

THE UNITED STATES – CHINA ECONOMIC RELATIONSHIP  
AND THE  
STRATEGIC AND ECONOMIC DIALOGUE

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before the  
Subcommittee on Asia, the Pacific and the Global Environment  
Committee on Foreign Affairs  
US House of Representatives

September 10, 2009

The Policy Context

The United States and China are the two most important national economies in the world:

- China will shortly pass Japan to become the world's second largest economy behind the United States;
- the two together accounted for almost one half of all global growth during the four-year boom prior to the crisis;
- they are the two largest trading nations;
- they are the two largest polluters;
- they are on opposite ends of the world's largest trade and financial imbalance: the United States is the largest deficit and debtor country while China is the largest surplus country and holder of dollar reserves; and
- they are the leaders of the two groups, the high-income industrialized countries and the emerging markets/developing nations, that each now account for about one half of global output.

It is clear that effective international policy coordination requires the closest possible cooperation between the United States and China. The two countries do not have to agree on every issue let alone pursue identical policies. But they must be willing and able to work

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constructively together, in terms of the domestic politics of each as well as their direct diplomatic contacts, if enough agreement is to ensue to permit progress across the entire spectrum of crucial international economic issues – ranging from recovery from the current crisis to creating a new global regime to counter global warming. Their relationship must therefore focus increasingly on the wide range of global economic issues for which they bear systemic responsibility rather than the bilateral frictions that have traditionally been its centerpiece.

In anticipation of these conditions, I proposed five years ago that the United States and China work toward the creation of an informal G-2 that could provide effective joint leadership of the world economy.<sup>2</sup> The idea was, and is, to develop a close working relationship between them that would supplement (not supplant) the existing steering committees, including the G-7/8 and the newly dominant G-20, and the multilateral institutions (notably the IMF and WTO). The overriding goal is to make those institutions function more effectively and thus strengthen the world economy.

My assessment of the initial meeting of the Strategic and Economic Dialogue (S&ED), and of its future prospects, is thus governed largely by an assessment of whether it is helping to create such a G-2. Viewed as a further extension of the earlier Senior Dialogue and Strategic Economic Dialogue (SED), I believe that the S&ED is indeed moving in that direction and holds considerable promise for continuing to do so. I thus strongly endorse the Administration's initiative, and praise the Chinese for their active participation in the process, and would offer a few suggestions for how it can best be used to achieve the desired outcome.

### The Conceptual Framework

To create and sustain an effective G-2, the United States and China must carry on a wide-ranging and continuing conversation on their respective views of the world economy and the global economic system. They must do so in the same way that Richard Nixon and, especially, Henry Kissinger discussed their global geopolitical concepts at great length and depth with Mao Zedong and Zhou Enlai in re-opening relations between the two countries in the early 1970s. Such exchanges are perhaps even more important in the economic sphere because China is a late-comer to today's global arrangements and institutions, having opened to the world only in 1978 after the postwar rules and architecture had already been in place for three decades.

As a new economic superpower, along with the United States and the European Union (which, however, speaks with a single voice on only a few issues and thus cannot form a G-3 with the other two), China understandably asks why it should conform to a set of rules and institutional arrangements that it had no role in creating. This is of course the historical problem of the powerful newcomer crashing the (sometimes cozy) club of incumbent systemic leaders, which has had disastrous effects on some occasions – Germany in the late 19<sup>th</sup> century and again

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<sup>2</sup> C. Fred Bergsten. 2005. A New Foreign Economic Policy for the United States. In *The United States and the World Economy: Foreign Economic Policy for the Next Decade*, eds. C. Fred Bergsten and the Institute for International Economics. Washington: Institute for International Economics. I developed the idea further in C. Fred Bergsten, Charles Freeman, Nicholas R. Lardy, and Derek J. Mitchell. *China's Rise: Challenges and Opportunities*. Washington: Institute for International Economics, 2008 and C. Fred Bergsten. 2008. A Partnership of Equals: How Washington Should Respond to China's Economic Challenge. *Foreign Affairs* 97, no. 4 (July/August): 57-69.

in the interwar period, Japan as well in the latter – though has been handled relatively smoothly in others (the United States in the late 19<sup>th</sup> century, Germany and Japan after the Second World War).

A central goal of the S&ED must therefore be to encourage the countries to seriously discuss their worldviews, at least on economic issues. It is of course difficult to do so with dozens of people sitting around a table in a formal setting so the Dialogue should provide maximum scope for smaller subgroups, particularly for the top officials, to carry on more informal and candid conversations. Those conversations can of course also take place during bilateral events, as when President Obama visits Beijing in November, and on the margins of the many multilateral meetings where leaders and top officials of the two countries frequently come together (G-20, G-7/8 “outreach sessions,” UN General Assembly, APEC, etc.), and the evolution of the G-2 relationship of course occurs through these interactions as well as the S&ED. By providing a full day or two of intensive interaction between key ministers of the two governments, however, the S&ED can and should play an important role in this process.

