New York and California. ICBC, China's largest bank, already operates in the United States through a New York branch. Under the terms of the approval, ICBC, China Investment Corp. and Central Huijin Investment Ltd. will become bank holding companies. The Chinese Government owns 70.7 percent of ICBC's shares. *See,* "Fed Allows Three Chinese Banks To Expand in U.S.", Greg Robb, MarketWatch, May 9, 2012.

[9] The Bank of China, China's third largest bank, currently operates two branches in New York City and a limited branch in Los Angeles.

[10] Agbank, China's fourth largest bank, currently operates a representative office in New York City.

ship. Senator Warner and Senator Johanns, the letter that you sent to Secretary Geithner on April 24th urging him to ensure that accelerated financial reform be a central aspect of the recent S&ED is a perfect example of the kind of pressure that makes a real difference. So thank you very much for send the letter.

And thank you again for the opportunity to appear at this important hearing.

THE US-CHINA BUSINESS COUNCIL
美中贸易全国委员会

Virginia Exports to China ($ million)

Growth in Virginia Exports, 2000–2011

Exports to China: 787%
Exports to Rest of World: 42%

Virginia's Top Export Markets, 2011	
1. Canada	$2.9 billion
2. China	$1.8 billion
3. United Kingdom	$1.1 billion
4. Mexico	$901 million
5. Germany	$868 million

Virginia's Top Exports to China, 2011	
1. Chemicals	$466 million
2. Waste & Scrap	$208 million
3. Computers & Electronics	$191 million
4. Machinery (except Electrical)	$152 million
5. Paper Products	$140 million

China is Virginia's 2nd-largest export market

Source: US Department of Commerce

THE US-CHINA BUSINESS COUNCIL
美中贸易全国委员会

Nebraska Exports to China ($ million)

Growth in Nebraska Exports, 2000–2011

Exports to China: 632%
Exports to Rest of World: 193%

Nebraska's Top Export Markets, 2011	
1. Canada	$2.0 billion
2. Mexico	$1.9 billion
3. Japan	$537 million
4. China	$380 million
5. South Korea	$332 million

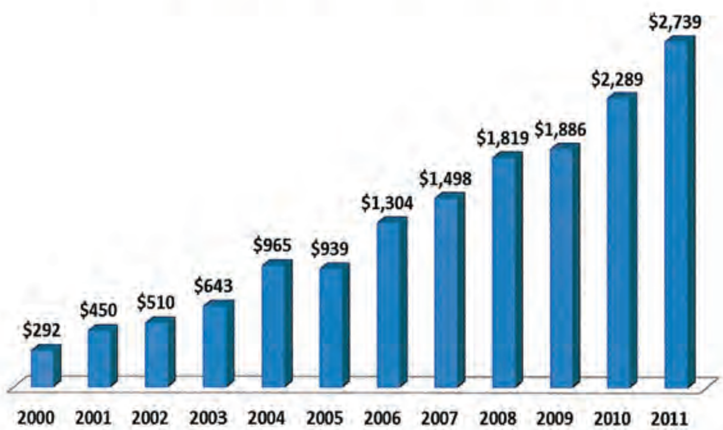
Nebraska's Top Exports to China, 2011	
1. Processed Foods	$239 million
2. Machinery (except Electrical)	$29 million
3. Chemicals	$26 million
4. Waste & Scrap	$20 million
5. Leather & Related Products	$20 million

China is Nebraska's 4th-largest export market

Source: US Department of Commerce

USCBC THE US-CHINA BUSINESS COUNCIL
美中贸易全国委员会

Ohio Exports to China ($ million)



Growth in Ohio Exports, 2000–2011

Exports to China: 838%
Exports to Rest of World: 68%

Ohio's Top Export Markets, 2011	
1. Canada	$18.7 billion
2. Mexico	$4.0 billion
3. China	$2.7 billion
4. France	$2.4 billion
5. Brazil	$1.7 billion

