Dr. Stephen Smith:

I would like to introduce our keynote speaker Dr. Fred Bergsten. Fred Bergsten has been the director of the Peterson Institute for International Economics since its creation in 1981. Dr. Bergsten has held leading positions in government including Assistant Secretary for International Affairs at the US Treasury, Undersecretary for Monetary Affairs, and represented the US on the G-5 deputies and in preparing G-7 summits. Dr. Bergsten has been a senior fellow at the Brookings Institution, the Carnegie Endowment for International Peace, and the Council on Foreign Relations. Dr. Bergsten was Chairman of the Eminent Persons Group of the APEC Forum from 1993 to 1995, authoring its three reports that recommended free and open trade in the region by 2010 and 2020 as adopted in the APEC summits in 1993 and 1994.

Dr. Bergsten was a member of the two leading commissions on reform of the international monetary system, "The Independent Taskforce on the Future International Financial Architecture," sponsored by the Council on Foreign Relations and the International Financial Institution's Advisory Commission that was created by the U.S. Congress. Dr. Bergsten has authored, co-authored, or edited 40 books on international economic issues, including "The Long-Term International Economic Position of the United States," which has come out this year, and "China's Rise: Challenges and Opportunities," which was published last year. For more on Dr. Bergsten's publications please see the handout that you have on today's speakers. So Dr. Bergsten, welcome to The George Washington University.

Dr. Fred Bergsten:

Thank you very much. It is a pleasure to be here and particularly to address this timely topic with President Obama just having been in Beijing and, as I would describe to you, having been implementing the G-2 in practice. When the *Financial Times* published its story on Wednesday of this week about the President's meeting with the President Hu Jintao, it said and I quote: "Yesterday's joint statement which covered everything from clean energy to space technology marked the attempted launch of a G-2 Global Steering Committee between the world's largest democracy and largest autocracy." That was the Financial Times of Wednesday of this week. The only problem with that characterization was they are just behind the times. It was not the launch of the G-2 Steering Committee, it was a step along a very long road toward achieving that at some point in the future.

The G-2 has been, in my view, in the process of formulation for a long time. A little "inside baseball," I originally proposed the idea five years ago in one of those many books. I actually briefed Bob Zoellick on the idea in December of 2004 as he was just leaving his post as U.S. Trade Representative. He immediately liked the idea, and as soon as he became Deputy Secretary of State, he started implementing through creating what was called the strategic dialogue which was led by the State Department for the U.S. under the Bush administration at that time with their counterparts in China. That was then upgraded by Secretary Paulson when he took over the Treasury a couple of years later into the strategic dialogue. And now the Obama Administration has converted it into the strategic and economic dialogue, which deliberately covers the whole range of topics between the two countries in the global context.

President Obama's visit to Beijing represents the first of what I strongly suspect will be annual summits between the President of the United States and the President of China to carry out what I am calling the G-2 and, of course, I will describe that in detail. I originally proposed the idea for economic management purposes. I have been gratified and interested to see that the G-2 term and concept has been picked up over the last year or so in the security dimension as well. As B. Bersinky (Berzhenke?) and Niall Ferguson, and some others, have extended the concept into a security domain, which I actually always thought would be harder to do it, they have talked about U.S.-China G-2 in that concept as well. So I would submit that the concept certainly intellectually, but as I will argue, in practice as well, is well underway. It is being implemented, it is on its way, and it is still in an early stage, so there is a lot to do, and yet very mixed results which I will talk about. I do think it is a fundamental component of the global economic and maybe broader architecture that is evolving here in the early part of the 21st century reflecting the fundamental changes in economic power and global relationships among the major countries.

It is essential to put the U.S.-China relationship and the G-2 notion in the broader global context. The traditional steering committee for the world economy for the last 35 years, I was involved actually when the G-5 got started at the summit level back in the 1970s in the response to the oil shocks, was the G-5 that became the G-7, which was the global steering committee for the last quarter of the 20th century. But it became increasingly illegitimate because it represented a shrinking share of the world economy, and therefore, and for some other reasons, it became decreasingly effective as the leading group trying to promote economic stability and prosperity. Therefore, in this decade the G-7 already started to invite an additional group of countries, the so called "outreach countries" or "plus 5": China, India, South Africa, Brazil, and maybe one other like Mexico or Korea would be invited to join the G-7, or G-8, with Russia for their lunches or dinners. That, of course, gave them second-class citizenship and did not really change the fundamental structure very much, but it reflected that even the G-7 recognized that the steering committee had to be broader if it was going to get anything done.

Then came the economic crisis of the last two years, which forced the world to get serious. You could no longer play around with institutional arrangements that were anachronistic so you had to get the right people in the room if you were going to deal seriously with the global crisis. So, the G-7 gave way to the G-20, and that is a fundamental revolution in world economic management. It means that half of the global steering committee is now emerging markets or developing countries. It means that a quarter to a third of the group, depending how you count Australia, Russia, or Asian countries, in short it is a move away from the Atlantic-centered, rich countries-centered steering committee of the past to a Pacific-centered, emerging markets, equality, at least of the steering committee, for the future. And that group, of course, was explicitly indicated in the last G-20 summit, the one in Pittsburgh just two months ago, as the primary lead committee for global economic management, and that, I think, will be the case here too. But, even the fans of the G-20, like myself, recognize that it is really too big to steer in an effective sense. I think it is going to be the main institutional arrangement for global economic leadership for the foreseeable future, but it is still pretty big: twenty countries. And that further strengthens the case for the G-2 at the heart of the operation, because the U.S., as the leading industrial country, and China, as the leading emerging market, even more so I think, are placed to the center of the process to lead global economic arrangements.

