Testimony of the Honorable Grant D. Aldonas
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Economics and Security in Perspective

Introduction

Chairman Bartholomew, Vice Chairman Blumenthal, members of the Commission, I want to thank you for the opportunity to appear before you and discuss the U.S.-China economic relationship and its implications for our economy and our national security.

I have been working on trade with China for over 25 years – since my early days with the State Department, as a lawyer in private practice, as the Chief International Trade Counsel of the Senate Finance Committee during the debate over China's accession to the World Trade Organization ("WTO"), as one of the lead U.S. negotiators on trade and investment issues under the U.S.-China Joint Commission on Commerce and Trade ("JCCT") and the administrator of our unfair trade laws while I served as Under Secretary of Commerce for International Trade in the current Administration, and now as a scholar, and investment adviser, and as an investor in my own right. I hope I can offer some perspective that will be useful to you in your deliberations.

I want to emphasize at the outset that there has never been a more urgent need to get our relationship right with China, for our own benefit, for China and Asia's benefit and for the benefit of the world trading system. When I say getting our relationship right, I do not mean the ritual prostration before the emperor known as the kowtow; nor do I mean demonizing China and creating needless friction and suspicion. China's rise economically does present us with challenges, both from an economic and security perspective, but that challenge does not necessarily imply a malign intent.

We are likely to have far easier time understanding China and addressing the real challenges posed by its rapid rise if we do so with an understanding that China's actions are taken in their own self-interest, rather than consciously to challenge the United States. Our response should be in kind – assertive about what is in our own self-interest, without suggesting any suggestion of conspiracy, conflict or confrontation. That is, after all, asking that we do no more than consciously adopt domestic and foreign policies that are most likely to ensure peace and a rising standard of living, both here and abroad, because of the contribution that makes to our own security.

That should be the measure of our policy toward China as well and a measure I would suggest for any analysis or recommendations made by the Commission.

Avoiding the Tendency to Sell the United States Short

When ever I discuss China, and particularly the United States' place in the world relative to China, I am always reminded of an economics profession I had at the University of Minnesota. He started his courses by saying that his favorite economist was Marx – Grouch Marx – because of Groucho's famous question, "Who are you going to believe, me or your own eyes?" In this case, I would paraphrase that by asking, "Who are you going to believe, Lou Dobbs or your own eyes?"

Any honest appraisal of the United States would say that it is, by far, the single largest, most productive, most competitive, most adaptable, and most resilient economy in the world. Our economy is more than twice the size of our nearest competitor, Japan. Our productivity gains over the past decade and half have outstripped every other developed country and virtually every developing country.

Our economy actually raised its growth rate this past year in the middle of an extended period of growth dating from the end of the bursting of the high tech bubble and the 2000-2001 recession. More Americans own their own homes than ever before and more Americans are graduating from high school and benefiting from post-secondary education.

Unemployment is below 5 percent – well below the 6 percent average that the previous administration defined as full employment and well below the historic average of the last 30 years. And, that is despite sustained increases in our population and a steady flow of immigration, both legal and illegal.

There is one other set of statistics that I like to cite because they do such a wonderful job of putting our relationship with China in perspective. The United States economy this past year produced roughly $ 12.5 trillion in goods and services. Of that total, our manufacturing sector accounted for roughly 11 percent. China's economic, by contrast, totaled $ 2.2 trillion at official exchange rates. A rough comparison would show Lou Dobbs that, despite all the stories he has produced about the demise of American manufacturing, our manufacturing sector alone would amount to more than half of the Chinese economy as a whole and would represent the 8th largest economy in the entire world.

In short, despite some serious challenges in terms of an aging population, wage compression for unskilled workers, lower social mobility, rising health care costs, and government debt, the economy itself is doing incredible well. I know that any measure of our economic health done at a macroeconomic level can obscure problems within different sectors of the economy, but the overall economic picture is incredibly bright and considerably brighter for a boy or a girl born today in the United States than it is for a boy or a girl born to day in China.

