Congressional Testimony

Assessing the Strategic and Economic Dialogue

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Toward a G-2

I have proposed since 2004 that the United States and China create an informal G-2 to help steer the world economy. The reason is simple: Progress is impossible on most important global economic issues without agreement by these two global economic superpowers. Examples including exchange rates and the international monetary system, the world trade regime and climate change. (The one notable exception is financial regulatory reform, where China is not yet an important player so most decisions remain with a subset of the membership of the Financial Stability Board.)

There are now three global economic superpowers, the European Union along with China and the United States. But Europe, or even the more integrated euro area, speaks with a single voice on very few issues. Moreover, its current economic weakness limits its influence on most topics. So a G-2 is the only practical possibility for achieving effective global economic leadership.

A number of other countries, including a growing number of emerging markets, are of course important as well. The G-2 is not intended to replace the G-7, G-20, or the formal multilateral institutions like the International Monetary Fund and World Trade Organization. Its goal is in fact to make all of them work better. But even the G-20 is too large to function effectively, so a smaller steering committee is needed.

The G-2 should be completely informal and indeed unannounced, or even acknowledged, by the two countries. As the Nike ad says: “Just do it!” They should forge close working cooperation on the whole range of global economic issues, which is essential for achieving progress either on bilateral problems or in implementing their global leadership responsibilities as the world’s two largest economies.

The most overt and visible step toward creation of a G-2 is the very frequent meetings between President Barack Obama and the top leaders of China, President Hu Jintao and Premier Wen Jiabao, who have gotten together on average every quarter since President Obama took office. But the Strategic and Economic Dialogue (S&ED), following its predecessors the Strategic Economic Dialogue and Senior Dialogue of the George W. Bush administration, is by far the most extensive institutionalization of the concept. The S&ED brings cabinet officers together once a year and has launched ongoing dialogue among many groups of officials on many topics. They are learning whom to call in each other’s capitals to address key problems, and how to deal with those officials, a central ingredient in international economic cooperation that has long ago been accomplished across the Atlantic and to a degree across the northern Pacific to Tokyo.

I thus believe the S&ED is a crucial component of US (foreign and national security as well as economic) policy and must be continued and indeed strengthened. Its ever-expanding agenda of topics and discussion-forcing, if not yet action-forcing, nature are extremely important. The administration should be congratulated for the serious attention and priority it has attached to the Dialogue, and it should continue and accelerate that focus in the future. Any successor administration should do so as well.

The Currency Issue

Abstract pursuit of a G-2, however important, is unlikely to win widespread support, however, now that the S&ED has been operating for three years. Have there been tangible results that suggest beneficial practical payoffs from the exercise and from the associated US policy initiatives toward China?

The dominant economic issue of this period has been the extensive currency manipulation by China. For at least five years, the Chinese authorities blatantly intervened in the foreign exchange market by buying $1 billion to $2 billion every day to keep the price of the dollar high and the price of their renminbi low. This produced an enormous competitive advantage for China in international trade, a current account surplus that exceeded 10 percent of its GDP in 2007 and an unprecedented buildup of almost $3.3 trillion of foreign currency (largely dollar) reserves.

The United States has thus rightly focused on this issue at every meeting of the S&ED as well as in many other contacts with the Chinese, both bilaterally and in multilateral forums. In recent years, it has correctly imbedded the currency manipulation per se in the broader context of the need for China to rebalance its development strategy away from export-led growth, featuring unprecedented investment levels (almost 50 percent of GDP) and repressed domestic financial markets, in the direction of relying on domestic demand (especially consumption and services).

It is now apparent that the US strategy has succeeded to a substantial degree. China's global current account surplus has declined to less than 3 percent of its GDP. This is primarily due to the rise of about 30 percent in the trade-weighted value of the renminbi since 2005, including its climb of more than 40 percent against the dollar. My colleague William Cline's new analysis[1] suggests that China's current account surplus could even disappear over the next few years if it permits the renminbi to continue strengthening at the pace of the last two years since upward appreciation recommenced in June 2010 after a hiatus during the global recession.

