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**PRESS BRIEFING ON  
U.S. CHINA RELATIONS  
AND THE UPCOMING VISIT OF  
CHINESE PRESIDENT HU JINTAO**

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*Transcript by:  
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H. ANDREW SCHWARTZ: Thank you all for coming to the CSIS-IIE briefing on the visit of Chinese President Hu Jintao.

We will get right to it today, but I'd like to introduce our participants here. We have Michael Green, former -- who's a senior adviser CSIS, former national security director for Asian affairs,

We're delighted to have Fred Bergsten and Nick Lardy of IIE here with us today. We also have -- who have co-authored this terrific book: "China: The Balance Sheet." It's been published by Public Affairs. It will be in stores on Monday. Their co-authors at CSIS are Bates Gill and Derek Mitchell.

We also have Kurt Campbell, CSIS senior vice president and Henry Kissinger Chair in Strategy.

And we will start with Mike Green.

MICHAEL GREEN: Good morning. I'm going to try to set some of the context for the visit of President Hu Jintao here to Washington. He arrives on the 20th. And my colleagues are going to talk about where China's going, among other things.

The debate surrounding the visit of President Hu would give one the idea that, inside the administration, there's an intense debate about whether to contain or to engage China. I think that debate is long gone. I've pointed out often that China's seventh-largest export market is Wal-Mart, one U.S. company. If the U.S. has a containment strategy, it's not a very clever one.

In fact, I think the administration has tried to manage China's growing impact and manage U.S.-China relations in a three-pronged way. And the first prong is to convey to China that indeed the United States is not trying to contain China's growth, would like to see China grow and be prosperous and the Chinese people be successful, would like to see China play a role in places like the six-party talks or the six-party energy dialogue that was convened in January.

In February of last year, I was sent to Beijing with a letter from the president setting the tone for the new administration, and one of the main themes was that the U.S. would like to take U.S.-China relations to the next level, to have an improved, productive relationship.

So the first prong is to reassure and encourage China.

The second prong, though, of course, is to hedge. We have strong alliances with Japan, we have strong relations with other countries in the region because we simply cannot predict where China will be in 20 years, unless you read the China balance sheet. So now it's perhaps possible.

And then the third prong is to shape Chinese decision-making, and to say, in effect, that the United States welcomes China playing a larger role, the United States would like for President Hu Jintao to be successful in dealing with the many challenges he faces, whether it's disparities in coastal and regional incomes or taking care of the 22 million people who move to the cities every year looking for jobs; that the U.S. recognizes President Hu's strategy of peaceful development as one that has merit, but that China has to play by the rules, has to be what Deputy Secretary of State Bob Zoellick calls a stakeholder in the international system; that China needs to be more transparent about its military buildup, needs to do more to protect intellectual property rights, to enforce the rule of law, to address the currency issue, and to take care about the company it keeps, whether it's Sudan or Burma or North Korea or Zimbabwe.

Those are the three key elements, I think, that set the context for the U.S. side and for the bilateral relationship and for the dialogue between President Bush and President Hu. The Chinese side, I think, is still defining what its role is going to be. When I was in the White House, I had a senior Chinese official visit me about a year and a half ago, and he was arguing that China is a benign force in the world and that China doesn't interfere in the internal affairs of other countries; that the days of Maoist revolution are long gone, that China's a benign force in the world. And he used the example of Sudan and he said, look, you know, we don't care about internal issues like genocide, we only care about the oil because we need the resources. And I said, well look, that's mercantilism. And the Chinese translator had trouble translating "mercantilism" and they had a big debate about it, and we figured it out, put the characters down. And then they had a big debate about whether I meant that as a good thing or a bad thing.

I think Bob Zoellick's dialogue on stakeholder, and so forth, has had an effect.

President Bush will be meeting President Hu for the fifth time since the -- well, basically in a year. He was with him in May at the VE celebrations, in June at the G-8. He had a long meeting in September in New York last year. And then, of course, his visit to Shanghai. So there's been an ongoing dialogue between the two leaders that's been increasingly frank and, I think, productive.

The challenge this time is to show the American public that there's some result, that there's some productive output from this increasingly candid and strategic discussion between the two leaders, and between people like Bob Zoellick and his counterpart, Dai Bingguo.

I think President Hu would like to come out of this meeting with all of the pomp and circumstance and protocol a Chinese leader needs to convey to his public when he travels abroad. I think he would like, perhaps ideally, to have a strategic partnership with the United States, the kind that China has sealed on his first visits to places like India or to Europe. But I think the Chinese side realizes that the administration's not going to agree on a strategic partnership. But at a minimum, I think he would like to convey that China is not a threat, that China's growing clout is benign for the world.

And he will, I think -- the Chinese side will try to convey that in part by buying things, over \$60 billion in procurements of Boeing aircraft and Microsoft software in large deals. Wu Yi, the state counselor for economics, was in South Carolina. There's a lot of buying going on. I suspect that won't be enough to convince the Congress or the administration, which wants to see some real structural reforms on the economic side, would like to see movement and strict enforcement of intellectual property rights and would like to see something on the currency. I think the other panelists may address this. I doubt that President Hu can deliver in a concrete way on the currency, so I would look for the words he chooses, the signals that he sends. And what he says about the currency will be the result of a collective decision in the Chinese leadership and will have real weight, but the administration will really have to squeeze it out of him.

The other areas, I think, that are worth looking to see if there's some progress and some productive output is how President Hu addresses publicly issues like Iran and North Korea. The Chinese are able to some extent to hide behind the Russians right now on the Iran issue. That's a problem. And on the six-party talks to some extent the Chinese are able to hide a bit behind the South Koreans, who are not eager to see the situation get tense. But in both Iran and North Korea, China has a very serious role to play, and in some ways is the pivot for whether we're successful in dealing with those problems. And President Hu will be under some pressure to say something and to signal, not only domestically here but to those countries, that China's patience is wearing thin.

So overall on this trip I wouldn't look for joint communiqués, I wouldn't look for concrete things beyond the buying sprees, but what President Hu says and how that's negotiated on some of these issues, I think, will be quite important and worth watching.

C. FRED BERGSTEN: Turning to the economic side of the relationship and what may transpire in the upcoming visit, the real question is whether Mike's bottom line is going to be enough to hold at bay those who want to take tough, responsive action against China.

I want to pick up on two things Mike said. He stressed, quite rightly, that the U.S. wants China to play by the rules. That's the whole responsible stakeholder strategy that Bob Zoellick has laid out. Mike also said we need for China to deliver now, come through with some substantive responses on some of the big economic issues.

I've been struck, as we have been briefing and testifying on this new book just the last two or three weeks, on how much frustration and impatience there is with China in both the Congress and the administration. I testified at the Senate Finance Committee two weeks ago today. There were eight leading senators there, some of the most thoughtful and knowledgeable members of the U.S. Congress. Nobody was headline chasing or posturing on that occasion. And they all expressed deep frustration that China was not responding to straightforward economic issues where the two countries that are in the top three or four in the world, depending how you define it, have a joint

responsibility to move forward, and it's just not happening. Impatience is growing. I discern this in the administration as well.

So I would raise the question whether a few words of the type Mike described that -- I'm sure he's correct -- are the best one can expect from the Hu visit will be enough to head off some negative actions in the Congress, even in the administration, such as the labeling of China as a currency manipulator -- which almost surely the Treasury will have to do in its next report, soon after President Hu leaves -- whether those words will be enough to head off action which could then lead to deterioration in the relationship.

The whole objective of the visit obviously, as Mike said -- to strengthen the partnership, try to move it forward. I think the risk is that it may rebound in the other direction. And the unwillingness or inability of the Chinese leadership to make significant progress on the substance of the issues, at least on the economic side, may cut in the other direction.

Now, I've worried sometimes in the past that Mike and his colleagues on the political side were kind of muzzling the economic negotiators and telling them, "Well, you can't be tough because you'll muck up the six-party talks or relationships in the Security Council over Iran." I think now it's almost the reverse, that the failure to get progress on the economic issues may undermine the overall relationship and then make it harder to work together on the security concerns.

Now, that's my snapshot on the upcoming trip. The substance that I've described, and particularly the interaction between the economic and security issues, are the topics of this new book. You will see the book is modestly subtitled, "What The World Needs To Know Now About The Emerging Superpower." And that's meant seriously. It's not heavy on policy. It's meant as a factual and analytical underpinning to understand the rise of China and what it means to the U.S. and the rest of the world.

We think it's the first effort to do that comprehensively and to integrate the security, political, social and economic issues in a comprehensive hole, put them together to try to suggest what all this means.

I want to just address one substantive issue for two reasons. A, it's the centerpiece of the economic debate, and secondly, it'll kind of show you how we're trying to present these things.

