

Thoughts about Managing the US-China Economic and Trade Relationship in the Years Ahead
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During his 135 days in office President Obama has received lots of advice. Think tanks nation-wide have prepared papers outlining what should be our nations' top priorities. How to manage the US-China relationship is a critical priority.

China is too big to ignore. It has already dislodged Germany as the world's third largest economy, and this year it could move into second place replacing Japan. But apart from its sheer size, our bilateral relationship is entwined in so many ways, economically and strategically, that ignoring it is not an option.

Fashioning a sound bilateral relationship with China has been uneven in the early years of recent Administrations. Both of our prior two presidents had rocky starts in their dealings with China. Today's economic and political environment does not make the task of managing U.S.-China economic and trade relations any easier---but it does make it more important.

In April the International Monetary Fund revised downward its January forecast and predicted that for the first time since World War II world growth would contract by more than one percent and that U.S. output would shrink by 3.8 percent. In March the World Trade Organization forecast that global trade, which for 60 years has been the engine of global growth, would decline by nine percent.

Recently a few commentators have suggested that they see some "green shoots" in the economic data. But last Friday the Commerce Department reported that the U.S. economy contracted sharply in the first quarter, falling at a revised annual rate of 5.7 percent after falling 6.3 percent in the fourth quarter. Our economy has not contracted more than 4 percent for two consecutive quarters in over 60 years.

During the first quarter of this year home foreclosures and delinquency reached record highs, and unemployment in April climbed to 8.9 percent. Not surprisingly consumer demand, business investment, and credit are severely depressed.

Last November we concluded a lengthy election process during which a number of candidates for President, Senate, and House of Representatives placed the blame for our economic ills at the doorstep of globalization, open trade, and China. China is criticized for keeping its currency undervalued and blamed for the loss of millions of good paying American manufacturing jobs. Newscasters on nightly television amplify these complaints.

Without question the combination of bad economic news and election rhetoric has intensified Americans' fears about their job security and fueled concerns that their economic opportunities may be severely eroded as an emerging nation with 1.3 billion people becomes ever more active in the global market-place.

Inevitably economic hardship stokes economic nationalism. Already the 111th Congress through May 15 has introduced some sixty bills that affect China, the vast majority in a negative way---ranging from amending the 1930 Tariff Act to make exchange rate misalignment by a foreign nation actionable under our countervailing and antidumping duty laws to requiring Homeland Security to purchase the uniforms for its employees exclusively from U.S. textile and apparel manufacturers.

The policy question we need to answer is: Whether we believe that China presents a threat to our nation's economic future, or is it in fact a needed collaborator in shaping and implementing solutions to the many serious global economic challenges we both currently face? In short, how should we manage our nation's economic and trade relationship with China moving forward?

My hope is that the Obama Administration will adopt a strategy of serious and sustained engagement with Chinese leaders at the highest level, meeting regularly and frequently to discuss in depth ways that we might work together most effectively to solve today's tough global challenges.

I also hope that the Administration will encourage and facilitate China's continued integration in international and plurilateral organizations that deal with those issues. China's size and importance to the global economy persuades that it should have a greater say in the International Monetary Fund, the World Bank, the International Energy Agency, and a host of other international organizations.

One of the biggest impediments in recent years to building a strong Sino-American relationship is that Americans, including their elected representatives, know so little about China. China is complex. And it has changed dramatically, both politically and economically, in a remarkably short period of time.

Today marks the 20th anniversary of China's suppression of anti-government protests led by students and intellectuals in Tiananmen Square, the violence of which shocked the world. What a difference two decades makes.

Today students are not marching against their government. Current polls show that a large majority of Chinese student believe the Communist government is taking China in the right direction. Economic nationalism is on a sharp rise. Most blame the United States for the economic crisis.

Since the 14th Party Congress in 1992 decided to open China's market and adopt a "socialist market economic system" to stimulate growth, China's trade and economic growth has soared, lifting more than 200 million people out of dire poverty and creating a growing and increasingly vocal middle class.

But China is still a poor country with its per capital income averaging about 1/15th of that in the United States and some 300 million still mired in poverty. China's leadership is acutely aware that continued growth is essential to maintain domestic support and stability. It does not want distractions at home or abroad. Hence, its emphasis on a "peaceful rise" and "a harmonious society."