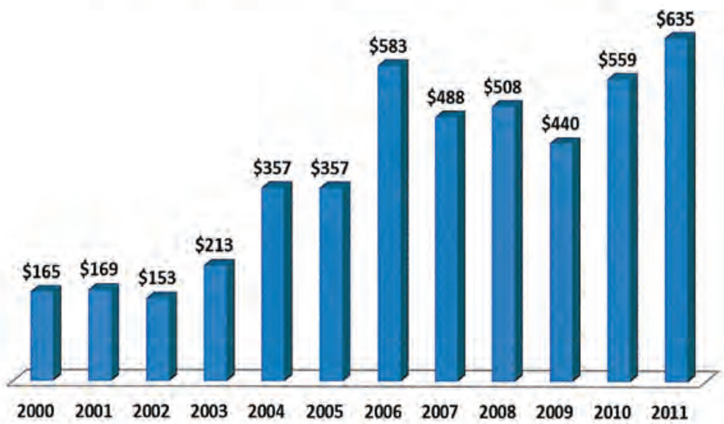
Ohio's Top Exports to China, 2011	
1. Machinery (except Electrical)	$543 million
2. Computers & Electronics	$339 million
3. Transportation Equipment	$338 million
4. Chemicals	$301 million
5. Waste & Scrap	$265 million

China is Ohio's 3rd-largest export market

Source: US Department of Commerce

THE US-CHINA BUSINESS COUNCIL
美中贸易全国委员会

Colorado Exports to China ($ million)



Growth in Colorado Exports, 2000–2011

Exports to China: 286%
Exports to Rest of World: 4%

Colorado's Top Export Markets, 2011	
1. Canada	$1.5 billion
2. Mexico	$755 million
3. China	$635 million
4. Japan	$393 million
5. The Netherlands	$317 million

Colorado's Top Exports to China, 2011	
1. Computers & Electronics	$154 million
2. Waste & Scrap	$124 million
3. Processed Foods	$110 million
4. Machinery (except Electrical)	$86 million
5. Chemicals	$51 million

China is Colorado's 3rd-largest export market

Source: US Department of Commerce

THE US-CHINA BUSINESS COUNCIL
美中贸易全国委员会

South Dakota Exports to China ($ million)

Growth in South Dakota Exports, 2000–2011

Exports to China: 975%
Exports to Rest of World: 106%

South Dakota's Top Export Markets, 2011	
1. Canada	$517 million
2. Mexico	$395 million
3. China	$70 million
4. Japan	$55 million
5. Germany	$43 million

South Dakota Top Exports to China, 2011	
1. Processed Foods	$44 million
2. Minerals & Ores	$7 million
3. Chemicals	$6 million
4. Machinery (except Electrical)	$5 million
5. Computers & Electronics	$3 million

China is South Dakota's 3rd-largest export market

Source: US Department of Commerce

THE US-CHINA BUSINESS COUNCIL
美中贸易全国委员会

Illinois Exports to China ($ million)

Growth in Illinois Exports, 2000–2011

Exports to China: 631%
Exports to Rest of World: 96%

Illinois' Top Export Markets, 2011	
1. Canada	$19.2 billion
2. Mexico	$5.7 billion
3. China	$3.9 billion
4. Australia	$3.7 billion
5. Brazil	$2.6 billion

Illinois' Top Exports to China, 2011	
1. Machinery (except Electrical)	$813 million
2. Waste & Scrap	$670 million
3. Crop Production	$620 million
4. Computers & Electronics	$394 million
5. Chemicals	$328 million

China is Illinois' 3rd-largest export market

Source: US Department of Commerce

PREPARED STATEMENT OF DEAN C. GARFIELD

PRESIDENT AND CHIEF EXECUTIVE OFFICER, INFORMATION TECHNOLOGY INDUSTRY COUNCIL

MAY 23, 2012

The Information Technology Industry Council (ITI) appreciates the opportunity to provide testimony on developments regarding China's indigenous innovation and intellectual property (IP) policies at the latest Strategic & Economic Dialogue (S&ED), including the Third U.S.–China High-Level Innovation Dialogue, which was held earlier this month in Beijing. ITI represents global leaders in innovation, from all corners of the information, communications, and technology sector, including hardware, software, and services. China, along with other emerging markets, is a critical market for ITI member companies. Hundreds of thousands of American high-tech jobs are directly tied to robust trade and business with China. In fact, some of the largest beneficiaries of that trade are American workers and businesses, many of them small businesses which manufacture electrical machinery and equipment or develop software that feeds into the tech industry's global supply chain.