Equally important and the message I most want to leave with the Commission is the fact that the economic challenges we do face lie squarely in our own hands to solve. We control our own economic destiny. Fingering China as the source of much of what ails us economically ill serves the political debate, which would be better focused on what really matters and on building the political consensus needed to tackle those problems.

My point is that the Commission should put the challenge presented by China's rise in perspective and never, ever sell the United States short. We have the wherewithal to shape our own future and the terms of engagement with China and the global economy as a whole if we are wise enough to use it.

Avoiding the Tendency to Demonize China

There is a tendency to demonize China of late, which is unfortunate for at least three reasons. First, treating China as a threat will become a self-fulfilling prophecy if we stay at it too long. I had several interesting conversations with Chinese officials in the aftermath of President Hu's recent visit to the United States. You recall that there were a number of hiccups in the President's visit, including the assignment of press credentials to a Falun Gong protester for the arrival ceremony, that led the Chinese officials to ask seriously whether or not the screw-ups were part of a concerted effort to embarrass President Hu and undermine U.S.-Chinese relations.

I explained that, as Americans, we are good at many things, but that we are not good enough at conspiracy (and don't aspire to be) to be able to coordinate such an effort. I also emphasized that, because of the blessings (and I do mean blessings) of an open and skeptical press, no conspiracy of that sort could remain hidden from public view. But, the incident does underscore the risk of letting the tone of crisis and conflict where there is none overwhelm what might otherwise develop into a stable and productive bilateral relationship.

Second, those who treat China as a threat often call anyone who disagrees with them naïve, but my own experience is that their bluster about the Chinese threat often obscures far more serious issues from examination and public debate here in the United States. The debate about currency manipulation offers a prime example.

There is no doubt that China's renminbi is undervalued – under certain assumptions. There is also no doubt that the Chinese have to intervene massively in the currency markets in order to maintain their peg to the U.S. dollar. And, there is no doubt in my mind that the intent is mercantilist – they do want to keep exporting to the United States because of the employment that their export production provides in an economy where they have to create many millions of jobs every year just to keep up with the growth in their population.

At the same time, it is not clear to me that if we got all that we generally ask for – a floating currency and a lifting of all capital controls – that the renminbi would actually rise. China's savings are roughly equal to the size of their economy. That is an extraordinary number and that savings rate goes a long way toward explaining the Chinese trade surplus – indeed, it goes farther toward explaining the surplus than does either Chinese competitiveness or American uncompetitiveness.

At present, the Chinese pool of savings and investment capital is locked in China. Like any restriction on exports, the capital controls have a tendency to lower the cost of the commodity (in this case, money) available to domestic producers. But, if the controls are removed, that capital can seek a higher rate of return elsewhere and much of it would flow out of China with the result that the renminbi would fall against the dollar, rather than rise.

The reason that seems counterintuitive is the tendency to confuse China's growth rate with the profitability of investment in China. China's growth suggests that the investment capital would stay home because it could earn a high rate of return with all that economic growth going on. But, the truth is producing in China is not terribly profitable for a host of reasons and the capital markets are not terribly safe, which means that a relatively safe investment in the United States could generate a higher rate of return for the Chinese investor while also diversifying their portfolio's risk profile.

My point in walking through that example is two fold. The first is to underscore that a focus on China's currency may turn out to be counterproductive in real terms – a case of be careful what you wish for – if the assumptions about the post-float situation are altered even slightly.

The second is to highlight the fact that a focus on currency obscures a far more significant problem from the perspective of manufacturing. That is the massive subsidy available to Chinese enterprises, particularly state-owned enterprises or enterprises in which the state or certain powerful Communist Party leaders have a stake. That subsidy flows from a capital market that does not price risk accurately, finances projects on a political rather than economic basis, and does not oblige the well-connected to repay their debts.