There is another context in which this all has to be put, of course, which is the broader historical context of the rising economic superpower, in this case China. The world has three economic superpowers at the moment: the United States, the European Union, and China. But, the European Union, despite some efforts, does not speak with a single voice on most issues. It does on trade and it has been an effective G-2 partner with the US on trade for 40 years, but on most issues it does not speak with a single voice, certainly not macro policy, certainly not fiscal policy, and certainly not most structural policies. And so, you cannot have a true European partner in managing economic affairs the way you can with the more or less unitary state like the United States or China. Therefore, it is partly because Europe is simply not organized or got its act together to play the same kind of role as the U.S. and China do in becoming the G-2. But again, there is the broader point: accommodating the rising superpower into the global economic power structure, indeed, the global structure more broadly. But, Gilb (Gilp?) and others who have written persuasive analysis of the history of such emerging powers demonstrated how the results were disastrous when the rising powers were not effectively assimilated into the global management structure: Germany in the 19th century, and, to some extent, Japan, in the 19th century, and again the inter-war period being classic cases where a failure to effectively integrate turned out to be disastrous in not just economic but in security terms as well. By contrast, the assimilation of the United States in the late 19th century was not bad when it was the rising power. Japan in the post-World War II period was not completely assimilated, but not bad. There is a mixed history, but in cases where it has gone wrong, the results have been literally calamitous and that is an essential reason why the rising superpower China must be effectively integrated into the system.

So I am thinking within that context, along with the one I have described, of how the tectonic shifts in global economic power require China and the United States to take a joint lead if we are going to have any kind of effective leadership of the world economic system today. It seems to me the substantive case is obvious and I will not go over all the data. I have written many things on it, but I do not need you to reiterate to this group. You have been talking all morning about how U.S. and China together dominate output of the global economy, growth of the global economy, and so by virtually any indicator you want, the U.S. and China together are the dominant players.

I think combining the economics and politics of it, the bottom line is that the United States and China simply have to agree if most international economic issues are to be successfully addressed at the global level. Now, I hasten to say at the outset that is not true of every issue. There are some exceptions. Reform of the global financial regulatory regime, for example, does not need to include China very much. China's financial regime is still at an early stage: currency is still not yet convertible and there are wide-spread capital controls. So, China's financial markets are not yet anything like the degree of sophistication in the U.S., Europe, Japan, or even some other emerging markets. So when one of the chief issues coming out of the global crisis is reform of international financial regulation, China is not even a major player in that, let alone an essential partner, as it is on most issues. Practically everything else that is high on the agenda does require China as well as the U.S. to take a lead.

Global economic recovery obviously is a case in point and there China has been the number one driver of the recovery from the global crisis. Trade policy clearly so, investment policy clearly so, where China is an increasingly two-way player with big investments going out by its own companies as well as being the largest host country for foreign investments except for the United States. And the international monetary system where China is far and away the highest holder of foreign exchange and, by now, the largest creditor country after having passed by Japan. It led the league in complaining about international role of the dollar.

China's own policies are badly foul up the international adjustment process through its massive intervention to keep its currency hugely undervalued and thereby artificially strengthen its competitive position and its big current account surpluses which are the flip side of the big U.S. deficits as the heart of the global imbalances issue. China is at the forefront of the governance reform questions, not just the G-20 and G-2, but the formal structures in the IMF and elsewhere, where China's increased clout, of course, requires it to be accorded a much larger share of IMF quotas and role in the leadership of those international institutions. I gave a speech in Korea two weeks ago, and to be a little provocative, I suggested that we should all agree that the next managing director of the IMF should come from an emerging market economy. That would be I think the most dramatic way to illustrate and reflect the growing clout of those countries, and I nominated some people, just to show that it was feasible from China, from India, from Korea, who could be extremely capable. Next, managing director of the IMF, (Joe Zhao Shuan?)., and the governor of the People's Bank of China, would be a natural candidate and a superb managing director of the IMF. Here I volunteered to be campaign chairman for the next MD of the IMF. The point is on all these issues, which are traditional global economic issues, is that you have got to have China and the U.S. agree or nothing will happen. Now that is, I think, especially clear as the global economic architecture moves into new areas, and it is important to remember the distinction in terms of China's engagement.

When we talk about reforms of the IMF or the WTO, we are essentially talking about modifying existing architectural structures in which China had no role in the creation. So, however we organize it, we are still basically asking China to work within a context where it was not involved in the creation and therefore may have some understandable hesitations about working together. There is no alternative. Pragmatically you just cannot abolish the IMF and World Trade Organization and start again, but that is admittedly a little more difficult for the rising power that would have had no role. When we are creating new regimes then it is particularly clear that you need the G-2 at the core. The most obvious case now is global warming and climate change where the world is in the process of trying to save the planet by creating a new global architecture with commitments on limiting carbon emission, rules of the game on how to do that, verification procedures, and the whole panel that any international regime would have. That is all starting pretty much de novo, starting afresh.