The issue that overrides and in a sense frames the whole economic relationship is the trade imbalance. And I want to refer you in the binder, the loose-leaf binder, to the tab called, "China in the World Economy," and the first sheet in there, which is headed, "Trade Imbalance." What we've tried to do to make it easier for you all and members of Congress, others, is to do one- or two-page summaries of all the key issues outlined in the book, and I want to refer you to this one, and then just kind of walk through it because it is the issue that overarches and frames the whole economic relationship.

The headline number is that the U.S. is running a bilateral trade deficit with China of over \$200 billion. Worse yet, the ratio of our imports to exports is 6 to 1. Just by reference, the worst it ever got with Japan was 3 to 1, so in that sense, it's twice as bad. And what it means is that U.S. exports to China have to grow six times as fast as U.S. imports from China grow just to keep the number from getting worse. In other words, it's going to get worse. A year from now it will be \$300 billion or so.

However, what we tell you in the book, what we tell you at the head of this summary two-pager, is you should not pay attention to bilateral trade imbalances. In a multilateral world, one should not -- repeat, not pay attention to bilateral imbalances. So we hope you won't stress that. However, in this case, the global trade positions of the two countries are accurately reflected in the bilateral imbalance. What do I mean by that? The United States is running a huge global trade and current account surplus -- annual rate of \$900 billion last quarter, getting close to a trillion dollars a year --

MR. : Deficit.

MR. BERGSTEN: The U.S. deficit -- sorry. (That error ?) in the book. A \$900 billion trade and current account deficit rising a hundred billion a year the last few years, getting close to a trillion dollars.

The global position. China is now, in the last two or three years, also running a very large global trade and current account surplus. It hit \$150 billion last year, second only to Japan. This year may be the largest of any country in the world. In a sense, the U.S. and China are mirror images. The U.S. global deficit is 7 percent of our entire economy, and China's global surplus is 7 percent of its entire economy. In short, mirror images. And that is what one should focus on, that the U.S. is the world's biggest deficit and debtor country; China is the world's largest surplus and almost creditor country -- it's got foreign exchange reserves close to a trillion dollars by the end of this year. So the thing to remember is that these are the two sides of the huge global economic imbalances which are probably the biggest single threat to continued economic prosperity and stability in the world.

So why do we have this imbalance? What we tick off and summarize briefly here are five causes that are often adduced to explain it. Now, one of the things we try to do in the book is to debunk myths, and three of the five widely stated causes we will suggest are myths. At the same time, we try to point out what are real problems, need to be dealt with, and we think one of the five fits that category.

The Chinese claim that one reason the U.S. runs a big trade deficit with them is because we won't export high-tech products to them. They say: If only you'd get rid of those export controls, all would be fine. Well, Nick Lardy ran the numbers. It turns out that if the U.S. had approved every single export license application last year, it would have taken 0.3 percent off the trade deficit. In other words, that doesn't go very far to explain the problem. And that's a Chinese myth to be debunked.

Likewise, a lot of Americans say, "Well, it's those low wages in China, unstoppable low wages. How can you compete with a country that pays a dollar a day to its workers?"

Well, it's true. Chinese wages are one-thirtieth those of American workers. However, Chinese productivity of those same workers is one-thirtieth of that of American workers. So the wages accurately reflect the productivity difference, and adjusted for that, there's a reasonably level playing field between the two countries.

Look at it another way. There are lots of countries in Asia and elsewhere that have much lower wages than China, but they're not big exporters to the world or the United States.

Look at it the other way. The U.S. has among the highest wages in the world. We're the world's second-largest exporter. Who's the largest exporter? Germany, which has even higher wages than we do. So wages don't explain it. You have to contrast and compare with productivity, so we debunk that American myth.

Third explanation: China is a closed market. They don't buy anything. Well, they keep their markets closed. They restrict their imports. Another myth.

China -- it may surprise you to learn -- and this is one of the main points in the book -- is an extremely open economy. The ratio of imports to trade in China is double that of the United States, triple that of Japan. It's gone up six-fold in the last 25 years of reform. China's realized import tariff, its customs revenues compared with the value of imports, is 2 percent, one of the lowest in the world. And even if you look at their nominal tariff structure, it's way lower than any of the other big developing countries -- India, Brazil, Mexico, any of those. In fact, it's falling now into the category of rich countries. So China is an open economy. It doesn't block trade, and that's, again, a myth that needs to be debunked in explaining the imbalance.

Well, what, then, does explain it? The main factor is that China has become the assembly location of choice for Asian-wide production networks assembling final product, components of which come from all over the world, including the U.S., but mainly from around the rest of Asia.

Indeed, something like 55 to 65 percent of all of China's exports to the world or to the U.S. are assembled products in which the value added in China is a relatively modest number.

So if you look at U.S. trade with other Asian countries -- Taiwan, Korea, Hong Kong, Japan -- you will find that the share they play in our trade deficit has plummeted over the last 10 years or so as China's share has risen, and if you put them all together, the share is actually lower.

So what we're showing in our numbers as a bilateral deficit with China should really be interpreted as a U.S. deficit with all of Asia, not as a bilateral problem with China to be singled out. So in that sense, that one's a myth, too. But in terms of understanding why China runs such a large recorded trade surplus the way the statistics are calculated in this business, the key element is to recognize that China has become this assembly point for production networks that are multilateralized throughout Asia.

But then comes the fifth and final point, which is, in our view, the big -- so, one of the implications from what I said at the assembly point of choice -- and it reflects those numbers I mentioned before, the six to one ratio -- the U.S., under any conceivable circumstances, will continue to run a very large and probably growing bilateral trade deficit with China. But as I said, that's not to be the focus. One should try to bring down the global imbalances.

And that goes to the fifth and final point, which we view as the big problem -- and the president even singled it out, mentioned it in his remarks at SAIS the other day, preliminary to the Hu visit -- and that is the currency problem.

China is an anachronism in the currency area. It maintains a fixed exchange rate against the dollar. And more importantly, it has intervened massively in the currency markets for the last several years, to keep the value of its currency from rising. Market forces would have long since pushed the Chinese currency up 20, 30, 40 percent against the dollar. China's running these huge surpluses, big trade surplus, huge inflow of foreign direct investment, speculative capital coming in expecting a revaluation of the currency.

But the Chinese siphon all that off by official purchases, block the rise in the value of their currency, therefore keep their products tremendously underpriced in world trade markets and make the world's most competitive country even more competitive. Indeed, by pegging to the dollar, over the last few years, when the dollar has gone down against the euro and most other currencies, the Chinese have actually ridden the dollar down and become more competitive when they're already the world's most competitive economy.

So this is a huge blind spot, in my view, in their policies, and we say that in the book. And that is, in turn, leading to charges in the Congress, elsewhere in the United States, elsewhere around the world, including, notably, in Europe, that in this one crucial area, China is not playing by the rules of the game, not being a responsible stakeholder, needs to move.

Now, how much difference does it make? In calculating that, one has to remember a critical fact. China, by keeping its exchange rate dramatically undervalued against the dollar, is promoting similar undervaluations of currency by all the other Asian countries. The reason is simple. The other Asians, understandably, don't want to let their currencies go up against the renminbi and lose competitive position against China. But

since the renminbi is pegged to the dollar, they therefore won't let their currencies go up against the dollar.

The result -- and Japan was intervening massively until two years ago; other countries have done it, more or less -- the result is that all of the Asian currencies are dramatically undervalued against the dollar, and all of Asia has essentially been absent from the necessary global adjustment process.

The dollar came down quite a lot two and three years ago, but only against the euro, the Canadian dollar, the floating currencies. Asia abstained from that, though Asia is the home of half of the world's surpluses that are a flip side of the U.S. deficit, the home of 90 of the buildup of foreign exchange reserves around the world, the areas that are growing the fastest and could afford some trade adjustment, unlike Europe, which is growing a miserable 1 percent. And so the absenting itself of Asia from the global adjustment process, because China keeps its currency down and the others stay with China, is a huge factor in the world economy.

Our calculation is that the Chinese currency is undervalued by anywhere from 20 to 40 percent, depending how you calculate it. If they would let the currency move up 20 percent, even over a couple of years, phase it in, and the other Asians went up with them, same amount, you would get a reduction of \$60 (billion) to \$80 billion per year in the U.S. current account deficit. That wouldn't eliminate even the half of our deficit that we need to restore a stable position to the U.S., but it would go a long way.

And the crucial point, I think -- in finishing my over-long remark -- is that the failure of China to permit its currency to move, as most other countries in the world are doing, leads to a major protectionist trade reaction here in the United States. The Congress, and even conceivably at some point people in the administration, will say, well, if they continue to insist on an unfair trade competitive advantage by blocking rise in the value of their currency, the only thing we can do, more in sorrow than in anger, is to hit them with trade restrictions. Schumer and Graham have talked about it. Much more responsibly now, Senators Grassley and Baucus, the most respected and responsible members of the Senate, have put much more serious and, I think, prospectively successful legislation in place just in the last couple of weeks. The point is -- and we know this from history -- that if currencies remain way out of line, trade protectionism follows.