I believe that the S&ED has played a very useful role, and added an important pressure point, in persuading the Chinese authorities to gradually reduce their beggar-thy-neighbor currency policy. China of course had to come to believe that such a change was in its national interest but the S&ED, and related US-China discussions, have been extremely important in at least two respects: convincing the Chinese of the (very powerful) case that a stronger exchange rate was in their own economic interest and emphasizing constantly that China's (exceedingly important) relationship with the United States would be significantly affected by their behavior on this issue.

[1] William R. Cline, *Projecting China's Current Account Surplus*, Policy Briefs in International Economics 12-7, April 2012, Washington: Peterson Institute for International Economics.

The S&ED thus passes the critical test from the US standpoint of having achieved, at least to a substantial degree, major progress on a clearly articulated central goal of the exercise. They will have to remain on the case because we cannot be assured that China will let the renminbi continue rising, which is required to avoid recrudescence of the problem, and the rate has in fact remained essentially flat for the last six months. Moreover, it would be desirable for the currency to rise enough (and China to rebalance more broadly enough) to fully eliminate the current account surplus and indeed convert it into a modest deficit. There remains the vexatious, if economically irrelevant, issue of China's continuing large bilateral surplus with the United States—which (on our numbers) exceeds their total global surplus (on their numbers) but is particularly misleading because only a small fraction of the value of exports recorded as coming to the United States from China is actually added in China itself. But I believe that the progress on this very difficult and highly contentious issue marks both a major step forward in US-China economic relations and a signal achievement for the S&ED.

Other Issues

There are of course a number of other important economic issues that the S&ED should help resolve. A true G-2, for example, would play a central role in addressing two of the key macroeconomic issues now facing the world economy:

- resolution of the euro crisis and, specifically,
- creation of additional lending capacity at the International Monetary Fund to reinforce the efforts of the Europeans themselves in financing adjustment programs in the euro area and to help other countries that are sideswiped by the euro crisis.

China, as the world's largest holder of foreign exchange reserves and a major surplus country, should be a large (probably the largest) contributor to such enhanced lending capability at the IMF. I believe the United States, as the world's largest deficit and debtor country, is correct not to contribute to that facility itself. But the United States should be pushing hard for the creation of a maximum "firewall," in light of its own huge interest in a stable resolution of the crisis, and so should be urging China to lend at least $500 billion to the Fund (and offering support for a corresponding increase in China's role in that institution).

There are fleeting references to these issues in the fact sheet on the S&ED distributed by the Treasury Department. However, there is no indication that they received major attention and Under Secretary Lael Brainard did not mention them in her report of May 16 to the House Financial Services Subcommittee on International Monetary Policy and Trade. Surely the world's two major economies should seriously address these pivotal global issues in their economic dialogue.

Many bilateral, including trade, issues must be addressed as well. The S&ED apparently covered an impressive array of such topics. It is particularly important that China has agreed to negotiate new international rules on export finance by 2014. This is an important aspect of global competition that is often distorted by national subsidies and China is not a party to the current international agreement that is centered on the OECD because it is not a member of that organization.

It will remain difficult to successfully resolve the large number of bilateral trade conflicts between the United States and China, however, as long as they continue to be addressed in a purely ad hoc manner. Some cases can be taken to the dispute settlement mechanism of the WTO, as both countries have done, but most of the trade issues cited in the S&ED fact sheet are not subject to agreed rules of the road. Disagreements are thus likely to fester, eroding both the bilateral relationship and, in light of the leading global position of the two countries, the international trading system as a whole.

I thus believe that the United States and China should consider launching negotiations for a bilateral trade agreement to provide a comprehensive framework to deal with the daunting array of economic problems between them—a list that is likely to continue growing as the economic relationship deepens further. Maurice R. Greenberg, the long-time CEO of AIG (long before its collapse in 2008) and one of this country's keenest and most experienced observers of China, has proposed that such an effort could aim to develop a US-China free trade agreement over a period of a decade or so. Another alternative would be to look for an early occasion to bring China into the Trans-Pacific Partnership, with its high standards for governing trade and investment in the Asia-Pacific region.

Any such effort would represent an extension of the G-2 concept into the trade policy area, as inevitably must occur at some point. The S&ED could productively begin that conversation, which of course carries major foreign policy as well as economic dimensions. It is already addressing possible components of a broader trade agreement such as a Bilateral Investment Treaty, government procurement, and reform of state-owned enterprises in China. Building on its considerable progress to date, the S&ED has a rich potential agenda for the years ahead.