If China is now the number two economic power of three global economic superpowers, it has clearly got to be central to the debate as how you organize that system, and I think that is in fact what is happening and I will describe it in a moment. That is the clearest one, but there are others. Developing new rules of the game for sovereign wealth funds; a big new component of international financial system. That too is pretty much a brand new exercise, the so called “Santiago Principles” that was agreed a year ago, a step in that direction. But again, it is a new dimension of international economic and financial relationships where the current power configuration has to be at the center of the process. Even though the WTO is a long-standing institution based on the GATT, the next round of negotiations in WTO beyond the Doha Round, whether it succeeds or totally flounders, would clearly have to be worked out intimately with China and other emerging markets. But again I think the G-2 would have to be at the heart of that. Therefore, the basic point on most, if not on all, issues, is that G-2 cooperation and the leadership are essential or else there will not be any progress. If we want prosperous and stable global economic order, we have to recognize that reality and structure our efforts both substantively and procedurally in order to achieve it, and I have used this shorthand term “G-2” to try to capture the notion that at the heart of that and as the essential component of it, the U.S.-China relationship must be accorded primacy.

Now, as it is obvious that you have to have agreement between China and U.S., it is equally obvious that you have to handle that G-2 very, very diplomatically in order to avoid upsetting the apple cart with other countries in a way that would undermine the entire process that you are trying to achieve. Some versions of my G-2 idea have gone beyond what I intended and have not really captured very accurately how I at least envisioned carrying it out in practice. The fact that the G-2 concept is worrisome to some was brought home to me at a dinner earlier this week by Jim Hoglan, the columnist of Washington Post, who I am sure many of you read all the time. He was at a conference in Europe couple weeks ago and he said: “The British and French took turns in expressing greater terror at the thought that the U.S.-China G-2 kind of leading of global economic negotiations.” For them it was huge specter to be avoided at all costs. We know that the Europeans are deathly afraid that the U.S. and China are going to show up at Copenhagen next month at the Climate Change Conference and announce an agreement that will force everybody else into compliance (I do not think it is going to happen), but Europeans are deathly afraid of that and have been devoting lots of its diplomacy to avoiding that. I think all of that is quite a good thing.

If the Europeans and others are worried that the U.S. and China are going to take a lead to reform the global economic system and constructive direction, I think it is very healthy because presumably it will encourage them to come up with some competing ideas and some initiatives of their own to prevent the U.S. and China having all the running by having some running of their own. One of my other favorite concepts is the idea of competitive liberalization in trade, meaning that if countries A and B get together and do a trade agreement that discriminates against country C, it will strongly encourage country C to strike similarly liberalizing agreements and ratchet up the process of trade opening around the world, and eventually you get D, E, F, etc. in line. And voila, you wind up at some point with global free trade. That is the whole concept of competitive liberalization. That is what Zoellick used when he was USTR, and that in fact is driving a lot of US global trade strategy, again, whether they articulated it or not. So I think it is a good thing that others might worry about a U.S.-China condominium, whether or not it happened because it would presumably encourage them to get in the game with ideas, initiatives, and efforts of their own.

Having said that, it is obvious that even if the U.S. and China agree, they would be unable by themselves to conduct global economic reform. Many other countries are needed, whether it is the other members of the G-20 as kind of the next ring in the series of concentric circles of leadership, or then whether it is the formal institutions like the IMF, the WTO; the multi-lateral bodies at the end of the day where most of this has to be implemented. In fact, I think the correct way to think about global economic leadership is as a series of concentric circles. You have the G-2 at the middle, you have then got the G-20 representing roughly three-quarters to 80% of global populations and output, and you have the formal multi-lateral universal (almost universal) institutions like the Fund, the Bank, and the WTO where the formal implementation takes place. Of course, there are all sorts of other groups in the middle: the G-7 will still probably be a sort of caucus for the rich countries, the BRICs caucus before G-20 meetings, the APEC countries get together in some context of the Asian-pacific basis, so there are all sorts of different groups, but think of it as concentric circles in terms of effective decision-making on this whole range of topics. The basic point, of course, is that even if the G-2 agrees on everything, which they will not, but if they agree on some things at least, they cannot implement it all. You have got to have a lot of other willing partners, and so, in the conduct of the G-2, you certainly have to avoid rubbing in its existence as the central group. And so the U.S. and China have been absolutely, in my point of view, right to deny that a G-2 exists, ever existed, or are even thinking about it. I follow the Nike ad, “Just Do It,” but do not talk about it, and in fact, I submit that is what is happening, but the U.S. and China are quite right in my view never to use the term. Indeed when others ask them about it, to deny they are doing it.

