The B.C. Lee Lectures

The Long-Term U.S.–China Economic Relationship: Getting It Right

The Honorable Henry M. Paulson, Jr.

June 5, 2007

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Cover photo by Spencer Anderson

Produced by the Asian Studies Center

Published by The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002
202-546-4400
heritage.org

The Long-Term U.S.–China Economic Relationship: Getting It Right

THE HONORABLE HENRY M. PAULSON, JR.
U.S. Secretary of the Treasury

I am delighted to be here and to have the opportunity to talk about the U.S.–China economic relationship.

Prior to the first Strategic Economic Dialogue meeting in Beijing last December, Heritage published a *WebMemo* offering insights and advice about the SED. One of the points made was that American officials should not approach the dialogue as an opportunity to lecture Chinese officials. In a similar vein, I won't approach our time this morning as an opportunity to lecture you, given the depth of Heritage's expertise on China. I look forward to sharing my views and to hearing about yours during the discussion following my remarks.

You are certainly familiar with the genesis of the SED. In August 2006, President George W. Bush and President Hu Jintao agreed to create an ongoing forum to manage our economic relationship for our mutual benefit on a long-term strategic basis. We held our inaugural meeting in Beijing, continued our efforts through a series of meetings among Chinese and U.S. officials, and held the second meeting two weeks ago here in Washington. This dialogue is important because we must get this relationship right. An open, honest economic relationship between our two countries is important—very important—to the future of the global economy.

For over 30 years, The Heritage Foundation has been formulating and promoting free-market public policies. Let me stop right there and thank you all. I had always just taken it as a given that, although there would be protectionist sentiment, the most knowledgeable economists and people here and around the world would support free trade and open markets. I am increasingly finding that I am disappointed on that topic, so I very much appreciate all you're doing and your strong advocacy of open markets and free trade.

There is much common ground in your commitment to the principles of free enterprise and the overriding objectives of broad-based economic engagement with China. Across the spectrum of economic issues, I believe it is in the best interest of the United States, China, and the rest of the world that China move more quickly to adopt market-based reforms; and that is one of the primary objectives of the SED—to speed the pace of reform in China.

We who believe in open economies are swimming against a strong protectionist tide these days. As I explained to the Chinese, a large section of the American public doesn't believe that the benefits of trade are being shared equally between or within our two countries, and Congress reflects that view. The Chinese delegation had the opportunity to meet with congressional leaders during their visit. I believe the meetings were mutually respectful, and it was beneficial for the Chinese to personally meet those who have such serious concerns.

Protectionism isn't a growing force only in the United States. It is playing a significant role in many parts of the world today and a role in domestic politics in China as well. This fall, the Communist Party of China will hold its 17th Party Congress to determine changes in leadership. This may impact many aspects of national policy, including the pace of economic reform in China.

The task of the SED is long-term, and that is difficult in a city where short-termism is the order of the day. A newspaper headline at the conclusion of the recent SED meeting said that it did not "resolve major issues." I looked at that headline, and I said that's right; we didn't resolve global warming; there's still a big trade imbalance; etc. This, in my opinion, misses the point. The dialogue is an ongoing process. To get results, we must build relationships and take smaller, deliberate steps forward together to create momentum for greater change. Through candid discussions, we will ease rather than increase tensions and get to solutions and action.

The second SED meeting produced tangible results that have laid the groundwork for greater progress. In particular, we made notable progress on civil aviation, energy and the environment, and financial services.

We announced a new air services agreement that will make it easier, cheaper, and more convenient to fly people and to ship goods between the U.S. and China. Over the next several years, we estimate that this agreement will stimulate about $5 billion in new business for our airlines as they take advantage of growing travel between our two countries. In addition to doubling the number of passenger flights over the next five years, by 2011 we will have full air cargo services available. Our future goal is to get a fully liberalized agreement in place, just as the United States recently accomplished with the European Union.

We also made progress in fostering further development of China's financial markets, an area which is crucial to China's transition to a market-based economy. The Chinese will remove a block on entry of new foreign securities firms and resume licensing securities companies this year.

