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United States: Department of the Treasury

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U.S. DEPARTMENT OF THE TREASURY

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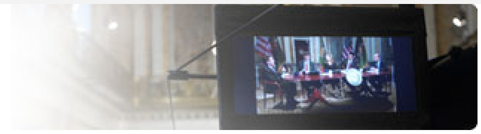

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U.S.-China Economic Engagement: The Road to Faster, Deeper Reform

New York – Thank you Paul for that warm introduction, and thanks to all of you for coming this morning. I am grateful to the Council on Foreign Relations for bringing us together to discuss an issue of great long-term importance: U.S.-China economic relations. Indeed, maintaining a mutually beneficial, open, and politically sustainable economic relationship with China is one of the United States' most pressing challenges – and greatest opportunities – in the realm of international economic policy.

– Thank you Paul for that warm introduction, and thanks to all of you for coming this morning. I am grateful to the Council on Foreign Relations for bringing us together to discuss an issue of great long-term importance: U.S.-China economic relations. Indeed, maintaining a mutually beneficial, open, and politically sustainable economic relationship with China is one of the United States' most pressing challenges – and greatest opportunities – in the realm of international economic policy.

The challenge is great because the stakes are high – for the United States, for China, and for the global economy. For the United States, China is the world's fastest growing major market for our goods and services. Since China's accession to the World Trade Organization in 2001, U.S. exports to China have grown five times faster than our exports to the rest of the world.

At the same time, China's prosperity depends on the United States. Last year, American consumers and companies purchased one-fifth of China's exports. Even as China diversifies its export markets, American demand continues to shape China's economy. Investment flows between our two countries are also expanding rapidly. Between just 2002 and 2006, U.S. foreign direct investment (FDI) in China grew from roughly $10 to $22 billion while in 2007 alone, Chinese direct and portfolio investment in the United States totaled nearly $10 billion.

As a consequence of this growth, the U.S.-China economic relationship has been forced to mature very quickly. With the increasing volume of trade and investment, it was inevitable that we would experience a range of frictions as we do in our economic relationships with other major trading partners. These frictions include growing concerns about trade imbalances, product safety, the Chinese government's large holdings of foreign exchange reserves, and China's foreign exchange policies.

While not surprising, these frictions have nevertheless caused some in the United States to question the benefits of maintaining an open and expansive economic relationship with China. The Bush Administration's answer to this defining question is unwavering: We are committed to strengthening our economic relationship with China and opening its markets to create new opportunities for American firms and American workers. In this effort, we are making full use of the policy tools at our disposal, and we have developed new approaches, most notably the Strategic Economic Dialogue (SED) launched by Presidents Bush and Hu in 2006.

In spite of the continuing frustrations and inevitable tensions in our economic relations with China, this Administration is taking a thoughtful and effective approach to accelerating reform and promoting U.S. interests. Would we like more rapid, deeper reform? Of course. But we are making steady progress and bringing clear benefits to America's workers, businesses, and consumers.

China's Growth Challenge

China's growth over the past three decades has been nothing short of miraculous. It has transformed itself from a poor, mostly agrarian, and almost closed economy into the world's third most important trading nation. In the process, China has benefited from economic growth averaging nearly 10 percent per year that has lifted hundreds of millions of Chinese citizens out of poverty.

The growth model that produced this enormous success has also been highly resource-intensive, and driven by heavy investment in industrial production and exports rather than growth in domestic household consumption. We see evidence that this model is no longer sustainable in China's increasingly wasteful investment, rising inequality, a large and growing current account surplus, and accelerating environmental degradation. We also see evidence of this in weak growth in Chinese employment and in household income growth that lags well behind the rise in GDP.

China's imbalances at home are mirrored by the imbalances China continues to generate abroad. High national saving – and its counterpart, weak consumer demand – provide the structural basis for large Chinese trade and current account surpluses that make China's economic growth increasingly dependent upon foreign demand, sometimes creating friction between China and its trading partners.

This is not simply an American critique of China's economy. China's most senior leaders tell us they are committed to addressing the imbalances between growth in rural and urban areas, between the coastal and interior regions, between reliance on domestic and foreign demand to drive growth, between rich and poor households, and between economic development and environmental protection. They are coming to realize, as we do, that their success in addressing these challenges would have enormous benefits for China and the United States.

Exchange Rate Policy

The critical question for U.S. policymakers is how we can best support and encourage this economic transformation. For our part, we understand that we will be judged by our success in helping the Chinese address this rebalancing challenge in a manner that brings continued benefits, while minimizing the risks, to the U.S. economy. China's exchange rate is one issue that has been viewed by some, I think mistakenly, as a litmus test for our success.

The untold story of our approach to China's currency policy is that it is working, albeit more slowly than we would like. Initially, after moving away from a pegged exchange rate in July 2005, China's actions were cautious, with the RMB appreciating slowly. More recently, however, the pace of appreciation has increased sharply, to roughly 7 percent in 2007, and 4 percent in the last three months alone, or 17 percent annualized. Since China abandoned the peg to the dollar, the RMB has appreciated roughly 15 percent against the dollar and 9 percent against other major currencies on a real trade-weighted basis. The foreign exchange market in China is also developing: daily RMB fluctuations are larger, the market is deeper, and we have seen rapid expansion in the use of foreign currency hedging instruments.