Wen Jiabao made a well-publicized trip to Europe a few months ago allegedly for the purpose of reassuring the Asian-European Meeting that China had no plans for a G-2 at all that would somehow hold those Europeans at arm’s length, so that is quite right, we should deny it. In fact, one could be really cynical and Machiavellian and say how could there be a G-2 when the Chinese keep sniping at the Americans? The Chinese keep raising questions about the dollar, lousy U.S. fiscal policy, profligate Americans, and all that stuff. And the U.S. snipes at China on a whole range of issues. If you want to be really Machiavellian, you could say, “Boy that is a really clever cover-up.” Well you know, if you want to demonstrate that there is no G-2, then what better way than to criticize each other and say those guys are off the wall and such and such a thing. So, how could there be a G-2 because they are so critical? I will go through some substance as to why I think that is a plausible explanation of some of the rhetoric that we hear, because you do not see any of it followed up. You do not see China selling dollars, and you do not see the U.S. retaliating against China on trade grounds because of its exchange rate policy. There is a lot of talk, but cooperation is very, very good. Again, just to finish the thought about the impact on third parties, certainly the objective that I have always had in mind for a G-2 was to make the global system and existing institutions work better, not to undermine them. My idea is that the G-2 should supplement, not supplant, the other institutional arrangements. On the view that I have repeated ad nauseum, that unless the U.S. and China agree, the G-20 is not going to get very far, the IMF is not going to get very far, and the WTO is not going to get anywhere, so you have got to have them at the core. The objective is not for them to somehow take over the world, but rather to provide a foundation so that the other institutional apparatus, but that means the substance of what we are trying to do here, works out much more effectively by being rooted in a prior agreement of the two key players. That, in a nutshell, explains at least the concept that I have always had in mind. Think of it as a caucus, not a condominium, but a caucus, of the U.S. and China trying to sort out their disagreements and start out with a foundation that may or may not survive the attitudes, views, and policies of other countries, but which is in my view a sina-qua-non for achieving wider agreement, if you want action, and that is basically the answer to other countries who may not like the idea. The basic answer to other countries is that the subsequent results will be better if you can get these two major powers to agree and provide a foundation for action by the world community more broadly. I am sure other countries' noses will be out of joint to the extent that they perceive the U.S. and China working together in that way, but if the results are positive and beneficial, as I would submit they will be, then the bottom line should be worth it. So that tees up the final question then: How's the G-2 doing? If one thinks as I do that a G-2 is at least in the process of formulating, how are they doing? What are the results? Does it justify the notion?

So I would propose to you today that we all start keeping a G-2 scorecard and we keep in mind the issues and track the results across the different issue areas and see if the G-2 seems to be working out and if it seems to be worth the candle and taking the risks which obviously do exist vis-à-vis other countries if they thought such a thing were happening. So I will just give a few initial thoughts on what I think the scorecard might look like at this point in late 2009.

Not surprising, well, maybe surprising to many, but not surprising given the intellectual construct that I have laid out, I think probably the best results have been on climate change. I say not surprising to me because it is a new area where the U.S. is not asking China to sign on to a regime that has been in place for fifty or sixty years, but is rather being constructed de novo. My argument is that it has got to be done with China and I would submit that it is therefore fertile ground for effective G-2 cooperation. My sense is that it is in fact beginning to bear that fruit. As I said, I do not think that the Europeans are justified in being terrified that Washington and Beijing are going to show up in Copenhagen with a post-Kyoto treaty ready to drop on everybody to sign, but I see a lot of progress between the two countries, including the memorandum of understanding that was signed at the SNED here in July which recorded substantial consensus between the two countries on most of the main principles and procedures for moving towards a new climate change regime, even more so what was agreed on in Beijing earlier this week with some rather fundamental commitments to lay out national strategies and national commitments on addressing the climate change issue. Plus a series of concrete specific steps on energy efficiency and other initiatives related to climate change. These move both countries, I think, down the road to quite a significant degree toward an effective response to the climate change and global warming problem. If that does work out with China in at the creation, I think it will be a major breakthrough that would both ratify the wisdom of working the issue on a G-2 basis and would provide some very promising precedence elsewhere.

Now, to go to the other extreme, I think the worst record so far for the G-2 relates to the international monetary system. That is largely due to the dispute over China's exchange rate policy where I think China is definitely in the wrong. Massive intervention to keep your currency under-valued and run huge trade surpluses when you are the world's most competitive country and most rapidly growing trading country is just wrong policy, and it violates the fundamental norms of both the IMF and WTO systems. Now, the U.S. is by no means absolved of responsibility either, to put it mildly. I was on a program with Marty Feldstein in Seoul two weeks ago and he put it very nicely. He said, "The U.S. and China both have to do two things to deal with the global imbalances, to bring the imbalances down: the US has to accept the lower dollar, exchange rate, which it is doing, but has to raise national saving in a big way to get the fiscal deficit down, which of course it has not yet done So the US is still to be heard from. China has to boost domestic demand growth in a serious and sustained way, and I believe it is in the process of doing that. The records for the last couple of quarters certainly shows that, though it is still to be seen how sustainable it will be, but China also has to let its exchange rate go up a lot more, but it has not done that. So, in this area, there is certainly still a big gap in the policies in each country before you can really say you have an effectively-functioning concord as to how to deal with the issues."

Despite the set of monetary and global macro issues, there is progress. Both countries obviously have taken enormous stimulus initiatives to lead the world out of global recession, and for the moment, or at least the next year or so, that looks like being pretty successful. Great credit goes to both countries, and particularly China, for having led the recovery, starting in the second quarter of this year. And even on the imbalances of both countries, they are down about 50% from their peaks of only two or three years ago. I have stressed how China and the United States are the big players on the world economy, growth, etc., but they are at the opposite ends of course on the big imbalances: U.S. debt and deficits, and China creditor and surpluses. But, both of those imbalances are cut in half from their recent peaks: U.S. trade deficit way down, and Chinese surplus way down, although both are still too big, they have both come down a lot. One must also acknowledge that China has let the RMB appreciate by about 20% from its lows of four years ago, 20% percent both in real effective terms and in bilateral terms vis-à-vis the dollar. That was only about half what was needed, but it is in the right direction, so some credit for that.