They will also allow foreign securities firms to expand into brokerage, proprietary training, and fund-management businesses. They will increase the quotas for Qualified Foreign Institutional Investors, the so-called QFIIs, from $10 billion to $30 billion and remove restrictions on the types of investments that Qualified Domestic Institutional Investors, the so-called QDIIs, can make outside of China. Together, these agreements will expand opportunities for U.S. financial services firms and, by allowing greater financial flows, help create the basis for moving more quickly to a market-determined exchange rate.

China will also allow foreign-invested banks, including U.S. banks, to offer their own brand of renminbi-denominated credit and debit cards and will complete decisions on pending applications for U.S. non-life insurers to convert into subsidiaries by the first of August.

Our discussions also focused on increasing government transparency and intellectual property rights. We signed an agreement to strengthen the enforcement of intellectual property laws and to maintain an exchange between our respective customs staffs to share experiences on counterfeit goods and seizures.

Through the SED, we also collaborated on a series of policies to help promote energy security and protect the environment, which will affect not only our two countries, but nations around the world. In particular, we reached agreements that will create demand and incentives for the rapid development and deployment of clean and efficient energy technology. We also agreed to work together as part of the World Trade Organization's Doha negotiations to discuss reducing or eliminating tariffs in order to increase access to important environmental technologies, goods, and services in this area.

I again pressed the Chinese to increase the flexibility of their exchange rate in the short term and to transition to a market-determined exchange rate in the medium term. The Chinese have taken some steps, and they can certainly do more. While currency reform is not going to eliminate our trade deficit, a market-determined exchange rate that reflects the underlying fundamentals of the Chinese economy is one component of the actions needed to address imbalances, and it's an important component.

Rebalancing China's growth to be less dependent on exports is key to reducing China's trade surplus and assuring that China can continue to grow in the future without generating large imbalances. Moving more quickly to embrace competition and market principles will also spread the benefits of China's robust growth more fully throughout their population.

Just as important is addressing the structural reasons why Chinese households save so much and consume so little. Precautionary savings rates would likely decrease, and consumption increase, if there were a stronger social safety net. Competitive retail financial services would allow the Chinese public to insure against risk, finance major expenditures like education, and garner a higher rate of return on their savings.

Investments driven by market signals and expected profitability rather than by administrative guidance, combined with a reduction in precautionary savings, would shift the economy from its infrastructure and export manufacturing focus and spread prosperity more widely. This can only be beneficial, and China's consumption and import level can only increase.

The question, of course, is how do we get there? We will have our third SED meeting in December. Between now and then, we will continue to work actively on the trade agenda, on opening markets, increasing transparency and innovation, rebalancing growth, and promoting energy efficiency and security, as well as environmental protection measures. We will continue our focus on financial services, moving at a faster pace towards a market-driven currency and expanding U.S. access in the services sector. We have room to be more creative and accomplish a good deal more.

As I said at the opening of the recent SED meeting, Americans are impatient to see real change. Today, China is partway between an administered economy and a market-based one. I believe that the greater risk for China is in moving too slowly, not in moving too quickly, and I have tried to impress that upon the Chinese at every opportunity. I view my job as working with Vice Premier Wu Yi to continue a constructive relationship that speeds our pace forward on the long-term strategic road while building confidence and encouraging both sides to overcome hurdles and focus on achievements.

Again, I thank you for the opportunity to be with you today, and I look forward to our discussion.

QUESTIONS & ANSWERS

QUESTION: Mr. Secretary, the currency peg to the dollar, even though it's been loosened a little bit, is still an issue of great concern to Congress. The Chinese have responded to U.S. criticism in the past by stressing fundamental weaknesses in their own banking sector and the need to maintain that currency in order to ensure economic stability there. Does that continue to be the argument that they advance, and how do you respond to that argument?

SECRETARY PAULSON: You're very right. What they've been saying more recently is that they've embraced the principle of reform and flexibility. They cite the fact that the currency has appreciated over 8 percent since July of 2005, and they sped up the pace of appreciation. And they stress the need for stability.

The way we respond is on several fronts. First of all, point out to them that when you look at what's happened in terms of the buildup of the reserves, what's occurring in terms of the trade imbalance, when you look at the renminbi on a trade-weighted basis, or even relative to the dollar if you make adjustments for productivity, there's a greater need to move the currency now than there was as of July of 2005.