The global economic crisis has not spared China. Its growth began to slow in the second half of 2007, and the downturn accelerated last year creating huge increases in unemployment when thousands of factories and assembly plants closed as the demand for their products plummeted and trade finance evaporated.

It is estimated that today urban unemployment tops 18 million. In addition roughly 20 million of China's 160 million migrant workers have been laid off, and close to 10 million recent college graduates are looking for employment. China's social security minister estimates that this year there will be fewer than 8 million newly created jobs.

Many economists predict that China's growth will fall to 5 or 6 percent this year, a big drop from its double digit average growth over the past 30 years. Six percent sounds high to an American ear, but China's leaders believe that the country needs to achieve 8 percent growth to absorb new labor force entries and to maintain domestic stability.

As it deals with the downturn, it must also deal with a long list of other daunting economic challenges--including a severe imbalance between investment and consumption in its economy, a widening income gap between its rural and urban citizens, a rapidly aging society, and demands from its growing middle class and an increasing number of NGOs for clean water and air and better health care.

China is confronting the downside of three decades of double digit growth generated by its over-reliance on investment in heavy industry. For example, its iron and steel sector, which has produced growth urgently sought in recent years, alone accounts for 18 percent of the country's energy demand. The five most energy intensive industries in China account for over 40 percent of its energy demand, create most of the air pollution, and employ less than 2 percent of China's labor pool (14 million)

The environmental effects of China's past growth strategy are enormous. In 2007 the World Bank reported that of the world's 20 most polluted cities, 16 are in China. It estimated that pollution is responsible for the premature deaths of 750,000 Chinese each year.

The shortage of clean water presents China with another serious environmental concern. Ninety percent of its urban groundwater is contaminated. Over 60 percent of its surface water is unsuited for agriculture or fishing, and 26 percent cannot be used for any purpose.

Only about 15 percent of China's land is arable, and future food shortage is a concern of global policy makers. Yet China is losing about 1,700 square miles of formerly productive agriculture land each year from actions aimed at stimulating growth.

China's Environmental Protection Agency in 2006 pegged the cost of China's environmental degradation at 8 to 13 percent of GDP. Organized protests motivated by environmental concerns are a growing trend and have sharpened the interest of China's leaders in green development and clean energy.

Adding to China's challenges is its rapidly aging population. The estimates are that roughly seven out of 100 Chinese are currently over the age of 65 and those numbers will more than double within three decades. Chinese often say that they fear their country "will grow old before it grows rich" and the statistics justify their concern.

Understanding these and other economic challenges that China confronts is critical to shaping effective strategies to deal with our joint economic challenges like global rebalancing, restructuring international financial institutions, implementing clean and efficient energy use, and the

environmental issues connected to climate change. Both sides would benefit from high level consultation and collaboration.

Developing an effective strategy of engagement will be tough but implementing it will be even tougher. On the Chinese side it will require persuasion of the Chinese leadership. And on our side it will require political support in our Congress which in turn will require a better informed American electorate.

To be successful, President Obama will need to begin by explaining to his fellow Americans why our regular and sustained engagement with China on economic and trade issues and serious efforts to integrate China into international organizations will advance our nation's economic and strategic interests.

There is an enormous knowledge gap.

Few Americans know that since 2001 when China became a member of the World Trade Organization, it has become the third largest market for our exports; that between 2000 and 2008 our sales to China have increased more than 340 percent, a growth that is more than four times faster than our sales over the same period to the rest of the world.

Over that eight year period, virtually every state in the union has seen near-triple digit increases in its sales to China. For example between 2000 and 2009 Illinois' exports to China have grown 371 percent topping \$2.5 billion, while its exports to the rest of the world have grown by 65 percent.

Although US-China trade has declined sharply in the first quarter this year, U.S. trade with China has fared better than its trade to the rest of the world.

And, few Americans are aware that in the decade up to 2007 the share of our global trade deficit with all of East Asia including China has declined from 75 percent to 49 percent, while share of our deficit with the rest of the world has increased from 25 percent to 51 percent.

Our trade deficits with other East Asia economies including Japan, South Korea, Taiwan and Singapore have sharply declined as their companies have moved their production and final assembly to China. For example, almost 90 percent of China's exports of electronics are made by foreign firms in China. Most of China's exports are made in China not by China.