Although RMB adjustment is still far from complete, the accelerated pace of appreciation is significant and welcome, and it should continue. China and the United States must be careful not to derail this reform through protectionist actions on either side that risk disrupting the relationship. The leadership and interest of the U.S. Congress on China's currency reform – and China's economic reform more broadly – are both needed and welcome. But it is especially important now, during a time of turmoil in global markets, that we remain steadfast in our commitment to an open and expanding trade and investment relationship between the United States and China.

As Secretary Paulson has often said, greater exchange rate flexibility is in China's own interest. The RMB movement that I have noted reflects the Chinese leadership's growing recognition that more rapid exchange rate adjustment allows for more effective management of the Chinese economy, including the risk of rising inflation. A continuation of the recent pace of RMB appreciation is also important to the United States, although it will not eliminate, or even decrease significantly, the U.S. global trade deficit or mitigate the challenges that American industries face from overseas competition. It will, however, remove a major source of perceived unfairness in the U.S.-China economic relationship, permitting us to devote greater attention to other issues with even more significant impact on our economic relationship.

Strategic Economic Dialogue

Under Secretary Paulson's leadership, the Strategic Economic Dialogue has created an unprecedented channel of communication between senior U.S. policymakers and their counterparts at the highest levels of the Chinese government that is focused on doing just that. Specifically, the SED is premised on the fact that China and the United States have shared economic interests and that we benefit from expanding our cooperation over the longer term. Central to our shared interests is leveraging U.S. expertise and support in helping China transition to a new model for economic growth that addresses its imbalances. This reform agenda runs broad and deep, ranging from macroeconomic policy to domestic regulation, investment policy to environmental protection.

For example, to assure China's future growth – without heavy domestic costs and huge trade surpluses – China must put more income in the hands of households and change policies that force these households to save so much of what they earn. This involves increasing the dividend payments from China's profitable companies, including state-owned enterprises, a reform that China has recently started. It also requires a stronger social safety net that reduces the need for Chinese households to over-save for a rainy day or old age. On these issues, we can contribute much in terms of expertise and capabilities in our ongoing dialogue with China's leaders.

To create more sustainable growth, China will also need to develop a vibrant and efficient financial sector, to provide Chinese households and firms with better opportunities to build wealth and hedge risk, and to fuel innovation as an engine of economic growth. Clearly, the American financial services industry has much to offer China in this regard. As you know, we are working to improve access to China's market for the American financial services industry. Like you, we are unsatisfied with the progress to date, but the SED has produced some significant Chinese commitments in financial services, such as China's agreement to allow greater market access in the banking, securities, insurance, and asset management markets. As I have argued to my Chinese counterparts, building a modern financial sector is not an easy task – but foreign participation, and the knowledge and skills that come with it, can play a big role in accelerating this process.

Ensuring markets remain open to investment is every bit as important as ensuring that they remain open to trade, so we are also committed to focusing within the SED on maintaining and expanding investment flows between our two countries. This is a critical component of rebalancing China's future growth from coastal to interior regions. As an example, we are intensifying discussions on the prospects for negotiating a Bilateral Investment Treaty and we have also recently established a U.S.-China Investment Forum to discuss the full range of investment issues that the United States and China face.

The SED has also made important progress in helping China address other barriers to its continued development. For example, in the area of product safety, China recently agreed to allow U.S. quality inspectors to conduct on-site audits of key Chinese exporters, a step that will help China develop improved standards and capabilities for critical export industries. Similarly, the SED has provided a forum to collaborate with China on addressing the terrible environmental cost of rapid growth to its air, soil, and water which looms as a significant challenge to its next chapter of economic prosperity. At last December's SED, the United States and China agreed to work together to tackle this problem by developing an ambitious ten-year plan for cooperation.

The Way Forward

As these examples demonstrate, the SED is focused on critical strategic issues of interest to both of our countries that require long-term policy prescriptions. This is why it is so important that we look past next month, next year, or the next election as we consider our economic engagement with China. In practical terms, that means we have an obligation to turn over to a new Administration a healthy U.S.-China economic relationship and a robust and enduring dialogue capable of continuing the progress I have just described. As I hope I have made clear this morning, I think we're on track. Through the SED we are making progress across a full, rich agenda of opportunities and challenges that are every bit as important to the United States as they are to China.

I understand and share the frustration of those who believe the Chinese are moving too slowly on many issues. On those, we must push. We must both cajole and support. We have been – and must continue to be – firm and clear when engaging with China that accelerated reform is as much in their interests as in ours. And when we are unsuccessful through dialogue in resolving key differences, we will not hesitate to take cases to the WTO or to make full use of WTO-sanctioned trade remedies established under U.S. law. But we must also take care not to vent our frustration in the form of punitive legislation or elevated rhetoric that could ultimately cost the American economy and set back the process of reform in China.

America's economic relationship with China is of equal importance to Republicans and Democrats, Congress and the Executive Branch, this Treasury Secretary and the next. I firmly believe the next Administration will inherit a U.S.-China economic relationship that reflects more meaningful progress across a broader territory than ever before. To be sure, the road ahead is long. But we are taking important steps in the right direction.

Thank you.