So we've got a bottom line of all this. And the thrust in our book -- and it goes right back to China as a responsible stakeholder -- is that continued financial misalignment of this type could put a major dent in the global trading system because of the reaction of our own Congress, European parliaments and governments, if it continues much longer. And that is why I think the administration has been correct to focus on this issue, why it's imperative that early and sizable action be taken on it by the Chinese, and one would certainly hope that something at least indicating a serious intent to move in that direction will come out of the Hu visit.

BATES GILL: My name is Bates Gill. I work here at CSIS. I hold the Freeman Chair in China Studies here. And it was my great honor and pleasure to work with these gentlemen in co-authoring this book that's just coming out, "China: The Balance Sheet." It was my task in the book -- and also, I think, this morning it will be -- to address questions of China's domestic, social and political transformation. This issue doesn't get a lot of, I would say, high political attention. I've noted that it does receive a great deal of sort of human-interest-related type media attention, which I applaud, but more strategically, I think it's extremely important for all of us in this country to recognize that what happens on China's domestic, political and social front, in my view, will do far more to define and shape the China that we face in 10 years than anything that might happen outside of China, or in ways that China externalizes itself.

My colleagues might disagree with that, but nonetheless, it's surely important that we in the United States have a much better grasp of these domestic political and social developments in China and what they mean for us. So let me say a few words about that as they appear here in this new book, and link it, then, to how I see these issues playing out in the upcoming summit with President Hu and President Bush.

In this one chapter on the domestic transformation in China, we focus on some of the key challenges which the Chinese leadership is facing, and which I presume keeps many of them awake at night. You're familiar with such problems and challenges as rising social unrest; the endemic corruption, especially at local levels, among party officials; the fraying social safety net -- the problems China is facing with regard to having sustainable health insurance, pension insurance, decent health care, decent public education, especially in the more remote and impoverished parts of the country; the problems which China is facing in terms of environmental degradation, and the beginnings, we believe, of how that degradation is having an effect actually on the prospects for China's economic growth; and how in the face of all of these challenges, the leadership is trying to adjust, trying to tweak its political and social policies in ways that it can stay on top of this tiger, allowing some social ventilation of different sorts to take place and adjust its policies on questions of human rights, civil liberties, and religious freedoms.

It's a very complex and difficult picture. We conclude, more or less, that for better or for worse, in spite of these challenges which clearly the Chinese Communist party is facing - in spite of these challenges, we probably ought to expect that for the near to medium term, for better or for worse, we're going to be dealing with the Chinese Communist party leading China for the next -- certainly next five to 10 years, or perhaps more. But this is going to be a very different party 10 or 15 years from now than it is today, just as it was a very different party 10 or 15 years ago than it is today.

So in other words, expectations of dramatic dissolution of the state because of these rising challenges, or expectations of some sort of dramatic shift towards Western style democracy, as much hoped as they might be in certain quarters of our country, are not realistic. And while we might want to call for these sorts of positive changes to take place in China, these kinds of calls ought to be tempered by realistic expectations.

One of the, I think, positive aspects we should look to for American interests regarding China's domestic challenges is that it's likely to keep China's leaders' focus inward. This is a good thing. I think because of the dramatic challenges and the overwhelming imperative which the Chinese Communist leadership has in maintaining economic growth and dealing with these social challenges, it seems to me less likely to be interested to engage in various forms of foreign adventurism and, likewise, is going to be keen to assure that its principal relationships, especially with countries like the United States and many of its neighbors, are stable, if not constructive and moving ahead smartly.

Also, I think, on the good side of this is that these social challenges that China faces at home present enormous opportunities for both American public and private interests to engage with Chinese counterparts from Beijing and down to the lowliest county and village, to assist in various ways, to help address these challenges, which provide benefits not only economically, for example, for American business interests, in many respects, but also, I think, in a political sense; because it will be through this kind of engagement -- and, I would argue, an intensification of this kind of engagement -- and through the provision of various forms of assistance, managerial expertise, know-how, and ways of addressing these types of challenges that we can expect to plant the seeds of positive change in China over the longer term.

Now, how will these domestic political challenges in China play out in one way or another during the upcoming summit and in U.S.-China relations more generally?

I guess, in a word, I think, with regard to the summit we're about to have, probably not much. I think, of the major issues which our two governments will be trying to grapple with over the coming summit -- namely, economic issues, number one, and then security-related questions, such as with regard to Iran or North Korea, number two -- questions of China's domestic political transformation and the need for greater freedoms, democratization and so forth strike me as receiving a distant third place, at least in terms of real substantive developments and progress.

Now that's not to say that these issues won't come up. Surely they will. We all recognize President Bush's very keen interest to express to the Chinese leadership their need, for their own interests, to move ahead in making their society a more open one, to recognize that in their own interest, it is surely wise, as a way of dealing with the social challenges they face, to allow for a greater role for civil society, to allow for a greater role for spiritual sustenance and religious freedoms; that these are indeed ways that strengthen a society's ability to deal with the problems they face.

But while I'm quite sure these kind of comments will take place in private and probably also in public, I don't think that they're going to be as important, in the near term sense, for this relationship as will be the economic and security issues.

One important area, though, I think, that does link as we try in this book to show the cross-cutting relationships across these various issues -- one important set of issues where I would suspect we're going to hear a lot more of on the domestic front is increased encouragement by the United States toward China to think about stimulating its domestic economy; that that is one approach, through domestic demand, that we might be able to address the problems of the trade imbalance; that through investment in China, infrastructural development, investment in high-tech imports, for example, to deal with some of the problems, such as energy, that China faces, investment in China's social safety net; that through these sorts of stimuli of domestic demand to make China a greater domestic consumer rather than a platform of export production, that this might be at least a good step in the direction of trying to right some of the imbalances that Fred has already discussed.

So on the topic of stimulus of domestic demand, I'll turn, then, the floor over to my colleague, Nick Lardy.

NICHOLAS LARDY: Thank you, Bates.

The Chinese leadership has outlined a strategy of moving towards a more consumption-driven growth path. And let me just sketch out why they're moving in that direction, what the nature of the problem is and how it relates to the presentations particularly of Bates and also of Fred.

In this area also, the United States and China are mirror images of each other. We have the highest rate of consumption as a share of our GDP probably of any major economy in the world, about 70 percent. In other words, about 70 percent of our GDP is accounted for by consumption expenditure by households. China is at the other end of the spectrum with about the lowest of any country in the world; indeed, it is the lowest that I'm aware of. There may be some obscure country that has a lower share of consumption by households. But China's about 40 percent. So the major -- you know, consumption is only contributing 40 percent of GDP. Now you ask, well, if it's only 40 percent of GDP, how has GDP grown so rapidly? Actually, what's happened is that capital investment has been a major driver of economic growth over the last five years. The rate of increase of investment has been in excess of 20 percent per year, so the investment share of GDP is very high.

Now, the second factor that has been driving their growth, particularly in the last two or three years, as Fred indicated, has been the growth of their trade surplus, which has added to demand. So the headline growth number has been very strong primarily because of high rates of investment and a very rapidly growing trade surplus. Over time, the contribution of consumption to GDP growth has actually declined.

Now, the leadership, I think, has wisely decided that this path of growth is not sustainable for several reasons. Fred has mentioned one; it engenders protectionism in the rest of the world -- the United States, Europe, and so forth. And they have explicitly

said this: We cannot continue to rely on the growth of our trade surplus because it will ultimately lead to trade protectionism abroad.

They're also concerned, as Bates mentioned, about rising environmental problems, which are to a considerable extent a function of their growth strategy. When you have a very high rate of investment and very high rates of investment growth, you're producing lots of steel.

China's producing a third of the global steel output. They're producing and using more than two billion tons of coal every year. They're not producing -- so those are all very capital-intensive, energy-intensive and tend to be in polluting industries. Consumer goods, things that are consumed by households tend to be much less energy-intensive, much less polluting. They're not producing very much of that because consumption demand has grown relatively slowly, and indeed as a share of the overall economy has shrunk considerably over the last two decades.

So they got a number of reasons why they want to move in this direction. What are they doing about it?

Well, they are doing several things.

On the income side, they're raising the personal income tax exemption. They're getting rid of the agricultural tax. So they're trying to raise incomes by cutting taxes. That will contribute to an increase in consumption demand on the part of households. But that effect is likely to be pretty modest because China relies primarily on indirect taxes rather than direct taxes.

On the expenditure side, they've announced a number of important programs in conjunction with Hu Jintao's strategy of developing what he refers to as the new socialist countryside -- greater provision of social services, particularly health care, which has almost completely collapsed since the reforms began in the countryside in the 1980s and the whole collective infrastructure has substantially diminished over this period, so the provision of health care is gone. And similarly, in the cities, we have the diminished provision of pensions and other kinds of social welfare, so there's going to be more social expenditures to provide the services.