In addition, and probably more importantly, I am convinced, maybe I am naïve, that the Chinese leadership, and more broadly Chinese society, has accepted the fundamental wisdom of rebalancing their growth pattern in favor of domestic demand and particularly consumer-led growth, rather than rely on ever-expanding trade surpluses. In part, that was the less of the crisis. When it turned out that relying so heavily on exports could really deliver a severe hit to your economy when global trade plummeted as it did with the crisis, but I think China learned that lesson. Moreover they had already begun to recognize that the growth model of the last five to eight years of relying on huge investment in heavy capital-intensive sectors with big reliance on growing export markets just was not a very sensible development strategy. It is not very efficient in terms of job creation, it is hugely energy-intensive, it is hugely polluting, it obviously causes big problems internationally, and it is all based on three erroneous prices: the exchange rate price is wrong, the energy prices have been suppressed and wrong, and the financial sector has been repressed, interest prices have been held down, in part because if interest rates go up and cause even more capital inflow, and increase upper pressure on the currency.

China has some big policy errors which I believe the leadership have recognized the errors and want to move out of, but we will have to see how fast and how thoroughly that happens over the next few years. One other piece of good news on the monetary system fund is that the U.S. has been leading the effort to reform the IMF governance process to provide more “chairs and shares,” as we call it, for emerging markets, particularly China, and reflect the change in the power structure. There Europe is a problem, being unwilling to give up its historical position, so I think there is, even in this area of the monetary system, considerable progress, but still, as I have emphasized, big challenges for the G-2 going forward.

Finally, international trade is, in a way, the trickiest of the policy areas for the G-2 to address. Neither has demonstrated much interest in the DOHA Round. China, in fact, sided with India a little over a year ago to bring the latest collapse, which is where things stand now. Therefore, I think China was actually contradicting its own interests in the trading system, but I cannot say the that the U.S. has been much of a hero either, particularly since the inauguration of the Obama administration, which has really not had a trade policy until the last week or so, and then it is only quite modest. This is a change for China, which puzzles me, and I think is discouraging. China, of course, went through great lengths to join the WTO a decade ago in large part because it was the clear strategy of Jiang Zemin and Zhu Rongji to use the accession to the global rules of trade to promote internal economic reform.

I think that was brilliant because it made global integration a central plank of the entire Chinese development platform, making China by far the most open of any of the emerging markets. It is open in economic terms in that trade to GDP ratio is double that of the United States and triple that of Japan. Congressmen seem to have trouble understanding the concept that China is one of the most open economies in the world. But of course, it is, and that was in large part both the result of and the driver of their membership where they were willing to take a lot of concessions to join the WTO ten years ago. But one does not see that now. Indeed, what one sees is China emphasizing the creation of an Asian block. Lee Kuanyu was in town a couple of weeks ago and his message was very clear: China is in the process of creating an Asian block. Doing it surreptitiously, but nevertheless creating, or attempting to create, an Asian economic zone which it dominates: the Ten Plus Three and the ASEAN Plus Three to enhance its global economic power. So, that could potentially cause big problems vis-à-vis the United States and vis-à-vis the rest of the world. In addition, there are lots of bilateral spats between the U.S. and China. Partly, in my view, it is just bad U.S. trade policy putting tariffs on tire imports from China and is not a very positive step particularly when you have no positive trade policy at the same time to offset against that. So, there are problems of that type. At the same time, without being too creative, one can see a bit of the G-2 at work.

The U.S. has hit China with new trade-protection measures, but China’s response has been totally measured, and I would say totally appropriate. They took the U.S. to the WTO over the propriety of what it has done and responded in kind by raising the specter of equal trade barriers against imports from the United States on probably equally specious grounds of the U.S. tire tariffs. It was tit for tatting in a very fair way and not beyond. Indeed, the U.S. and China reportedly had an awful lot of consultation before the U.S. put on the tire tariffs to make sure that the response would be measured and not excessive and not bring on a sort of retaliatory spiral that would lead to a trade war, and we have heard no talk of that, despite the spats. Countries realize other countries have domestic and political problems and have to deal with them. The issue is that you manage it in a way that it does not lead to a spiral and a global economic problem. I think China's response to U.S. actions and U.S. expression of concerns over China's steps, like taking China to the WTO are so far wholly appropriate and avoid, despite serious economic conditions, the risk of serious escalation of trade conflict. Even there I would suggest that potential conflict has been contained and managed pretty well. I would say that has probably been the biggest test for the G-2 so far, and I would say reasonably okay.