The ability to freely access foreign markets such as China and compete on equal terms has been critical to the health of the tech sector, and has underpinned the United States as an innovative economy. As our economy recovers from a severe recession, it is critical our companies be able to access the 95 percent of the world's consumers who live beyond our shores. More than 75 percent of the global growth in the tech market during the next 5 years is projected to take place overseas. Maintaining free and open global markets will support our economic recovery and help achieve a shared goal of promoting U.S. exports. Indeed, U.S. exports to China are on the rise. Last year, our exports to China were nearly $104 billion, up four-fold from a decade ago. Yet, U.S. tech companies operating in the China market continue to face increasingly challenging and complex market access barriers.

To be clear, our industry welcomes efforts of China and other Nations to promote innovation. Where we have difficulties is when policies under the guise of innovation policy are developed and implemented in a manner that favors domestic companies at the expense of foreign players. Moreover, we are beginning to see some of this new, creeping protectionism being replicated in other parts of the world.

Today, I would like to highlight that, despite some rollbacks of China's problematic policies, many challenges remain that continue to create market access barriers for U.S. technology firms. I would also like to underscore our concerns over how these policies are being mirrored by developing countries in such markets as India, Brazil, Russia, and other major markets our companies rely on for growth. Finally, I will provide thoughts on how our industry can work with the U.S. Government to address these challenges in both China and around the world.

China Continues To Champion Indigenous Innovation

China's indigenous innovation policies have been around for some time, dating back to the 2006 Medium- and Long-Term National Plan for Science and Technology (MLP). The chief aim of this plan was to foster the development, commercialization, and procurement of Chinese products and technologies. More precisely, it was developed to give a leg up to domestic producers by compelling Chinese Government agencies and State-Owned Enterprises (SOEs) to adopt rules and regulations favoring products and services that use Chinese-developed ideas and technologies. One of the most notable of China's policies to advance indigenous innovation was its effort to establish a national catalog of products to receive significant preferences for Government procurement. Among the many problematic criteria for eligibility were stipulations that products contain intellectual property (IP) developed and owned in China and that associated trademarks be originally registered in China. This was an unprecedented use of domestic IP as a condition of market access that no other country in the world requires, and one that made it nearly impossible for American companies to qualify. IP is developed all over the world, not just in one country.

China has since backed away from this policy, and at the 2011 S&ED agreed to revise policies that link innovation and procurement. The rollback of this policy was due to the combined efforts of industry and like-minded Governments around the world, including our own. But the indigenous innovation policy drive extends well beyond the catalogs and is morphing into other similar policies under different nomenclature.

Indeed, the Chinese Government has transitioned to support indigenous innovation approaches within a new policy under the twelfth 5-Year Plan called "the decision to develop Strategic Emerging Industries," (referred to as SEIs). In short, the SEI initiative can be seen as an important and sweeping program to develop indigenous technology at the expense of foreign industry. These developments come despite high-level commitments made by the Chinese Government to treat foreign-invested enterprises equally under the indigenous innovation program. Despite efforts to claim "indigenous innovation" is nondiscriminatory, China's leadership, as recently as December 2011, has referred to this initiative as "one of self-reliance." Some would say SEI is now the new code word for indigenous innovation.

In October 2010, shortly before the Chinese Government began to walk back from its indigenous product catalogs, it began to promote the concept of SEI's. In a high-level State Council decision, the Government selected seven strategic sectors including "next-generation IT" for renewed Government support. China also announced it will spend $1.5 trillion on the development of these seven sectors, through 2015. Should Beijing distribute the funds evenly among the seven industries over 5 years, this would mean China's tech industry would receive annual Government funding of roughly $42 billion each year through 2015. To put a point to it, this support would all go to Chinese companies.