Many Americans believe that we are losing good jobs here at home because our companies have moved their production for the U.S. market offshore to lower wage countries, like China, when in fact more than 80 percent of US overseas investment is in high wage countries, and the great bulk of what U.S. companies produce in China is sold in China, not exported to the United States.

In addition, few Americans know how much our core interests overlap in key economic areas such as trade, global growth, energy security, food and product safety, environmental protection and climate change, as well as on critical strategic and foreign policy issues such as nuclear containment, North Korea, Afghanistan, drug trafficking, piracy, and regional security.

Most Americans do not appreciate that solutions to these and other complex issues vital to our national wellbeing require the attention and joint effort of both the worlds' largest and its fastest growing economies.

For both economic and strategic reasons, it is overwhelmingly in our national interest to maintain a close, candid, constructive, and collaborative relationship with China, and that requires regular and frequent high level engagement.

We know that high-level engagement works. Between 2006 and 2008 Cabinet Officials from both governments met for two days twice a year in a process called the Strategic Economic Dialogue---the SED. They held their fifth and most recent two-day meeting this past December in Beijing.

The goal of the SED was to discuss complex long term economic challenges and to craft solutions satisfactory to both governments. All governments, including our own, tend to be highly compartmentalized; few have identical organizational structures. These meetings helped to circumvent the stovepipe structures that impede decision-making by bringing to the table all the high level officials on both sides required for a decision.

For example, until last year's reorganization, China did not have Ministries devoted to energy, health, social security housing and the environment. And even where our Cabinet Secretary has a counterpart, responsibilities are often divided among multiple agencies.

Take China's Ministry of Transport which is responsible for transportation networks, but its National Development and Reform Commission is responsible for policies and budget. To collaborate effectively on projects, our Secretary of Transportation needs to meet with leaders of both agencies.

These face-to-face meeting enable both sides to understand better the concerns of their counterparts and led to a number of positive outcomes.

We saw that early last year when members of Congress were considering punitive legislation directed at China's currency policies, there was little movement in the value of the Yuan. When the threat of legislation was taken off the table, our Treasury Secretary was able to accelerate discussions with China on ways China might reform its financial system to allow its currency to move more toward a market determined exchange rate. In large part as a result of this positive engagement, China's currency appreciated about 20 percent, which benefited both economies.

Engagement has also helped us make progress in solving a number of our bilateral economic issues. For example, the second meeting of the SED took place in 2007 when food and safety issues were very much in the news. High level officials from both governments met and seriously discussed effective ways to deal with these issues.

By the time the third meeting of the SED occurred, representatives of our Food and Drug Administration (FDA) and our Consumer Products Safety Commission and their Chinese counterparts were able to announce a Memorandum of Understanding covering how they would cooperate in food and safety investigations. Representatives of our FDA have publicly stated that they

had never before enjoyed such a high level of positive interaction with their counterparts in China. They have now established offices in Beijing, Guangzhou, and Shanghai.

And engagement has enabled us to take steps that could help avoid potential controversy arising out of restrictions placed on inward investment from the other country. At the fourth meeting of the SED held last June, the two governments agreed to begin negotiations of a bilateral investment treaty to protect the interests of their respective investors in the other's economy. With economic nationalism on the rise in both countries, such an agreement would move us in the right direction.

The SED has not only provided an effective forum for raising and solving economic issues of concern to both our governments, but it also created a mechanism that avoids having to initiate talks among strangers in the heat of a crisis. Personal relationships matter.

Accordingly, I was very pleased to learn that when Secretary Clinton was in Beijing in February on her first overseas trip as Secretary, she announced that she and Secretary of Treasury Geithner would share leadership of a high level dialogue between the two governments that was started by the Bush Administration. She stated that the agenda would be broadened beyond economic issues to include security and political issues.

Subsequently when President Hu Jintao and President Obama met at the fringe of the April 2nd G-20 meeting in London, they announced that they would establish a new US-China Strategic and Economic Dialogue (an S&ED); that Chinese State Councilor Dai Bingguo and Secretary Clinton would co-chair the "strategic track;" that Vice Premier Wang Qishan and Secretary Geithner would co-chair the "economic track."

Day before yesterday Secretaries Clinton and Geithner issued a joint press statement that the first Dialogue would occur in Washington D.C. the last week in July and focus on "addressing the challenges and opportunities that both countries face on a wide range of bilateral, regional and global areas of immediate and long term strategic interest."