The interesting new issue that now comes on the agenda in the trade context is the initiative that President Obama took in Singapore ten days ago when he took his first positive trade initiative. He announced that the U.S. would participate actively in something called the Trans-Pacific Partnership, this very small trans-pacific FDA for small economies, but which has the potential to immediately grow to seven or eight. I think Korea and Japan will jump in it fairly quickly, and so within the APEC context, you do have the potential for a significant trans-pacific trade agreement which would avoid having to "draw a line down the middle of the Pacific," in Jim Baker's favorite term. And would provide for a first time, and I think quite positively, a forward trade policy initiative put forward by the Obama administration. The U.S. does that in part as a response to what I described before: the Chinese effort to create an Asian block, or, to put it more neutrally, the evolution toward Asia-only trade agreements based on the ASEAN plus one plus one plus one etcetera which inexorably are moving toward an Asia-wide trade agreement that would discriminate against outsiders, including the United States. In my view, the United States has wisely not opposed that or blocked it, which it could not have done anyway, but has said we want to move in parallel on the trans-pacific front so as to minimize the trade distortions and the political implications of a discriminatory Asian arrangement, thereby liberalizing trade on a trans-pacific basis at the same time.

The interesting question now on the agenda I think will be how China responds to this trans-pacific partnership initiative. Assume for the moment that I am right and that the initial group of four little countries immediately adds Australia, Vietnam, maybe Peru, and the U.S. comes in and that is eight. Korea and Japan will both clearly join it if it does develop substantive momentum, and so then you would be up to ten countries, including three big Asians, or four if you include Australia as an Asian country. And then will be the interesting question of how will China respond? Does China participate in that which would then seal it as a trans-pacific parallel to the Asia-only agreements and really avoid the risk of drawing a line down the middle of the Pacific, or will it stand aloof in preference for its own Asian block efforts and try to discourage the rest of Asia from participating along with the United States in the trans-pacific area? I think that is a test for the G-2 concept of relationship. I do not know how that will come out, but I hope it will be positive, constructive, and move in the two directions simultaneously, but that one is a test to be seen.

So to wrap it up, the record to date I think is mixed but is quite promising in terms of a huge new component of the global architecture of the type represented by the G-2 ideas. Obviously, it is in its early stages and will require lots of refinement. It clearly has to be done in very skillful ways to avoid risking severely adverse effects from others so that it can achieve its objective, at least as I would view it, of strengthening the global system, supplementing rather than supplanting what is done elsewhere and achieving its purpose of getting the two most important players together before everyone else is brought in. I think it is on its way of becoming an effective steering committee within the broader G-

20 steering committee, and I think it will be a central part of the global economic architecture going forward. Thank you very much. It was a pleasure.

Audience Question #1: I think you know that China will be an active actor of the trans-pacific regime. This is my answer. I have a question: You mentioned you know that Chinese top officials . . .

Bergsten: Could you please identify where you are from?

Audience Question #1 continued: I am a visiting professor from SAIS at the Johns Hopkins University. So, you mentioned that you know the top official from the Chinese central bank, Zhou. He argued in the G-20 conference, and said that the Chinese currency, the RMB, will play an important role in the international monetary system. So I guess maybe it is hard to define the important role of the Chinese currency RMB, but can you imagine what is the attitude of the United States? If the U.S.'s attitude is not positive, what other positions from Russia, Japan, or EU about the . . . you know I think I mentioned the RMB can be the world exchange currency. This is my question. Thank you.

Bergsten's Response: Well, it is a big subject and if you are interested I would refer you to my lead article in the new issue of Foreign Affairs that actually goes into the role of the dollar in some degree. I think it is decidedly premature to talk about a significant global role for the RMB. The currency is not yet convertible on capital account, there is still extensive exchange controls so the RMB still does not yet meet some of the basic requirements and criteria for playing a significant international financial role. I certainly think it will evolve in that direction over the next ten or twenty years, yet China does most things faster than we predict so it might be even faster, but I think that will take some time. I think it is a wholly desirable development. One of the thrusts of my Foreign Affairs article is that the United States should be quite relaxed about a modest, gradual, orderly decline of the international supremacy of the dollar. In fact, I am not clear the international role of the dollar is much in U.S. interests anymore. It is too complex to go into here, but I certainly think the U.S. should have no problem in an increased role for the Euro in the short-run, the RMB in the longer-run, and the special drawing rights at the IMF as a reserve asset. Given the dominance of inertia in the financial matters, it will be a very long time before the dollar is no longer the major international currency, but its market share will probably decline gradually which is fine and dandy, in part because if the RMB, like the Euro, becomes a global currency, it means the authorities of the issuing country have a greater responsibility for international monetary stability and I think will play that role. So, if the RMB does becomes more and more important, it seems to me to reinforce the G-2 concept. Maybe in that case with the European central bank, or G-3, in the financial domain, that is fine, but I think it is a healthy thing, which is however to be measured in maybe a decade or so rather than anything more imminent.

Audience Question #2: Hi, thanks, I am Emma Ashburn with the Asahi Foundation. I would just like to follow up with that question, another RMB question. Lately it seems like there has been more high-level talk about U.S. officials asking China to revalue the currency. What do you think the time-frame would be for that and what conditions does China see necessary before it does that? When they talk about the middle of next year, what will change before then and what can the U.S. do to encourage that and what should they not do? Thanks.