We then go on to explain that this is very important. It's a proxy for their reform progress, and it's very difficult to have a market-driven economy if you don't have market price signals. It's very difficult to have a financial system that works without those kinds of price signals, and if China wants to get where they're going to need to get in terms of the development of their economy and rebalancing their economy away from simply lower value-added exports, they're going to need to move more quickly. We explain it, and I think there are some powerful arguments that can be made, and we make the arguments, largely because they are a sovereign nation, in terms of what's good for China and why it's good for China.

But I always conclude by making the point that there are many countries around the world that don't have market-driven economies, but there's no country as big and powerful economically as China, and one that is so integrated into the global economy in terms of their trade in goods and services and so cut off from the global economy in terms of their capital markets and their currency. That's an unnatural act, so we're continuing to make the argument, and we need to make more progress.

HARVEY FELDMAN, THE HERITAGE FOUNDATION: This is essentially a follow-up question. When you've made these arguments to the Chinese, what response do you get? And a second question, if I may, along the same line: When you discuss the need to move toward a more consumer-driven economy rather than an export-driven economy, what response do you get for that?

SECRETARY PAULSON: Well, I would say thank you very much for the questions. The positive is that we agree on principles, so no one questions, first of all, that they understand and can present the arguments as well as we can in terms of why they're going to need more currency flexibility and why they should be moving in this direction.

I would say the same thing with regard to a consumer-driven economy. They see a need to have a more balanced growth and to spread the benefits more broadly among their population. When you talk to them about capital markets reform and talk about the fact that there's $2 trillion of individual savings in Chinese banks getting 2.5 percent a year, which is negative return after interest and taxes, and what the difference would be if they were earning 6 percent or 8 percent, they embrace the principle. They are very interested in talking about health care and social security and pension systems and all of these things.

What it really is all about is the pace of change and timing. They're proponents of gradualism. I remember talking to a Senator who had been in China and said that he'd had a good conversation about currency, and he came back and thought they agreed and was very disappointed that they didn't move much faster. And I said, you agreed, and you were thinking you were going to move this much in this period of time, and they're thinking this much in this period of time.

So the big part of our discussion really centers around timing and making the case, which I think is becoming clearer and clearer, that as the economy is bigger, more complex and diverse, and more integrated into the global economy, it is going to be increasingly difficult to be a no-man's land halfway between using administrative means and market-driven means. This is going to be a growing challenge for them unless they speed up the pace of reform.

Also, what you're going to find, I believe, is that the longer they go without opening up—and I'll just step back again and say a big part of what we're doing here with the Strategic Economic Dialogue is not about the WTO. I think the Chinese agreed to a fairly minimal level, and there will continue to be discussion about whether they are complying with the WTO, and we have dispute resolution mechanisms for dealing with the WTO; but a large part of the path to reform is going way beyond WTO, opening up to competition in goods and services, and as their economy gets bigger, they have growing domestic industries that are increasingly politically powerful.

As I explained to them, market-driven economies are great, and every businessman I know loves competition; but they like less of it in their sector, so everyone's willing to take a little protectionism in their own sector. The longer they wait, in many ways, the more difficult it is for the Chinese to open up because they've got great protectionist sentiment.

This is about timing and the pace of reform. We agree with the principles, and then we've got priorities. Then the question is: What are the signposts along the way to show you're moving, and what are the deliverables, and how fast are you going to move? As I said, they look at it, and they've sped up the pace of appreciation of the renminbi, but where they need to get is to a market-driven renminbi.

So a big part of our emphasis is not just on flexibility in the short term. They need that in the short term. But a big part of it is to have capital markets that will work so that in the intermediate term, we're not debating anymore about whether the renminbi reflects market fundamentals. It's market-determined.

QUESTION: Mr. Secretary, what prompted the rather precipitous 8 percent drop in the Chinese market yesterday, and more important, why did the U.S. markets respond virtually with no movement?

SECRETARY PAULSON: Well, first of all, let me say that as Treasury Secretary, I never comment on what prompted any market move. And let me tell you, when I was in the private sector, I didn't either, because you often don't know. But I do want to say something about the Chinese capital markets.