Now, that goes back to the other sense in which the United States and China are mirror images of one another, the third dimension, that is on the savings side. If we look at the households sector, China's households have the highest rate of saving of any country in the world on a voluntary basis. It's about 25 percent of disposable income. And as we know in the United States, we hit an all-time historic low last year with actually a slightly negative rate of savings; that is, American consumers are spending more than their disposable income by increasingly going into debt. So we have China at 25 percent, the United States at roughly minus 1 percent. These are very, very profound differences we'll take some time to address.

But the hope of the leadership is as they provide more social services through the budget, that households will perhaps feel that they don't need to save quite so much they are now saving for health care, since less than a fifth of the population is covered by any kind of medical insurance; they're saving for retirement because less than a fifth of the population participation participates in any kind of pension program. They have been saving to provide education for their children, and remember, in China, you pay tuition and school fees and book fees and so forth starting in the first grade. When you get to college, it's more subsidized, but primary school's a very expensive proposition for low-income farmers, so they're proposing to get rid of all those fees and costs in the countryside over the next few years.

So that's the long-term strategy on the expenditure side, a little bit on the tax side. But I would emphasize -- and this, I think, goes back to what Fred said -- I'm not expecting this to lead to a huge increase in consumption. In the short run, it may gradually raise the share of consumption in GDP, which will reduce the trade imbalance as Bates suggested, but it's not going to happen overnight, and I would say in some respects, the government policy is actually still fairly cautious.

Provision of social services out of the budget tends to be running at about a quarter of budget expenditures, is not going up very rapidly. They need to do much more in this domain, I would say, more rapidly, not only to meet their own needs for provision of higher levels of health care and other social services, but to reduce over time their large global current account surplus.

MR. SCHWARTZ: Before we go on to Derek and Kurt, I'd like to ask our colleagues who are on conference call to mute your phones. We're experiencing some feedback and some background noise.

Derek?

DEREK MITCHELL: Thank you. I want to echo the pleasure it has been to work with my friends on this book.

One thing I want to add to what has been mentioned about the folders in front of you. For those watching on television, these papers are actually available on a website that we've put up, [www.chinabalancesheet.org](http://www.chinabalancesheet.org). So those of you who want to check it out online, those of you in the room who might lose these folders, you can find it online. And there's actually additional information. There are charts and there are other one-pagers and things on more specific issues you could find there, and it's sort of a live site that we'll keep current.

It's not a coincidence that in the book, and here, as well, that my topic, foreign and security policy, comes at the end, because in fact, I believe, that foreign and security policy is a function largely in China of their domestic concerns; that they are focused like a laser right now on the issue of domestic stability; that if there's a political slogan, it's, "It's domestic stability, stupid;" that everything is about keeping that transitional period in

China smooth. They have enough challenges at home, and that externally they're looking at creating a peaceful international environment, having a good relationship with the United States as the most important market, as an important investment source, and also, making sure that there is no containment strategy outside their borders, maybe led by the United States, and to have good relations with their neighbors and beyond -- also the need, the desperate need for resources, including, but not just exclusively, oil and natural gas, to fuel that development. It means they go out and they engage with Sudans, with Irans, with Burmas, with Venezuelas, with others, in Africa and elsewhere.

And finally, of course, is the issue of Taiwan, which you can call an international issue or a domestic issue, depending on your perspective, but in this case, in the perspective of international affairs, their desire to isolate Taiwan internationally is a key pillar of their global strategy -- there are only maybe 25 or so nations that recognize Taiwan as the Republic of China diplomatically -- but even otherwise trying to keep Taiwan out of international organizations to make sure that Taiwan is not accepted until they accept the so-called one-China policy, or principle, and in this case for the Chinese, even if then we're not sure what China's intentions are towards Taiwan, this is a central element of their foreign policy internationally.

Now, when it comes to the Hu visit, I would echo what Mike Green suggested, which is this issue of symbolism versus substance, that on the Chinese side, the symbolism matters most of all; the fact that they call this a state visit when the administration does not, that they want to make sure that Hu Jintao gets the kind of face that previous presidents have gotten and has -- whether it's a 21-gun salute or a 19-gun salute, or whatever the trappings are that go into the Chinese context, this is very important.

For us, of course, the United States, this is not important. What we care about are results. And on that front, as Fred Bergsten suggested, there's a lot of frustration at all levels, and even on the foreign policy front. There's a sense that the Chinese are not giving on anything. They're not sure if it's a matter of confidence or arrogance; increasingly confident that they can withstand the kind of pressures that the United States puts on them. Usually there are sort of these token human rights releases around the time of a visit. We haven't seen that. There were reports of Zhao Yan, I guess, the researcher at The New York Times, and that was a false rumor. And, you know, you sometimes wonder if it's more cynical to release them right before, or not to release them, which one you like -- which one's better. If they don't release them, you get angry they don't release them. But to release them is also a cynical kind of move. But right now they're withstanding that kind of pressure and not sort of checking the boxes in these areas. And again, that goes to foreign policy.

The two issues that were raised before -- Iran, North Korea -- are right at the top. I think Iran will be right there. You see today that the vice foreign minister of China is going to Tehran and Moscow to talk about the issue, I think trying to highlight the issue that they're a responsible stakeholder. They want to keep this issue out of the U.N. Security Council because then they'd have to be on record on this, and perhaps lead to

sanctions. They have their own interests regarding Iran, with oil, again, with other economic interests. If you take them at their word, they also believe this is an issue that can be settled through dialogue, through diplomacy. And clearly that should be pursued. But it's interesting, when they send their diplomats over, it is a contrast to the United States that is not engaging in bilateral discussions. And these things occur pretty regularly where the Chinese will take the opportunity to take the high road and demonstrate that diplomacy is the way they like to go, that patience is what's required, that dialogue is what's required. But the question is always what happens if that fails? At what point are they willing to turn the screws when they have these other interests that they want to take care of?

When it comes to North Korea, there's some evidence perhaps that North Korea may come back to the six-party talks soon. This is up to the eye of the beholder because there's a lot of movement. China has sent its defense minister there over the past week or two. Hu Jintao went about a month ago or so, and there was no result out of that, which was somewhat surprising that the president of China would go and there'll be no result. This would be a fairly cost-free kind of result or deliverable that the United States would like to see from the summit because the North Koreans wouldn't be giving anything, they'd just show up; hopefully they could actually show up to do a deal and to be serious, but they wouldn't even have to in order for the Chinese to say, "I delivered them to the table. We're pursuing dialogue." If there's any kind of deliverable, I would think that might be one that could be helpful. But North Koreans have their own mind, they'll do it in their own time. And I'm sure the Chinese will hope that that's something they can provide.

On the issue of Taiwan, just very briefly, relative to that is the issue of military modernization of China, and that they have come out with their new military budget of about \$35 billion for the year, up by about 15 percent. The DOD annual military power report will be coming out next month, nicely disentangled from the Hu visit, and will, I think, accentuate the issues of military transparency. I'm sure the president will raise these issues in the context of Taiwan and the military balance and the dialogue across the Strait. The same way the Chinese tell us that when it comes to Iran and North Korea, we will tell the Chinese you must engage in dialogue without preconditions – interesting kind of reverse message.

And that issue of Burma might come up, I would imagine, because gratefully from my perspective as someone who cares deeply about the Burma issue, that issue the Chinese are getting more engaged on, and this president, to his credit, his attention to democracy and human rights, Burma has gotten on the agenda, and China is a critical issue when it comes to getting at the issue of Burma. If it weren't for China's support for that regime, you know, it would be much tougher for them to withstand the pressures, though they have engaged in isolation strategies throughout the past several decades. But China is a critical element.

So with that, I don't want to go on much longer. We'll get to questions. Let me turn to Kurt.

KURT CAMPBELL: Thanks very much. I seem to have had difficulty finding a place at the table. Let me just say assuredly, this is not China's problem. China is sitting pretty much near Fred and Bates and they are center stage in almost everything associated with the diplomacy, which leads to really the first point, and I take a slightly different view from my colleagues about the meaning of the summit and what it suggests. If you listen to our commentary so far, you would get the sense that the United States government spends an inordinate amount of time at the highest levels thinking about strategic developments in Asia. And I would profess or suggest that that is absolutely not the case.

And one of the most interesting dynamics about this most current period in strategic developments – if you look at over the last ten years, in fact in history, there has probably never been a country that has risen to strategic significance as rapidly and dramatically as China has, even faster than the role of the United States at the first part of the last century from about 1890 to the First World War, so dramatic strategic rise and ascent. And I would say that corresponding with much of this time has been a sense of U.S. preoccupation largely away from Asia where we have been primarily focused on the Middle East, rightly so on dramatic developments in Iraq and now Iran and the Middle East. And so, I think one of the more important points that I would want to make is that although China is very important, and I think is gaining greater strategic significance and attention, it's demanding more attention in central levels of the U.S. government.