More Than Just Government Procurement Policy

Our concern is that despite U.S. "success" in rolling back some of China's IP requirements and procurement catalogs, the Chinese Government continues on its path of discriminatory innovation policies in an increasingly sophisticated way. This includes a new web of indigenous innovation policies under the SEI banner, continuing lack of IP protection and enforcement, mandating local standards, and an alarming trend of using vague national security concerns related to information security to discriminate against foreign tech companies.

In particular, the trend to promote and favor indigenous IP is a core aspect of the twelfth 5-Year Plan and Strategic Emerging Industries policies. The policies below are a sampling of those and other kinds of specific troubling policies China is now promoting under the SEI program:

- A new SEI "core products and services catalogues" being drafted by the Chinese Government that will likely end up guiding Government and SOE procurement decisions;
- A stated policy goal to satisfy 30 percent of domestic semiconductor market demand with indigenously designed semiconductors by 2015;
- Reaching an 80 percent self-sufficiency rate for flat panel displays by 2015;
- Creating a "Chinese Domestic Cloud" based on indigenous technologies and IP;
- Providing preferential public procurement incentives for domestic information security technology manufactured in China; and
- Providing $1.2 billion in subsidies in 2012 alone to develop indigenous networking technology IP.

Ironically, while China seeks to foster the development of its own IP, it also remains a persistent outlier when it comes to IPR infringement. Some progress was made in 2011 with the launch of a State Council Special Campaign and a related State Council level office to increase IP rights protection efforts, specifically targeting the usage of pirated software by Government agencies. There were also positive statements made at this month's S&ED that indicate China will extend this campaign to commercial enterprises. Despite these commitments, the trend lines still appear markedly negative. In addition, the United States Trade Representative (USTR) in its recent 2011 Special 301 Report alluded to an "alarming increase" in trade-secrets theft of U.S. IP-intensive industries originating from China.

Of equal concern to the global tech industry is China's drive to develop its own unique national standards outside the norms to which the industry has adhered during the last few decades. This includes not only mandating standards for the commercial market, but also doing so in ways that make it difficult to address problems through trade remedies. For example, while the Chinese Government agreed to "suspend indefinitely" at the 2005 U.S.–China Joint Committee on Commerce and Trade (JCCT) China's homegrown WIFI standard WAPI, it is now a de facto mandatory standard. China has managed to do this despite previous commitments by compelling its State-owned telecommunication carriers to include WAPI in commercial bidding documents for WIFI equipment.

Since WAPI, our industry has seen China issue a plethora of problematic tech standards. UHT/EUHT is a good example, which is yet again another Chinese attempt at developing unique standards to compete with WIFI. Despite widespread opposition from both foreign Governments and industry, and compatibility issues with existing WIFI standards, the Chinese Government earlier this year approved the standard. UHT/EUHT advanced as "voluntary," but we have concerns that, like WAPI, it will become a de facto mandatory standard once the Government communicates its "guidance" to State-owned industry. Other examples include China's new standards for wireless 4G encryption, or various competing national standards for cable TV video-encoding, both of which we fear will likely end up as de facto mandates.

We face myriad discriminatory opaque market access barriers for global companies looking to do business in China from these technical unique national standards. This is in stark contrast to the voluntary, industry-led and global standards which have helped to drive innovation and growth for our industry.

Beyond standards, China continues to increase burdensome testing and certification regulations on tech products sold in both Government procurement and commercial markets that are inconsistent with global norms. We often see overlapping, unnecessary or onerous testing requirements related to safety and other product testing, most of which is conducted in Government-affiliated laboratories. The far-reaching Multi-Level Protection Scheme (MLPS), for example, places huge barriers on many high-tech products going into critical infrastructure systems in China. This includes unworkable testing mandates and domestic IP requirements. China's encryption rules are perhaps the most onerous. They bar foreign companies from selling key security technology that is now the bedrock to ensuring consumer and business trust in the Internet.

In sum, while we have now have more official Government-to-Government dialogues that cover these issues with China than with any other country, our success in rolling back problematic policies remains limited. China continues to mandate problematic standards, force the disclosure of sensitive IP, and enact preferences for local products in an increasingly sophisticated way. It is incredibly important to address this now, especially since such protectionist models are being replicated in other markets.