Because you remember when there was a drop of about 10 percent a number of months ago, and then there was follow-on volatility all around the capital markets around the world, a number of people were questioning why a drop in the Chinese market seemed to precipitate some of these other market moves, because the Chinese capital markets were closed off. Their capital markets aren't part of the global financial system.

And at that time, what I'd said—as a matter of fact, I was in Shanghai talking about their capital markets one week after they dropped. I had set up that speech a long time earlier to talk about their need to reform, and I'd said then that, although there's a lot further development that needs to go on in the Chinese economy, that the manufacturing sector and the economy overall is well ahead of their capital markets in its development and that the capital markets are not reflective of or representative of where China is overall. China does not have broad, deep capital markets with sophisticated institutional investors. They don't even allow things like short-selling. All they can do is buy shares, and if the market starts to go down and they want to limit their losses, the only thing they can do is just sell.

A lot of changes need to take place over time, and what I've argued to the Chinese is that there's no really well-balanced, fully developed economy that's competitive that doesn't have world-class competitive capital markets, and there's no economy with world-class competitive capital markets that isn't open to competition. So the most important thing the Chinese can do is open up to competition and let world-class financial firms in there. The benefit is China's when that happens, because it's going to help their economy overall develop. Those capital markets have a multiplier effect; they'll employ Chinese people, they'll be regulated by Chinese regulators, etc.

Now, to step back, I would say that it doesn't surprise me that the markets in China could drop precipitously or be very volatile and that this is not reflected elsewhere, because they're closed off. I've heard some people speculate that maybe the last time the reason that markets all around the world moved is because they looked at what happened in China and they said that maybe the markets are reflecting some fundamental problem in the Chinese economy.

Because often I think people are worried about the wrong things with China. They're worried that—they take a look at the growth of the Chinese economy over the last 20 years, and they look at this line, and they just extrapolate that going forward, and then look ahead 20 or 30 years and think that they're going to out-compete everyone, be the biggest economy in the world, and they're worried about that, rather than taking a look at all the fundamental issues the Chinese need to deal with.

Maybe the biggest concern we have is not that China will do too well. It's been a terrific thing that China and the U.S. have accounted for so much global growth, but if the Chinese were to have a problem in their economy, what would that mean for the global economy? Who knows why there was volatility all around the world when the Chinese market fell? But at least today it doesn't surprise me that there's no volatility. It could be volatility in any market, and I think that the Chinese market will have less volatility when it is more fully developed and more competitive.

EDWIN J. FEULNER, JR., THE HERITAGE FOUNDATION: Mr. Secretary, let me ask one if I may. You mentioned briefly the question of intellectual property rights. Is it better or worse today than when you were going there five years ago? Do they take it seriously as an issue?

SECRETARY PAULSON: If you'd said what are the two big issues that everyone understands and can relate to, it is the currency because it doesn't reflect economic fundamentals and IPR because it's outright counterfeiting, stealing. I very much believe that they take it seriously. They want an innovative society. They want to move up the value-added curve. They have been putting the legal structure in place. A lot of this has to do with enforcement.

People that have spent more time in this area than I have—Sue Schwab, for instance—will talk about the progress they've made in dealing with business software, as opposed to consumer, and some of the things they are doing. Wu Yi will talk for a long time about the 200 initiatives they've got in place. There's no doubt they're moving; but, again, this is like currency. We want them to move quicker. The Office of the U.S. Trade Representative's people tried to negotiate the one case on access and the other on enforcement, and then they gave up and filed the WTO case. They are making efforts, and they're making progress, but the question is: Is it fast enough? And the answer to that question is no.

QUESTION: Notwithstanding the progress of reform in China, here in Washington, given the protectionist sentiment in Congress, do you think that there is enough traction within the Administration dealing with Congress to address these issues with China's currency and IPR? Also, do you think that the Chinese are able to internalize that there is a division in our country between the executive and legislative branches?

SECRETARY PAULSON: We certainly explained to the Chinese—I'm very candid. I clearly explain what the sentiment is in our country, and I think many of them understand that. And I explained that Congress is reflecting that sentiment. They have been told that there are certainly going to be trade bills, protectionist trade bills and others that I'm sure their authors wouldn't characterize as protectionist but are designed to deal with this issue.