Bergsten's Response: As I said in my remarks, I think that it is really critical for China to start letting the RMB appreciate again. On our calculation, it is now undervalued about 20% on a trade-weighted basis and about 40% bilaterally against the dollar. Incidentally, I think that is now the biggest global imbalance. On our calculations, the dollar is not over-valued in any general sense. The dollar-euro rate, the dollar-Canadian dollar, and most of the G-7 currencies are about right. Those are about at equilibrium levels, at least as we would calculate them, so there is no generalized dollar over-valuation anymore, even though the U.S. is still running a current account deficit of maybe 3% of GDP. The one big global misalignment is the undervaluation of the RMB and of six to eight Asian currencies that are essentially pegged to the RMB. The Asahi and everyone else talks about being pegged to the dollar, but since the RMB is pegged to the dollar, they are really pegged to the RMB, and the reason that Malaysia, Thailand, Korea, and lots of others keeps intervening to keep their rates from rising against the dollar is that they do not want to rise against the RMB because it would hurt their competitiveness with their big competitor, which is China. It is important to remember that the Chinese undervaluation is not only distorting its own position in trade in the world economy, but is dragging much of the rest of Asia with it, and, even though you have got a large number of other countries that are big economies, big trading countries, big holders of reserves such as Taiwan, Singapore, Hong Kong, when you add all of them up, it is like another China in terms of annual account imbalances and currency impact and all that. So if you could get all of those currencies to revalue by the needed amount, it would take another hundred or hundred-fifty billion dollars a year off of the current account deficit. That would achieve much, if not all, of the remaining adjustment that is needed in the U.S. external balance, so it is big stuff that we are talking about here. It is very important.

When will they do it? As I suggested, I think the Chinese leadership has genuinely bought into the rebalancing notion, but, like any cautious political leadership, they worry about jobs in the short-run. They are still in the early stages of recovery from the global crisis so they do not want to rush something that will add further to the internal adjustment requirements that they face. At the same time, we know they have already begun to curtail the very rapid expansion of credit that was going on in the Chinese economy earlier this year and was even beginning to generate some over-heating risks, not goods inflation but asset inflation, and so I would suspect that in terms of the need to head-off insipient inflationary pressures at home plus to achieve some of those long-term structural objectives I talked about before, give more accurate price signals to promote domestic-led, rather than export-led growth. I would not be surprised to see China move sooner than the consensus, by which I mean starting to let the rate appreciate gradually. Again, as I said, if they are 20% undervalued, I would not expect or advise them to revalue 20% tomorrow morning. I think going back to the gradual 6 or 7 percent a year of 2006 and 2007 would probably get you to about where you need in three years. I would rather see it a little faster like see them do ten percent for two years and achieve the adjustment more quickly, but if they get the process going, let it appreciate pretty regularly or gradually. Set them at a path that would get them at equilibrium in two or three years. Then I think you would have a big boost to global confidence, you would be bringing the imbalances down, and you would be achieving, incidentally, one of the G-20's major purposes of a rebalanced as well as recovered global economy.

Audience Question #3: Well, as you mentioned, there are misunderstandings about G-2, and so for people whose job is not primarily research or publishing papers, policy, or lobbying, what do you recommend for us to do to minimize the negative results that are associated with misunderstandings of G-2?

Bergsten's Response: I would just use one or two of the bumper-sticker lines that I suggested: the goal is to supplement, not supplant the existing institutions; it is to be a caucus, not a condominium; to make the global institutions and policies work better; it is not to put anyone down, it is to try to improve prospects for agreement among the broader groups by getting the two key players to agree first. Seems to me all that is quite plausible by way of defense against critics whose over-riding concerns may be turf, and prestige, and sadist rather than substantive outcomes. If the results justify the means, then I would think you could sell that pretty well to your friends.

Audience Question #4: I just want to ask a question about the merits of what I kind of see as sort of macro-managed international monetary orders; Bretton Woods I, having come out of New Hampshire, dying in 1973, and Bretton Woods II may be on its deathbed now. You mentioned a lot about how the U.S. does not want to be the core anymore in this core-periphery model, but to what extent do you see the next monetary regime, whatever it will envision, Bretton Woods III, or whatever it is going to be called, being macro-managed or micro-managed from the bureaucratic level as opposed to allowing the market to do it justice in terms of exchange rates.

Bergsten's Response: Well, I think there are two pieces to it, and most of it will be market-driven. What I described before, the modest decline in the role of the dollar, steady increase in the role of the euro, maybe later the RMB, and maybe some increased role for the special drawing rights for the official reserves. I would describe that as moving towards a multiple-currency system to replace the dollar-centered system of the last hundred years. The dollar has been dominant for a hundred years for a simple reason: it has not had competition. There was no other currency based on an economy anything the size of the United States, or financial markets anything the size of the United States. So, even when the U.S. economic performance was lousy, policy was lousy. In the seventies and parts of the eighties, the dollar maintained its dominance, even when it was doing really poorly. Why? No competition. Helmut Schmidt always, well I always try to rope the Germans, when told "Deutschmarks should play a big role," would respond "Well, East Germany is about the size of Oregon." And their GDP never got to be more than a quarter of ours, never played more than about a quarter of the dollar's role, and that is about where it leveled off. That is where the EU and Euroland changes that. The Euro is now a currency based on an equivalent-sized economy with equivalent-sized financial markets. The Euro is not quite equivalent to the dollar yet because there are no Euro bills or Euro bonds. The European financial markets do not yet have competitors for our treasury bills or treasury bonds because they do not have a unified fiscal policy or any European assets. If you would like to diversify into Euros, you would have to buy Italian treasuries or German bunds, but they are mainly long-run and are not fully-competitive with U.S. financial instruments. Now, I think Europe will evolve into that way. When it does, the Euro will become a full competitor to the dollar in the global financial markets, but that is also not going to happen overnight. Nevertheless, I would describe where we are headed as a multiple-currency system, rather than a dollar-based system. I think the big issue is whether the official management of that system becomes more internationally-cohesive and coordinated through the IMF with the G-20, and within that the G-2, and basically drive the process.