But let's remember – let's look back – how many speeches has the president given on China or Asia in the last year? How many speeches on Iraq? I think that number, when you compare, is something like 120 to 0, right? So let's just keep in mind at the strategic level, the United States is really focused like a laser on the Middle East. And to be perfectly blunt, in some respects, Chinese friends like it that way. They appreciate the fact that with U.S. sort of attention focused elsewhere, it allows China to play a larger role in Asia as a whole, which leads to – I think – some dynamics and some tradeoffs that they have to manage carefully in their summit with the president. They are astute observers. They may not note how the American democracy works effectively, but they are astute observers of the executive branch, and they really understand how the executive branch works. And they know that the president is weakened. They appreciate the fact that he is spending much of his political capital on Iraq and there is this development on Iran, which they had not – perhaps the president had not – anticipated.

One the one hand, they would like very much to get the acclaim and the due reception of a great power on the rise like China, but on the other hand, they do not want to attract too much attention to themselves during this period of dramatic ascent. And they know something about the United States that I think that we don't appreciate about ourselves as much, which is any country that rises dramatically, whether it be a democracy or an authoritarian regime like China is going to cause concerns, strategic concerns, because the United States is not going to give up aspects of its global predominance easily. And that's something that Japan understood fifteen years ago, probably Germany understood. And so I think on the one level, China wants to get

welcomed, wants a high-profile visit, but doesn't want too much attention so that attention is directed on some of these trade issues that Fred and others have put on the table. The other issue about the declining influence of the executive branch, which does worry Chinese friends, is what it means on trade legislation and the like. They depend on a strong executive to be able to deal with rising course in Congress asking for more action on macroeconomic issues and the like.

I would also suggest if you listen to most of our discussion, it suggests that we are engaging in shaping China. And I would say, if you sort of tasted that as a wine, that's sort of like a vintage 1996 bottle of wine. And I would say, in the more recent era, that what you have is China more effectively managing and engaging the United States in ways that sometimes we're not fully aware of, associated with aspects of China's rise. And so I think it's much more equal powers meeting each other than it is the United States as a tutor and a door opener for China as a whole.

It's also the case that I think somewhat to the surprise of many Americans who grew up during a period of time where there was enormous anxiety, and in many cases, animosity in Asia towards China, one of the most astonishing developments in the last five or ten years has been the rise of what we might call China's soft power, the attraction of China, both in Southeast Asia and elsewhere. If you look at public opinion polls throughout the world, imperfectly measured in the Pew context and elsewhere, they reveal public attitudes about China much more positive than many of us anticipate. And indeed, in many respects, much more positive than the United States as a whole. So I would say just simply that I think Chinese leaders have a strategic goal associated with our meetings with Washington leaders that are not simply the long sort of laundry list of let's race Taiwan. I think their larger set of strategic issues are to get the respect from the United States, but hopefully not too much attention during a period of really dramatic ascent in Chinese power.

The second point, I would just say, slight difference with some things – it is often said that the United States has a strategy towards China. I think one of the biggest problems is that in fact we have two strategies towards China that are largely unconnected to one another. And I know something about that, having served at least a little bit of time in the U.S. government. There, I think, is a very effective strategy to engage China with political engagement, welcoming Chinese friends in the international environment into organizations, opening our market as Mike Green said. Those are major contributions to China's peace and stability. On the other hand, we also have a very effective policy called hedging, which has to do with maintaining our alliances and our military presence in the Asian Pacific region, all things are also very important. What I think has been the case – and this is not unique to the Bush administration; this is unique to American government – is that each of these strategies are largely self-contained and not well connected to one another. So in many respects, I would argue at least, that we have at the executive level really two largely independent strategies vis-à-vis Chins, and that we are coming to the end of that phase where that is allowable, if you will, and that one of the things that we'll see in the next phase of U.S.-China relations is a much greater effort, I believe, to try to integrate these two very important elements of

U.S. strategy, which have won largely unencumbered and unlinked up with the other aspect of U.S. strategy.

Third and last point, one of the interesting things – and Bates has made this, I think, very important point – is that unlike the 1990s, summits and meetings between U.S. and Chinese leaders are much more regular occurrences, right? So it's not this sort of – it doesn't carry this sort of same – oh my god, what's going to happen – quality that we had in some summits in the 1990s. Nevertheless, I think there are always issues on the agenda that have the potential to surprise us that could – you know, despite the backgrounding that could come out of this meeting – and actually create headlines. And if I had to sort of nominate one issue, I agree with Fred and Nick that trade issues are going to be a big deal. There is going to be a lot of jaw-jaw about it. But if there was one issue that came out of the summit that would be a little bit of a surprise that could create a little tension between China and the United States, I would nominate Japan. I think Chinese friends are going to raise some real concerns with the United States about our strategy vis-à-vis Japan in terms of bolstering Japan, not only as a political ally, but as a military ally, and are going to raise some concerns about Yasukuni Shrine. And I think this will be done in private, but I have no doubt that there will be some suggestions and some discussion about that in public. And it puts the United States in an extraordinarily awkward position because, on the one hand, we are very close to Japan and recognize that we need Japan as a powerful ally and supporter of our overall goals and objectives in the Asian Pacific region, and privately, we also know that the Japanese, if you will, are on a bad wicket when it comes to Yasukuni Shrine in the sense that as long as this goes on, Japan is rapidly losing air speed and the ability to shape the larger agenda in Asia, not just with China, but with other countries in the region as well. But, because so much politically is riding on this, it's difficult for us to say to the Japanese friends directly, you are hurting yourselves in this process. So stand by, I think the Japan issue will likely cause some concerns behind the scenes in this summit.

Thank you very much. Back to you, Andrew.

MR. SCHWARTZ: Great, and with that, we'll take some questions. Jennifer?

Q: (Off mike.)

MR. GREEN: First of all, it was my experience that the administration, indeed the president, tried very hard to maintain discipline that you did not pull your punches on trade in order to get success in North Korea, or you didn't pull your punches on arms sales to Taiwan in order to improve the trade deficit. In fact, the mindset in the White House when I was there was very much that if you do that, you'll open up a Pandora's box. You have to keep all issues moving forward on their merits, because if you start pulling from column A to get success in column C, the whole relationship will come unraveled and you'll be teaching the Chinese side the wrong lessons about how commercial power translates into influence.

On Iran, I don't know how or why these leaks started coming out about potential use of force. I do know that the Chinese tend to react to those, and the Chinese do have an interest in stability. And when the Chinese have moved and put pressure on North Korea, for example, it has often been because they feared that if they didn't, the U.S. would start taking unilateral actions that would destabilize the situation in ways China didn't want. So I don't know the reason for those leaks, but I suspect they were taken very seriously in Beijing.

Q: I'm really surprised by what sounds like your sense that the Chinese are prepared to announce some kind of substantive movement on currency. It's a hard thing for a Democrat and a poli-sci major to say that every friend I have on Wall Street says there's not a chance they're going to do that.

MR. BERGSTEN: What made you think I said that?

Q: Well, I didn't say you said it flat out, but the whole tone of the discussion seemed to indicate that you thought there would be movement there. So my question is twofold – do you think there is going to be movement there? And this is the be-careful-what-you-wish-for – let's say we wake up on the 21<sup>st</sup> and Hu says, damnit Fred, you're right. We're going to move to 30 percent in a year. What would be the inflationary impact in this country if they did that? Yeah, there's no discussion at all of the press here. We're just simply talking about a trade deficit. So clear up – you're not predicting that they are going to do this? What if they did?

MR. BERGSTEN: No, my least worry is that they'll move 30 percent and so we'll have an inflationary kick.

Q: But that's what we're calling for, right?

MR. BERGSTEN: We are, but at best, it would phase in over several years. Indeed, the dollar in aggregate is overvalued 20 to 30 percent against an average of the world's other major currencies, and that is an inevitable correction that is going to happen, and it is going to have inflationary pressure in the U.S. It is going to push U.S. interest rates up higher than the Federal Reserve would like. It is going to dampen the growth of domestic demand in our economy. And, if it happens precipitously, and/or is delayed further, so when it happens it is sharper, it will have a severe hit to our economy. I think I did say that, in my view, the biggest single risk to global growth and prosperity is in fact an unraveling in a disorderly way of these big global imbalances. However, they've got to be corrected and the issue is to get it to happen and steer it as best one can in an orderly way. That's why I stress the need for the Chinese to start moving and permit the rest of Asia to move with them to begin a gradual, prolonged currency adjustment period.

Remember, when the dollar came down 10 to 15 percent in 2002-2003, it's not at all against China. China, in fact, rode the dollar down. But when the dollar came down against the euro and others, it was very gradual and it was very orderly. There was very

little effect on U.S. inflation or interest rates. Now, our economy had a lot of slack at that time. Now, we're about at full employment so we're going to have bigger effects. But note, just to be clear – I'm glad you raised it – unfortunately, I do not think the Chinese will move on the currency, at least with any degree of magnitude commensurate to the need, which is used. And that is why my fear – again, just to be clear – my fear is that their failure to move will intensify the congressional and perhaps broader reaction against them, which will lead to trade restrictions and other measures.