#### The Current Agenda and Deliverables

Heads of government and top officials, however, will become impatient with lengthy meetings of this type if they do not also address issues of current concern and deliver results that will attract support at home. Thus it is imperative that the S&ED tackle topics of immediate salience and at least set broad policy directions that will help resolve them. There are at least three such issues on the global, and hence the United States – China, agenda at present:

- recovery from the global economic and financial crisis;
- reform of the international economic architecture, to help prevent future crises but also for long-standing structural reasons; and
- creation of a new international regime to save the planet from global warming.

I believe that the S&ED, building on the last year or so of the previous SED, has made substantial progress on at least the first and third of these topics.

On the world economy, China and the United States have led the way on fiscal and monetary stimulus. As a result, China recorded growth at an astounding annual rate of 15 percent in the second quarter to lead the global recovery. The US recession has bottomed out and renewed expansion, perhaps at a more robust rate than most forecasters now expect, has probably already begun.<sup>3</sup>

Surplus China and deficit America also seem to have reached a meeting of the minds on the shape of the recovery and future growth patterns. They appear to recognize that it would be a huge mistake, and indeed again unsustainable, for China to resume its reliance on export-led

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<sup>3</sup> Michael Mussa. “Global Economic Prospects as of September 2009: Onward to Global Recovery.” Paper to be presented at Sixteenth Semi-Annual Meeting on Global Economic Prospects at the Peterson Institute for International Economics, Washington, DC, September 17, 2009.

growth and ever-rising trade surpluses or for the United States to again become the “global consumer of last resort” and run huge current account deficits. Instead, China must expand domestic (especially consumer) demand and the United States must re-orient toward exports and productive investment.

It is too soon to judge whether the public pronouncements of the two governments in the direction of achieving these restructured growth paths will be fully realized. The early signs are promising, however:

- the US external deficit in 2009 will be about half its peak in 2006, and improvements in the real trade balance kept the economy growing through much of 2008 and sharply reduced the depth of the recession in the first half of 2009;
- China’s rapid growth in the second quarter occurred despite a sharp fall in its external surplus, and my colleague and top China expert Nicholas Lardy forecasts that surplus will decline to 5-6 percent of China’s GDP this year from its peak of 11 percent in 2007 (though that is at least partly due to their early and strong recovery from recession and could be reversed as their exports again expand when the rest of the world picks up).

The two governments will need to take further policy steps to sustain and build on this progress even as the recovery is still taking place. In particular, China has blocked further appreciation of its exchange rate against the dollar over the past year and indeed intervened in the currency markets at record levels in the second quarter to keep the renminbi from rising.<sup>4</sup> For its part, the United States must substantially reduce its budget deficits as soon as the recovery permits if it is to avoid a renewed escalation of its external imbalances.<sup>5</sup> If it can foster these additional measures, the G-2 will have been highly successful in correcting one of the major global economic problems of recent years and indeed an important cause of the current crisis. That could mark a major achievement for the S&ED.

The G-2 must likewise lead on global warming and there is similar evidence that the latest S&ED may have taken an important step down that road. The most tangible result of the July 2009 meeting was in fact a Memorandum of Understanding (MOU) that, while wholly procedural, committed the two governments to work intensively together toward the installation of national energy and environmental policies that will significantly cut their carbon emissions.<sup>6</sup> Two experts on US-China relations, Banning Garrett and Jonathan Adams, believe that this agreement has potentially game-changing implications and “could catalyze a global transition to low-carbon sustainable economic development”<sup>7</sup>:

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<sup>4</sup>Goldstein, Morris, and Nicholas R. Lardy. *The Future of China’s Exchange Rate Policy*. Policy Analyses in International Economics 87. Washington: Peterson Institute for International Economics, July 2009.

<sup>5</sup> Bergsten, C. Fred, ed. *The Long-Term International Economic Position of the United States*. Special Report 20. Washington: Peterson Institute for International Economics, May 2009.

<sup>6</sup> The two meetings of the former SED in 2008 had already agreed on a Ten Year Energy and Environment Cooperation Framework that provided a foundation for the new MOU.