We intentionally scheduled the SED here in Washington when Congress would be in session. We encouraged the Chinese to go up and listen and to have an exchange. When they came back, I think they were encouraged because Congress was respectful and polite, and the leaders in the Senate and House made their case clearly but respectfully. We explained to them afterwards that the fact that they are respectful shouldn't be taken as a sign that there is going to be no legislation, because these issues are serious issues.

Now, if you're asking about my view on this, to me it's the easiest thing in the world to argue and advocate for China to open up their markets to competition because it would be great for U.S. companies, but it will also be great for the global economy and good for China. I believe that the more progress they make in going beyond WTO in opening up their markets for competition the easier it will be for me to fight the battle I have to fight to keep our markets open.

I am a big believer in trade, and I think trade with China benefits the U.S. I believe imports are positive as well as exports, but there are plenty of people who don't share my view. Again I will be more effective and the Administration will be more effective if we have more progress from China.

QUESTION: Bill from the Voice of America. With 20 months left in the Bush Administration, what are your goals for completing the SED process if you're having meetings every six months, and do you hope that this process will continue into the next Administration?

SECRETARY PAULSON: I would say that would be one of the major goals—that this would be considered successful enough to continue for some time in the future—because this relationship with China is very important to the world. It is important to our country and their country. It's multifaceted, and the economic relationship is very important.

What we get with the SED is an opportunity to speak with one voice and an opportunity to speak to a broad spectrum of leaders at the top in China. One thing I have learned over the years is that, rather then speaking to those who have nominal responsibility for one issue or another, you have much more progress if you can speak to a broader range of the leadership to address these issues on a long-term basis and be able to have a mechanism for dealing with tension and short-term problems. Some of the trade cases in the U.S. we are able to talk about as a result of the dialogue: food safety issues and others. That is a process that is very important and ongoing, so I would like it to continue.

Now, in terms of the objectives I have for the next 20 years—it's a Freudian slip, because I really do think that's the time frame people should be looking at in this important relationship. But in terms of the objectives I have, I tend to be pretty pragmatic, and I don't think this is easy. I know what the sentiment is in China. I know what the sentiment is here. So my objective is to keep making progress, keep moving the ball forward, getting results, and I would like to get more and keep getting more. I am impatient, but I know we are going to get more as a result of this dialogue than we would without it. I know that when you have Wu Yi here, with all the scrutiny we have, we're going to get more results than if we didn't have that process.

We are going to keep working and we will be back in Beijing in December. This is ongoing. So what I would like to do is hope that 20 months from now, we can point to a fair number of tangible changes in the Chinese economy that wouldn't have taken place without the SED and that China is more integrated into the global economy and more open to competition.

QUESTION: To follow up on that, in the 20 months that remain, is there a strategy of engagement with other nations who will often privately talk about these concerns but are perfectly content to see you shoulder 95 percent of the work?

SECRETARY PAULSON: Great question. My own view is that almost everything I have seen since I have come to government is more effective if you can approach it on a multilateral basis, so the issue is getting other trading partners to work with us. Every conversation I have had at the G-7—and the Chinese are often there—we take this up. When I talk at the International Monetary Fund, I say we are talking about currency surveillance, but how many currencies need to be surveiled? What's the elephant in the living room? So I bring it up all the time.

I think there's general agreement. I think there's lip service, and maybe there is quiet diplomacy. If I look at it cynically, I would say some nations talk about it at the G-7, but when they go to China, then it's a trade mission and they are signing deals. But I think we can continue to make progress and deal increasingly with this issue on a multilateral basis.

QUESTION: Regarding the $25 million in Banco Delta Asia funds that was transferred to North Korea, I read this morning that a Russian bank may be handling those funds now. My question is, specifically regarding China and their involvement with those funds, how you feel they will react to that?

SECRETARY PAULSON: I'm not going to get into details or say anything more until there is something to be announced, but what I would say about Bank Delta Asia is, first of all, remember, let's not lose sight of the fact that we are talking about de-nuclearization of the Korean peninsula, and this is driven by the State Department. If we are going to be successful, the biggest reason will be because it's done on a multilateral basis. It is being addressed through the Six-Party Talks, and China is a key part of it. China is a constructive player here, and so that's a big driver. Again, a lot of what we are talking about is behavior change.

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