Remember, the U.S. has already put on substantial increases in import barriers in six major sectors of Chinese exports to the U.S. There is legislation pending out there that could be much more extreme, and this is with the U.S. economy at full employment and growing very rapidly. If you cyclically adjust U.S. trade policy, you should be terrified, because in a year or two, if the economy has slowed down, unemployment is going up, our global trade deficit's a trillion (dollars), the bilateral with China is 300 (billion dollars), there is a hot political campaign for the White House in 2008, you can imagine a very big deterioration of U.S. trade policy that would be aimed at China. And to me, the tragedy is that China, in my view, has had a brilliant trade policy, it's integrated with the world – as I said, become one of the most open economies in the developing world. It has used that to promote internal reform. Yet, by its failure to move on the currency, it risks a backlash against its own strategies that would undermine its basic domestic policy, which my colleagues have pointed out, is at the centerpiece of the country's whole national strategy. In other words, this blind spot – as I would term it – is really risking and undermining of the country's entire social and political, as well as economic position. So the stakes are indeed very high.

MR. SCHWARTZ: Those of you at the table, if you could hit your mikes, it will help the rest of us, and please identify yourself and your news organization.

Q: Marty Walker from UPI. Question for Bates Gill. Mr. Gill, you said that you thought that the internal domestic challenges that are looming were likely to keep the Chinese leadership focused on internal issues for some years to come. Isn't there a wildcard, though, in China's need for energy and particularly the way that China has been pretty aggressive in looking for energy and oil supplies? I'm already sort of hearing -- in some of the other think tanks around town -- concern about China's very forward diplomatic and indeed economic policies in Latin America, in Africa. Is this a wildcard that could disrupt your concept of China's inward focus?

MR. GILL: Thanks very much. I am of the general view that we in the United States have thus far tended to over exaggerate this issue of energy in our ever desperate search to find yet another major competitor with which to pick a fight. Let's look at the numbers a little bit. And I am no top specialist on this question, but the basic numbers tell a good story.

First of all, China is less dependent on foreign sources of energy than we are, by a considerable number. Of China's overall domestic energy draw, about 12 percent is gained from foreign sources. The vast majority of China's energy needs are met by

domestic sources: coal – 70 to 75 percent of China’s energy needs are met by its own huge coal reserves. Now, that presents obvious problems, as Nick suggested because the coal is not burned efficiently and it’s dirty. But in this new 11<sup>th</sup> five-year program which was announced they have rightly intended – one of the only substantive numbers you get out of that whole planned is announced in March, is their intention to dramatically improve energy efficiency in China.

Now whether they meet the numbers they propose is a big question, but it is clearly important to note that they recognize the need to diminish, if at all possible, or at least stabilize their dependence on foreign energy sources. And one way they are going to do that is through coal efficiency and clean. The other way they are going to do it is by dramatically ramping up on nuclear power. China is going to be one of the biggest -- fastest growing, I should say, producers of nuclear power over the next 10 to 15 years. I don’t think they are going to meet their very ambitious targets in terms of plant construction, but these are big goals, and they recognize they need to build from about one or two percent of their energy draw being provided by nuclear to double that to about 5 percent or more hopefully in the next 10 or 15 years. Obviously there are vast untapped hydro sources of energy in China as well, although that creates some social and domestic problems.

My general point is this: In some respects, I think China is being a lot smarter about its energy future than we are, and, yes, they are dealing with countries that the United States finds unsavory and difficult like Iran and in the Sudan, Burma, Venezuela, elsewhere. But in the global marketplace of energy exploration and production, the fact that China is working in those countries simply means that there may well be other sources of energy, which – that we can tap into that China will not be. So I don’t want to entirely down play this aspect of our potential competition with China, but I think we need to be very cautious and look at these numbers and make sure that we don’t over-exaggerate it either. I’m very encouraged.

And one of the important announcements that may come out of our summit next week is that China and the United States will seek to expand their dialogue and discussions on this very issue, which is something badly needed in order to I think diffuse what is sometimes an over-exaggerated sense of competition and a new Cold War over energy resources.

MR. BERGSTEN: Yeah, could I just add two sentences to that because it’s really important. One of the main things of our book is that the U.S. and China should be viewing themselves as allies, not competitors on the energy issue. They are the two biggest consumers of energy in the world, the two biggest importers of energy in the world, two of the most inefficient users compared with Japan and the Europeans, and instead of, in the case of China, scrambling for a so-called assured source of supply, which is a mirage in a global market like energy anyway, the U.S. and China should be teaming up.

We should be moving heaven and earth to get China in the international energy agency, which coordinates the policy of course of the consuming countries. You can't have effective cooperation and coordination among the consuming countries, vis-à-vis OPEC and the cartel producers unless you have got all of the big consumers in the room, and that means notably China. The IEA is only OECD countries. It is ridiculous not to have China and India, Korea – Korea is in the OECD now – but China and India, but particularly China on our side of the table in the energy policy debate internationally, which is now of increasingly critical importance because of the rise and potentially further sharp rise in global energy prices.

So for the U.S. and China even to be viewed erroneously or excessively as Bates said, as rivals, challengers, competitors in global energy is a huge error in the interest of both countries, and that is one thing we really stress in the book.

Q: Washington is trying to relate that to the Unocal incident.

MR. BERGSTEN: That would be on of the issues front and center on the table, would be joint efforts to expand world energy supply, and Chinese investment in U.S. energy companies, U.S. energy resources, as they do in Canadian resources right now would be one of the essential issues on that table – on the table, and likewise I suspect U.S. firms might have some interest in some energy development efforts in China in that part of the world. So that would be – you are absolutely right, Martin, that would be one of the central issues that could arise quite positively out of the kind of reversal of psychology and mindset in dealing with the issue from where it is now.

MR. MITCHELL: It seems to me there are two aspects of that question. One is the issue of energy competition, which has been addressed here, and the other is the issue of competition in the international system, which is the issue that you brought up when you are talking about in Bates' references, which is the Zimbabwe, the Burmas, the Sudans, and Venezuelas, and that is what we deal with in my chapter, which is that when China gets engaged unconditionally in these places that otherwise are considered rogue regimes or worthy of isolation or sanction or a program of various sorts, that China provides an alternative pool of support, and therefore it becomes much more difficult for the United States or the U.N. or others to deal with these issues of international norms and values.

So in that way you have a kind of latent competition, and you have a development, very nascent, of course, of kind of the multi-polar world that China is seeking, where there are alternatives to the United States, alternatives even to sort of the fundamentals of international values, the international system, again, that China can provide, and that is where we get at the issue of getting resources, energy in places where otherwise we fear to tread; we don't even allow our businesses to tread. And that is a concern; that is a real concern over the longer term.

Q: Jim Wolf, Reuters.

I would like to ask you about a part of the recent quadrennial defense review, Mr. Campbell, Mr. Mitchell, Mr. Green. On China, the QDR identifies it as a country at a strategic crossroads, and says the U.S. will seek to influence China's policies, and it announces that it is going to bring forward the development of a long-range strike capability by some 20 years. I wonder what you think of the wisdom, or lack of it, of such a policy statement from the Defense Department, and how do you – if – in any case, how do you think that is likely to influence Chinese thinking about military relations with the United States?

MR. CAMPBELL: I think there is some of Secretary Rumsfeld's military diplomacy that resembles a finger in the eye, frankly. And I think that there are enormously important things that we have to do militarily to prepare for strategic uncertainty in each, and one of those dimensions indeed have to do with China. And it is prudent for us to actually create long-range strike capabilities that are affected in an environment where many of our forward bases are more vulnerable today than they were just a few years ago.

I think doing that more quietly and not so explicitly in the China section would have been probably my recommendation, but I think there are important lines that the administration is trying to set. I think it may have the unintended consequences, rather than causing Chinese friends to say, wow, we really better moderate now to respond in kind, so I would just say that I think there are things in the QDR – I think the programmatic aspects of the QDR make an enormous amount of sense. Some of the rhetoric I think probably could have been toned down a little bit.

And I think what is interesting – again, I think on all matters of profound importance, there had been deep divisions in this administration, and there have been divisions in almost every other administration, but they are just deeper in this administration. So whether it's on the Middle East or Iran or Iraq or diplomacy – huge, major debates.

And I think that we are probably heading into a period where there are going to be more debates again on China. And I think the reason that there hasn't been over the last couple of years is because largely we have been focused elsewhere and because China has been a very important supporter in aspects of this global war on terrorism, but more recently with China moving very effectively to get some of our bases out of the stands and positioning elsewhere, you see that China is taking, shall we say, a slightly different take.

And if you read carefully, you know, the two major statements that have come out of this administration on China, both very good, but both extraordinarily different – one is the so-called, which we focused on, which is the Zoelick and what Zoelick had said, and if you compare and contrast that with what Secretary Rumsfeld presented at the Shangri-La estate they are very different, one much more hard nosed, inclined towards military moves and potential solution; the other I think a more open window about what is potential and what is possible in terms of the scope of future U.S.-China relations.