<sup>7</sup> Banning Garrett and Jonathan Adams. “Do We Know Change When We See It?” chinadialogue.net. August 27, 2009. Available at: <http://www.chinadialogue.net/article/show/single/en/3231-Do-we-know-change-when-we-see-it->

- the leadership of the two countries at the highest level now endorse climate-change science and take climate change seriously as a strategic threat to both nations and the world;
- the two are committed to scaled-up domestic actions to implement policies aimed at transitioning their economies to clean-energy systems and low-carbon development; and
- the strong and public commitments by the two leaders to both meet the climate-change challenge and to engage in unprecedented US-China cooperation is a new and essential ingredient to energize the two governments at all levels and the two business communities to vastly scale up their collaboration as well as national efforts.

Here too serious and sustained follow-through will be essential to realize the potential payoff. But there is now a common understanding of the strategic threat faced by the two countries, and agreement on both the essentiality and feasibility of China-US cooperation. Garrett and Adams conclude that the “humble MOU may be pointed to as a historic turning point that marked a strategic shift as important in its global impact as the US-China opening nearly 40 years ago.”

### The Future Agenda

Hence there is substantial evidence that the initial S&ED, building on other United States – China contacts and its own predecessor forums, has made an important contribution to resolving two of the central problems now confronting the world economy. Future meetings of the group will obviously need to expand this cooperation further but the startup has been impressive and deserves strong support.

There is much less indication that the two countries have been able to use the S&ED to address some of the other systemic issues that confront them. China has expressed great anxiety over the stability of its huge official dollar holdings (probably now above \$1.5 trillion). It worries about possible restrictions on its future direct investments in the United States, as in the infamous CNOOC case and more recent instances involving Huawei and others.<sup>8</sup> The United States is concerned that China is resuming an industrial policy strategy that encompasses selection of “national champions” and wide-ranging subsidies for preferred sectors, as well as maintaining its currency intervention policy to preserve a substantially undervalued exchange rate for the renminbi.

There are additional important opportunities for G-2 leadership on key global economic issues. China and the United States need to get together on the related topics of stronger IMF

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The underlying analysis is in *A Roadmap for US-China Cooperation on Energy and Climate Change*, a January 2009 report prepared by the Pew Partnership on Global Climate Change and The Asia Society.

<sup>8</sup> Daniel H. Rosen. 2009. *China’s Changing Outbound Foreign Direct Investment Profile: Drivers and Policy Implications*. Peterson Institute for International Economics Policy Brief 09-14. Washington: Peterson Institute for International Economics.

surveillance of national economic policies (which China needs to embrace) and reform of the governance of the international financial institutions (where the United States needs to give up its veto over major decisions in both the IMF and World Bank and its “right” to select the President of the Bank). Both countries have a major (and frequently articulated) interest in preserving an open global trading system but they still appear at loggerheads over the Doha Round in the WTO, which their frontal disagreement brought to a screeching halt over a year ago. They have barked at each other’s discrimination against foreign suppliers under their respective fiscal stimulus programs rather than joining together to renounce all such protectionism themselves and leading the way toward a new compact on government procurement policies that would proscribe such behavior everywhere.

It is particularly important that the two countries’ new understanding on common strategic priorities to collaboratively address climate change be followed by sustained, scaled-up efforts. To be effective, the MOU’s statement of common strategic interests must be translated to real projects on the ground. Tangible projects with clearly articulated goals must include a wide range of players in the public and private sectors. This collaboration will make it possible to create stronger constituencies which both contribute toward stated goals on climate change and foster greater transparency of domestic action and policies.

The United States and China will of course continue to have bilateral problems that must be addressed along with these systemic topics. Any two countries with such a large and growing volume of trade and investment will inevitably encounter periodic disputes; the largest number of trade conflicts arises between the United States and Canada, or sometimes the United States and the European Union, simply because they enjoy such extensive commercial ties. Even these more traditional problems will be easier to resolve constructively, however, in a G-2 context in which the United States and China have developed much more far-reaching mutual understandings and can place those issues in a broader systemic framework.<sup>9</sup>

The S&ED, at this early stage of its evolution, has both a positive record of achievement and a rich agenda for future action at both the broad conceptual and very practical policy levels. The two governments should be encouraged to continue, broaden and deepen the approach over the months and years ahead. I hope that the Congress will continue to monitor the process to make sure that it realizes its full potential.

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<sup>9</sup> In this trade policy context, it is also important that President Obama reject the ITC recommendation to erect new barriers to import of tires from China. The low-grade tires that we import from China are no longer made in the United States, and are not going to be made in the United States, so the imposition of controls on imports from China would simply shift the sourcing of those imports to other countries rather than increase production and employment in the United States. Such a step just prior to the upcoming G-20 meeting would also be a major setback to its efforts to resist the spread of protectionism.