The IMF is right now one of the great disappointments, or as one could say failures, of the international economic architecture. It has tried different approaches to improve its surveillance over not just national economies, but the interaction of national economies. On an issue like the Chinese currency issue, which is the bread and butter of what the IMF is supposed to do, it has failed totally. Now, when we say the IMF has failed totally, it means that the main countries have failed since they make up the IMF. You cannot blame, well you can put blame on the management sometimes, but it is basically the countries. They failed to do it. We know that they did not back the Cains at Bretton Woods in 1944, but there is no effective mechanism in the existing international system to deal with surplus and deficit countries. The IMF has clout over borrowers when it lends to them. It does not have it over a big borrower like the United States, which can borrow in its own currency, but the IMF has no clout at all over surplus countries. So the issue there, in my view, is whether to link the IMF and the WTO in a more direct way.

WTO agreements, the articles of agreement to the WTO, have similar proscriptions against competitive currency devaluation and beggar-thy-neighbor as the IMF does. They have never been tested and never been used. The issue is whether wanting a multilateral solution to these things to enable the WTO to effectively threaten, and, even in extreme cases, apply trade sanctions against countries who maintain manipulated and competitively-undervalued currencies. Now, free-traders do not like to think in that direction, but since one of the assumptions of free trade-thinking is equilibrium exchange rates and avoidance of big payment imbalances, I think you are logically driven in that direction. Now, I do not think that is going to happen overnight, but if you wanted a significant change that would improve the international payments adjustment process, that would probably have to be part of it. So, the big test however is to reform the IMF's system. That means again, G-2: U.S. and China, working out a way, now being on opposite ends of the balance, where they could agree on a meaningful role for the IMF in monitoring and policing the whole international monetary system. Maybe that will await the day the RMB becomes a significant international currency, and therefore China has a bigger responsibility for the system, but I would hope it happens sooner. But, that is a big test. That, and along with the things I mentioned on trade, are probably the biggest tests for the G-2 in the foreseeable future.

Audience Question #5: 1:05:50 – [unintelligible] (audience member basically says that a lot of Chinese people distrust the concept of the G-2 and think it is some sort of trap. What are the thoughts on that?)

<u>Bergsten's Response</u>: I am sure there are such people. I think the truth is that there is a great ambivalence towards the concept in both countries. In the United States, there is a certain appeal to working out new systemic arrangements that would overcome the risk of conflict between the U.S. and China, and would provide a more positive foundation for global economic management. At the same time in the United States, there is an understandable reluctance to give up its own dominance and accept a true partner. Because I said right from the start in thinking about the G-2, what differentiates it from current, or at least until recent, is that US policy was really viewing China as a true partner in the whole sense of dealing with all these issues I talked about, and to some Americans, that is a hard thing to swallow. It is used to being the dominant country, and besides, China is not a democracy, it is not a full-market economy, and it is still a developing economy in terms of per capita incomes. So, they say this is sort of a weird economic superpower. You know its poor, it is non-market, it is not democratic, and all that is very different. There has never been an economic superpower that had any of those three characteristics, never mind all three. So, it is kind of hard for many Americans to get their minds around that this is going to be a true partner in going forward to steer the world economy, and so there is an ambivalence here. In China, I am sure you are right. On the one hand, I discern a lot of Chinese are flattered or honored, or think it would kind of be a great thing to be a part of this G-2 steering committee. On the other hand, a lot of responsibility goes with it, and many Chinese, I'll put this deliberately, still hide behind being a poor country, and say, "Well, we are a poor country, and even though we are the second largest economy in the world, we have the big trade surplus, and we are the biggest creditor country, none of that counts because we are a poor country, Do not look to us to take on any international responsibility because that is for you Americans and Europeans, you rich guys." So, there is a real ambivalence, and understandably so.

The rising power always wants more power without the responsibility. We saw it in Japan for twenty-five years. So, there is ambivalence both places, and that requires a lot of internal debate and discussion as to what is the appropriate role for the individual country in the world economy, and certainly the relationship between the two countries. So while I understand what you say, there are doubts. Whether it is appropriate to view it as a trap where the U.S. is somehow sucking China in. I have lots of confidence in the Chinese leadership and people to avoid being trapped. I do not worry too much about that, but I do take the point that assumption of significant responsibility for global economic leadership, particularly coming so fast in light of the dramatic rapidity of China's rise to global power status. I mean that is tough to assimilate and get your mind around and absorb that concept into your policy-making and your policy-thinking. There is inevitably a lag in the perceptions of reality, and even then, of the willingness to assume the kind of responsibilities that go with the territory of being an economic superpower. So it is difficult, but one reason I push the idea is to try to push thinking about it in both countries, and at least promote an evolution of thinking that will move in an ultimately successful direction for both. It is tough, and I fully accept that there is opposition to it in both countries for different reasons, and that is why I am so encouraged that there seems to be as much progress as I would argue there is.

<u>Dr. Stephen Smith</u>: On that forward-looking thought, we will have to end this session. Thank you Dr. Bergsten.