MR. MITCHELL: Let me just very quickly – and maybe it's speaking somewhat for Mike as well. I mean, the president says this relationship is complex since China is complex, which doesn't sound very profound, but perhaps for this president who sees things in black and white oftentimes, this is profound, that he sees China as complex. And you can I think walk and chew gum on this, as I think the administration has to a degree.

They did come in looking at China as this strategic competitor. They never really used that term after they came into office, but they were viewing China as the next big issue they needed to focus on. 9/11 put that off. I think the EP3 incident, the spy plane incident, began that process. That was kind of a wakeup call. We have got something seriously here. We can't be casually antagonistic; we have to understand. That started a process that really 9/11 put an end to. China became a back-burner issue as a diplomatic matter.

And in fact in the 2002 national security strategy, China was mentioned as a partner, and, you know, and part of a great power, condominium of powers to fight terrorism. So instead of being part of the problem, it became sort of part of the solution. At least on the diplomatic side, we didn't need a problem with them; we have other issues.

That doesn't mean, though, that the Defense Department has ever taken its eye off of the China ball, even from day one. And I'm not sure even, you know, when Kurt and I were in government, that we took our eye off of the China ball, watching the way China was developing. And since 1999, their military modernization has accelerated, and their capabilities have gone much quicker than we ever would have expected.

And the Pentagon has been watching that and that has been a very quiet element of their approach since day one. You have their net assessment office, Andy Marshall, and I think if you go into his office, from what I understand, he has big maps of China and India. He looks 20 years hence. That is where they are focused on the longer term, where are the real challenges to American interests and real traditional challenges to the United States even past this issue of terrorism on conventional challenge. And China is front and center, and that just hasn't changed.

So when you look at QDRs and such, China is still there in the back of their minds, sometimes in the middle of their minds, maybe not the front because we are fighting a way but, you know, this issue, as you look around the world, which country can challenge the U.S. over the longer term and I think China is right there at front and center.

MR. GREEN: On the QDR, maybe as Homer Simpson said, you don't want to say the soft part loud and the loud part soft sometimes. I agree with Kurt on that, but if you look at the PLA documents, and many of them are public, they have a mirror debate,

which is about access denial, asymmetrical capabilities, using cyber warfare. This is part of the reality of the U.S.-China relationship.

We are in a game of strategic and military and high tech maneuver against each other because there is in the Taiwan Straits and elsewhere the possibility of competition and confrontation between our forces. That was true when Kurt and Derrick were in the Pentagon; it's true today. The Clinton administration had that reality and at the same time brought China into the WTO. The Bush administration is dealing with that reality, and at the same time pushing for the stakeholder dialogue in a constructive relationship. It is just how you have to manage the China issue.

Dr. Rice, our secretary of State, not secretary of Defense was in Australia a few weeks ago highlighting this problem and pointing to this, and sounding very much like Secretary Rumsfeld and asking for more transparency. So I don't think it's a Pentagon-only problem; I think it's a problem the whole administration sees and that the president will probably talk about.

On shaping China's strategic choices, it's not just about long-range precision strike or military assets. I think one of the very important developments in Asia these days is the strengthening of the U.S.-India relationship; the U.S. Japan alliance is stronger than it has ever been. I think if you look closely at where the Europeans are now on China, they are also in a somewhat different mode than they were a year-and-a-half ago when they were pushing to raise the EU arms embargo. They have now joined us in a WTO case against China on autos and auto-part issues.

So I think China is not just looking out and seeing the United States as the country that has to be convinced that they're not a problem; they're going to have to deal with the entire system in many ways. Their diplomats are very good. They have some soft power, it's true, but they have a real challenge. And I think the visit here in some ways is where they'll look for the "Good Housekeeping Seal of Approval" that China is not a threat, and it's very important, not just for how it's viewed here but for how it's going to be viewed in the rest of the world as well. That will matter a lot to China.

MR. SCHWARTZ: In the back.

Q: My name is Kato (sp) with the Asahi Shimbun Japanese newspaper. The question is for Dr. Campbell – a Japan issue. I think that Dr. Campbell pointed out, rightly, the issue of Japan in this summit. I think it's true that the U.S. would be put in a very awkward position if this issue is raised by China. But I think what the Bush administration can do about it is very limited because if China brings this up it's not because China wanted help from the United States to solve this issue, but just to marginalize Japan or weaken the alliance between Japan and the United States.

What could, really, or should, the Bush administration do about this issue if Hu Jintao brings this up?

MR. CAMPBELL: First of all, Kato-San, I agree that I think one of China's subtle strategies when issues like North Korea and Iran comes up is to point out that there is a broad perception, a wider perception – it may not be shared in the United States as much, but globally there is a perception that we're not as interested in diplomacy and that we're moving more rapidly either to marginalize the issue or to force on the issue or Iran. And I think China's desire to paint these pictures in ways that, you know, play not as positively globally in terms of American views about the United States are obvious.

On Japan, I think the president has done this just about right in the sense that he has been very clear, the country that he speaks about the most internationally – and I actually think Mike Green gets a lot of credit for this – is his relationship with Koizumi, and I value that. I think that's incredibly important. But sometimes it's important to say really hard things to good friends. I wouldn't say it publicly but I would say it privately. I would communicate to him that, look, this is not working for you – you know, sort of the line from "Jerry McGuire," "Help me to help you." Let's not do this. Let's move in a different direction.

I wouldn't be at all surprised, to be perfectly honest, whether that has been tried, but I think that the political elite, the top couple of guys in the LADPO (ph) are so painted in a corner on these issues that they may need some help from the United States. We may actually need to help them out of this box. I'll tell you the way to do this, though, is not in diplomacy with China.

So basically what the United States – what President Bush will say to President Hu – and I have high confidence in this – is that Japan is a good friend. They are a sovereign democracy. We give them advice but they make their own decisions ultimately. You need to try to do what you can to reach out to build stronger trust and confidence with Tokyo during a difficult period. That's what I would say.

Q: Thank you. Chris Rugaber at BNA Publications. I want to go back to trade and had a question for Fred Bergsten. You were talking about the openness of the China market and their role now as an assembly point. I was wondering if this is affecting the United States more or differently than other countries. It was mentioned the other day I think by someone at the National Association of Manufacturers that the U.S., despite growing exports to China, is losing market share there to European companies. So given the openness of China's markets, I mean, is there a reason that anyone sees why that's happening? Is that because of currency or – why isn't the U.S. selling more there and why is it losing market share to European and other competitors?

MR. BERGSTEN: Nick, you ought to answer that. Nick is the expert on that.

MR. LARDY: Well, start with the basic facts. Over the last five years our exports to China have grown 160 percent; our exports to the rest of the world have only grown 10 percent. China is accounting for a huge share of U.S. global export growth. I'm not sure about the share in China. The main reason our share of total exports – excuse me, the main reason our share of the China import market is going down is this

assembly activity, because as Fred indicated, a large portion of the imported parts and components are coming from elsewhere in Asia. They're coming from Singapore, Malaysia, Taiwan, to some extent Korea and Japan. They're coming to some extent from the United States, but the United States is a relatively small supplier of the parts and components.

So as their exports ramp up, they're sucking in huge quantities of parts and components that are going into products that we are buying and that the Europeans are buying. So our share of their total import market is probably going down.

MR. BERGSTEN: One other point worth mentioning, because it's sometimes not understood well – a lot of factoids in this book that you'll find very fascinating and I think useful – we know that one of the big elements in China's export prowess and these big trade surpluses is its use of foreign-invested firms that have come into China. Well over half their exports are produced by foreign-owned firms, not indigenous Chinese firms. But some people translate that into thinking that U.S. firms have a big role in China, and that's another myth. Less than 10 percent of the foreign direct investment in China is from U.S. firms. There are some high-profile, well-known cases, but the big investment in China is from Hong Kong, Taiwan, Korea increasingly hugely in recent years, Japan.

And so the U.S. is really a very small part of that picture and that needs to be kept in mind. Again, one Chinese myth that we try to debunk is that, well, why would you care about your trade deficit with us? All of our exports to you are being generated by your American firms anyway and they get the profits. Well, that would be fallacious for a lot of reasons, but it's just not factually true because U.S. firms are a very small piece of the foreign investment presence in China, and that too needs to be kept in mind.

MR. SCHWARTZ: Great, we're going to take just a couple more.

Q: Paul Eckert from Reuters. A question more to Michael Green and Derek Mitchell -- Derek added Burma to a list of strategic issues that may well find themselves in the Security Council in one form or another – Iran, North Korea, Sudan. And my question is, what's missing in U.S. diplomacy that might stop China from, say, hiding behind Russia on an issue or hiding behind South Korea, and really exercise that stakeholder role. Is there some mix of carrots and sticks? Is there a bad cop/good cop thing that could work between the United States and China to get results basically?