Mirroring China

In recent years, the Chinese economic model of growth has become increasingly attractive to developing countries around the world. More troubling, a significant number of Governments have begun implementing new trade-restrictive policies similar to those of China. These policies continue to undermine the ability of American tech companies to compete fairly in critical markets. The spread of these policies has become particularly acute over the past couple of years as Governments wrestle with economic and political challenges at home.

Specifically, these Governments, which now include the likes of India, Brazil, Argentina, and Russia, have begun implementing a number of policies designed to boost their domestic manufacturing, high-technology and R&D capabilities, and services—often at the expense of foreign companies. We have seen India follow in the footsteps of Beijing through a recent national policy that mandates onerous local content requirements for electronic procurements. Or, take for example Argentina, which has put in place an import-licensing scheme that discriminates against foreign technology goods. Then there is Brazil, which has mandated the local sourcing of telecom equipment to be used to build out infrastructure to support new spectrum.

These types of policies will reverse decades of global growth and innovation. The U.S. Government has been successful in reversing some discriminatory policies in several important markets. But these reversals appear more tactical than permanent, and discriminatory policies are continuing to proliferate. If left unchecked, these policies will lead to a crippling loss of competitiveness and global market share for our companies, undermining economic growth and job creation here in the United States.

The Solution: Let's Get China Right

The first step in setting things on the right course is to ensure we get China right. China is obviously too big to ignore, and as we have seen, has created a new model for development which some call the "Beijing Consensus." The U.S. Government should continue concerted efforts to address specific trade barriers, as well as strategically address the broader, underlying trends of protectionism and promotion of Chinese national champions. We commend past efforts by our Government to address China's indigenous innovation policies, and we urge continued support of bilateral dialogues such as the S&ED, JCCT, and Innovation Dialogue. The Administration's role in pushing back numerous policies, including the indigenous innovation catalogs, has been instrumental. The United States should continue working closely with the private sector and with other Governments to develop a clear, coordinated strategy for encouraging China to adopt global norms. When we have been most successful in dealing with China, it has been the result of close cooperation among Governments and between our Government and the private sector. And this needs to be an ongoing, results-based effort.

At the same time, we need to recognize that China does not speak with a single voice, and there are a growing number of actors that have begun to see the world as we view it. This includes increasingly global Chinese enterprises that are embracing global standards to help lower their costs to sell their products in overseas markets. Or sophisticated consumers that want the same products sold in developed markets, not the out-of-date and bland technology mandated by a Government bureaucrats. While it is not always easy to find these actors, and even challenging to get them to speak out, it must be done. Real change in China will only come when its own citizens realize the negative effects of its industrial policies.

Towards a Global Solution

The time has finally come to develop a more comprehensive strategy to defeat these policies at a global level, promote the global benefits of effective policies that support open markets and nondiscriminatory innovation, and defend growth, innovation, and job creation. This strategy should focus on those countries where retrograde policies are most acute and serious, and are increasingly being recognized by developing Governments such as India and Brazil. While this effort needs to include a high-level, comprehensive tier of work, it must also be tailored for individual markets. Recent successful efforts by a broad array of private-sector coalitions to roll back discriminatory industrial policies in China and India can serve as effective models for these efforts.

This means the U.S. Government, in collaboration with the private sector, must communicate to these Governments a clear vision for viable alternatives to which they can turn to achieve the results they want in fostering innovation and development. This includes understanding that Governments can and will continue an important role in fostering innovation, such as through promoting STEM education or creating tax incentive for R&D. At the same time, Governments must clearly recognize that most innovation comes from the private sector. In the short term, we suggest that the U.S. Government begin to address these concerns at the G20 to be held next month in Mexico City.

Our industry is already working with the U.S. Government to identify and analyze the most pertinent challenges, and to provide other Governments possible solutions. More is needed, however, to raise the level of attention—both within the United States and with our trading partners—regarding the existence of these challenging problems and how to combat them creatively. These steps are necessary to ensure that American technological competitiveness remains strong.

Thank you.