Without question we need to continue the regular high level dialogue on critical foreign policy issues. Elevating leadership on the strategic discussions to our Secretary of State signals our government's conviction that our relationship with China in the Secretary's words "is the most important bilateral relationship in the world in this century."

The new S&ED is expected to be held annually and begin with one day devoted to a plenary session of all participants, both those concerned with strategic issues and those concerned with economic issues. On the second day the economic and strategic groups would meet separately.

I am told that one of the reasons for having a plenary meeting of the strategic and economic participants is the keen interest Secretary Clinton, U.S. co-chair of the strategic tract, has in the subject of environment and climate change, an interest that Vice Premier Wong Qishan, China's co-chair of the economic track, shares. The plenary session is apparently a way to bring the two leaders together for discussion of this issue.

One downside I see in the newly merged structure is its sheer size. The old SED which focused exclusively on economic issues brought together as many as 30 participants. The old Strategic Dialogue led by our Deputy Secretary of State also involved multiple participants.

A plenary session involving all of the necessary foreign policy and economic policy discussants in a plenary session could so enlarge the group as to impede the relationship building that has been so helpful in the past and risk becoming a media event rather than a serious negotiation.

Another downside I see in the new structure is the stated intention to meet yearly rather than twice each year. Formerly, four days (two full days twice a year) were devoted to our economic discussions. Now it is proposed that one day once a year will be devoted exclusively to our economic discussions.

Our bilateral agenda is long and growing longer, and the global economic environment is more challenging, which suggests the need for more rather than fewer meetings.

On the issue of climate change, for example, there is a widening gap between the positions of industrialized countries and developing countries on the appropriate path forward. Negotiations commenced this week in Bonn among representatives of participating nations and three more meetings will follow before the December Summit in Copenhagen. If the United States and China could find a way to begin to bridge the gap, together we could make a real contribution to a successful Copenhagen summit.

Also on the issue of the global imbalance, Secretary Geithner was in Beijing this week. He urged the Chinese government to expedite the move from an export oriented economy to one supported by domestic consumption by increasing government expenditures for more generous health care, retirement, and educational benefits so as to persuade Chinese citizens that they can decrease their precautionary savings and increase their consumption of goods and services.

Significantly, China is today the largest holder of our treasuries. With press reports circulating that the Chinese leadership is concerned about how our future unfunded liabilities will affect our longer term financial strength, we should not be surprised if they look to our Secretary of the Treasury for reassurance.

How to work effectively with Congress on the one hand and China on the other to manage this critical bilateral relationship and to make progress on the tough economic issues confronting our nation will take all the skill and political will the new Administration can muster.

We will continue to have legitimate economic differences with China, as we do with all of our major trading partners. When we believe that China or any trading partner has violated recognized rules of the World Trade Organization, or the rules of other international organizations, we should act and use the dispute settlement mechanisms provided to resolve the problem. Hence, it serves our interests to continue to integrate China into existing international organizations.

On the trade front we have a number of concerns with China---its use of non-tariff barriers to limit U.S. exports, its failure to protect adequately U.S. intellectual property rights, and its dumping of Chinese products on the U.S. market.

Our government has taken China to the WTO on a number of occasions. Of the cases we have brought, we have settled four (involving kraft liner board, semiconductors, subsidies, and financial news services), won two (involving auto parts and enforcement of intellectual property rights), and currently have two pending (involving, market access and subsidies for famous brands).

This is how the WTO trade regime should work. It enables us to resolve trade issues under mutually agreed, transparent rules. To act outside the agreed rules governing our trade relegates us to the law of the jungle, generating hostilities to the detriment of our economic and security interests.

Time and time again we have seen the beneficial effects of engagement and the detrimental effects of belligerence. In my view efforts to engage China on the tough issues of the day and to integrate it into international organizations is a proven way to advance our interests.

This year as we commemorate the 200th birthday of President Lincoln, a great American leader from Illinois, we look back with affection on his many wise statements. Those who today belittle serious and sustained engagement with China and disparage efforts to integrate China into established international organizations, insisting on a more bellicose approach might recall that it was President Lincoln who said: “Am I not destroying my enemies when I make friends of them?”

Thank you.