MR. GREEN: I think Derek did a very good job describing the subtle emergence of two poles, if you will, or several poles around places like Sudan or Burma, and one is sort of represented most starkly by us, and we want to interfere in their internal affairs and make life better for people, and the other represented by China, and they believe very firmly in not interfering in internal affairs; just leave us alone. In many ways it is a projection of China's own domestic desire to be left alone onto the world stage if they can – if the Chinese side can develop a sense of community in Asia that the Americans

should leave us alone and stop trying to democratize us and change our systems. That's a good line of defense for China as we push China to change its own system.

What's interesting is that in many ways that's what Japan sounded like 15 years ago when they were talking about Asian values being different from American global values, and you've heard that in India a lot too. And I've been quite fascinated that nowadays you hear the Japanese and Indian foreign ministers and deputy foreign ministers talking about democracy and rule of law, and so China's growing impact on the world is in other stakeholders if you will, like India or Japan or the EU, raising concern to the point where I think they're starting, in their relationship with China, to also ask not exactly what we're asking for but ask for China to play by the rules.

And Burma is a case in point, possibly, because ASEAN is also shifting on this – I think Toxen's (sp) ouster in Thailand, for example, or Udjono's (sp) strong stand on democracy, the first directly linked to the president in Indonesia. I think increasingly, even in ASEAN, this traditional ASEAN way and non-interference in internal affairs is becoming a bit a thing of the past.

So, to answer your question, I think if China sees that the agenda in the region and the agenda of its neighbors is about following the rules of the road and good policies in places like Burma, I think China will react to that because a lot of these debates are going on within China about its own future. So it's very broad and atmospheric, but I think that will have an effect.

The other thing that tends to make China move, frankly, is when they worry, in cases like North Korea or Iran, that the U.S. or the EU or other powers, but primarily the U.S., will take tough stands unilaterally – will give up on a multilateral approach. That's what I think got China to cut off the oil to North Korea and get them to show up to the six-party talks. I think that's what got China to send tough messages to Pyongyang in the past. It's when they worry they're going to lose control of it. And we want them in multilaterally, but the delicate balance is we've got to make it clear that just reestablishing stability in the status quo is not sustainable, but if we overdo it we start losing friends and allies around the world, so it's a very delicate balancing act there too.

MR. MITCHELL: Well, you do have to make it clear to China there's some kind of cost because they're getting a benefit right now out of the quiet engagement of Burma: their resources and energy, access to the Indian Ocean. I mean, they have a very robust military relationship, and that's what's driving India to be much more friendly to the Burmese regime. They're concerned strategically about Chinese influence on their border. So as long as it stays at sort of a low level in Burma and not really in the spotlight, and they're not so isolated by the region – the region doesn't see them as an essential obstacle to regional peace and stability through Burma – they can get away with what they've got and what they're doing, and they see a real advantage; they see a vacuum that they can move into.

But the key is to put a spotlight on it, to really focus on this issue that you're not being responsible, that this is having an impact on regional peace and stability. You're not a constructive actor. And in fact they may see it also in their interest because of cross-border refugees and drugs and infectious disease and such, but it's very difficult. Right now they see a lot more benefit than cost. So it takes, I think, quite a comprehensive approach and sustained approach that, given how we're distracted elsewhere, could be difficult for the U.S. to lead, but I think we ought to.

Q: Barbara Slavin of USA Today. To Mike Green, why is this not a state visit? I seem to recall that under the Clinton administration Jiang Zemin had quite a visit, with a big state dinner and all the trappings – why not? And to Mr. Mitchell, how would you describe or analyze the Chinese-Russian relationship at this point? How close are they? How important is that apparent alliance now for U.S. action in Security Council on Iran and other issues? Thanks.

MR. GREEN: There is going to be an awful lot of pomp and circumstance in this visit. There will be a South Lawn ceremony and – I've lost track of how many guns, but there will be a lot of guns firing – I can't remember if it's 19 or 21. It will look good on TV in Guangzhou and Szechwan – a president who will be happy in that. The Chinese side is calling it a state visit. They're checking their box.

We have a domestic political context in the United States as well. You know, I think President Hu would like this to be a visit – his first as leader of China, chairman of the Central Military Commission, president and head of the party – his first visit to Washington in that capacity. He would like to have a strategic partnership with the U.S. in a perfect world. Instead what he's getting is this dialogue about stakeholder and an aspiration to improve relations and have China play a role, but a recognition they're not there yet.

And that's the context, I think, that has shaped a little bit of the negotiations about the protocol because we also have our political context. We also, I think, on the U.S. side, don't want to give China a free pass, a "Good Housekeeping Seal of Approval" without some change in behavior, and it all gets very subtly worked into how you handle statements and press statements and press protocol and all of this. And frankly, it may be different now but when I was working in the NSC preparing for past visits of Chinese leaders, well, over half of the negotiations were about protocol and substance, and that became part of the currency of – bad choice of words – part of the ingredients of how we defined our relationship and not –

MR. BERGSTEN: We need to revalue that, too.

(Laughter.)

Q: But Clinton allowed a state visit, didn't he, so it's the difference between the two administrations or –

MR. GREEN: I think – if Kurt was still here – we all heard Kurt address that. The Clinton administration used the word “strategic partnership” as aspiring to or aiming for, but they –

MR. MITCHELL: Working towards.

MR. GREEN: – working towards – used the word “strategic partnership,” allowed it to be part of the rhetoric, and did things that caused a backlash. I think generally, you know, the administration handled China pretty well, but stepped a little too far for where the American public is, and to manage U.S.-China relations well I think you have to have these three prongs I’ve talked about. You need to keep trying to strengthen relationships but you can’t get too far ahead of where the Congress is or where the public is in their view of the relationship, or else you end up making things more problematic.

MR. MITCHELL: That’s as much, I guess, sort of the rhetoric of the relationship as anything. We would say in the last five years that – the Clinton administration talked about working toward a constructive strategic partnership and the Bush administration actually implemented it in the first year, the way that Colin Powell talked about the best relationship ever, I talk to my counterpart every week. I mean, that’s pretty close, but they don’t talk about it in those terms.

On the issue of China-Russia, it’s a very complex issue. There is a confluence of common interests on a range of matters between the two sides. It makes it more tactical than strategic, and they talk about it as we have a strategic partnership. And in fact, China and Russia were the first to have a document that talked about a strategic partnership, and China has used that as a model for other documents with other nations and this idea that alliances aren’t where we ought to be putting our focus; it should be informal strategic partnerships. But this conflict of interests goes to issues like separatism. You know, Chechnya Russia has, and China has Taiwan. There is the issue of the so-called color revolutions where the domestic sort of developments in the former Soviet republics from NGOs – and they say it’s George Soros, it’s the Western NGOs that are causing these problems. China has a great concern about instability now because of their transition at home and so does Russia, so there is a confluence of interests there.

Russia is looking to sell military weapons. They’re using whatever they can to get money and capital and China is buying. Russia has enormous amounts of energy and China needs enormous amounts of energy. I think they both have sort of – they feel they’re stronger together than they are separately, and while Russia is trying to withstand pressures from the United States themselves because of clamping down internally – so does China – and they’re seeing a benefit internationally to work together, I think, more and more on trying to keep the United States at bay to try to balance this unipolar world, and that includes the U.N. Security Council on Iran and otherwise.

But having said that, even though there are these tactical issues and a lot of things where they just happen to have a confluence of interests – they have a long border, they have a long history – there are debates within Russia as well about whether it’s wise to be

selling advanced weapons to a country on their border that's growing faster than they are, that is absorbing much of the Russian far east through economic engagement and social and population movements. There is a lot of energy gamesmanship from Russia right now over where the pipeline ought to go, that oil pipeline. When they talk to the Chinese – it seems every time they talk to the Chinese they say, oh, yeah, we'll do the spur; it's going to happen, and then they go to the Japanese and say, yeah, we're going to do your thing. They never quite resolve it and the Chinese are getting quite frustrated by that.

So there are a lot of things there that remain – there's not a lot of trust between the two sides. Issues like missile defense – recently the Russians caved with the United States in 2001. So they're dealing with each other in practical terms. They both see it greatly in their interest. But whether it forms into some hard alliance strategic partnership, you know, that is a function I think of their relations with the United States. If the United States – their individual relations with the U.S. go very bad, the U.S. is truly seen as a problem for their stability, for their internal affairs, of their hold as a government, then perhaps a more close alliance might form, but I think we're far from that at this point.

MR. SCHWARTZ: Thanks very much for coming today. Now, I'm a lifelong Baltimore Orioles fan, but what we have here resembles more like the New York Yankees' lineup. (Laughter.) I'd like to thank our participants, our distinguished colleagues from IIE, the authors of "The China Balance Sheet," Dr. Green. And please stay tuned; next Monday we'll have a follow-up event – a formal book release event at the National Press Club. Thank you for coming.

(END)