A high non-performing loan rate among Chinese state-owned banks translates into a zero cost of capital to their well-connected borrowers. It also, incidentally, translates into a lower rate of return for the average Chinese depositor, which, of course, reinforces my earlier point that there could be considerable capital flight from China in the absence of the capital controls. But, for purposes of its impact on our economic interest, that sort of subsidy tends to draw investment and employment artificially towards China at the expense of the United States, to be sure, but of even more damaging effect on the growth prospects of the Chinese neighbors in the region.

As a matter of trade policy, we would do much better to focus on the problem at the heart of the Chinese capital markets that distorts investment decisions and affects employment prospects even in an economy as larger as the United States. We should treat it as the trade- and investment-distorting subsidy it is and ensure that the Chinese understand it and address it in those terms.

Finally, treating China as a threat betrays an insecurity about America's position in the world economy that is unjustified and, perversely, dangerous by handing those in China who want to see the United States as a threat in order to justify actions and policies that are, in fact, inimical to our interests. In that sense, demonizing China is self-defeating.

One does not have to scratch the surface very far in China to tap into some massive insecurities about China's place in the world. That translates into an assertive nationalism reminiscent of the trends that led toward conflict early the last century. That nationalism is manipulated by politicians in Beijing in order to preserve their grip on power to be sure, but it is also a potent force that would exist even without that manipulation. In other words, there are plenty of people within the Communist Party and throughout China that will tend to see China's rise as coming at the expense of the United States and they will take some satisfaction in that view. It will reinforce the tendency to see the United States as an enemy.

If, out of our own insecurity, we respond in kind, we are simply feeding that tendency in China. All the more troubling if we respond in kind when we do not need to feel insecure about our own economic future relative to any other nation in the world.

China's rise can be enormously productive for the United States and the rest of the world if we are shrewd enough to see that and develop our own economic and foreign policy in ways that would reinforce that effect on both the global economy and our own. If, on the other hand, we let our own insecurities about America's place in the world cloud our judgment, we could find ourselves in precisely the unhealthy circumstance that Great Britain, Russia and France did in responding to the economic challenge that a rising German and Japan created at the turn of the last century.

It is worth underscoring, as we debate whether globalization is inevitable, that the result of conflict that arose from getting the relationships between rising powers and those already on top was the division of the world into warring camps for the better part of the last century and untold grief and suffering for most of humanity throughout that era.

Debunking Myths

I think the most important contribution that the Commission could make is to debunk a number of myths about China and our economic relationship with China. We need to debunk those myths precisely so we can focus on what really does matter and do something about it with a strong bipartisan political consensus behind any actions we take.

One myth is that China – and Chinese unfair trading practices – are responsible for the trade deficit. Another is that the trade deficit means that we are falling behind and becoming less competitive in the global economy and that China is the principal beneficiary of our decline. Our current account deficit, both in total and bilaterally with China, has hit all time highs in the past year before abating recently due to a surge in demand for U.S. exports. There are two points worth making about the deficit, both of which underscore how wrong it is to rely on our trade deficit as a measure of our competitiveness or China's strength.

The first point is that it is not China's competitiveness, fairly or unfairly gained, that is driving the deficit; nor is it a lack of American competitiveness. Consider this, the deficit has fallen sharply in recent months. No one would say that China has done anything new to open its markets or end subsidies to its own producers in that time, least of all those with the greatest stake in making the argument that the deficit reflects Chinese unfair trade practices. Nor would anyone say that American competitiveness improved for some significant reason.

And, yet, the deficit has fallen. The appropriate conclusion to draw from that set of facts is that there are other forces driving the deficit and any answer to the deficit is likely to come from actions other than those we might take in the trade sphere relative to China.

This was just as true when we had such trade conflict with Japan in the late 1980s and early 1990s. Our bilateral trade deficit exploded for a time, but then narrowed significantly in 1991. Again, no one would assert that Japan suddenly opened its borders to trade at that point. What, in fact, happened was that the U.S. economy had tipped into a recession and slower growth in the United States meant a lower appetite for imports from Japan and elsewhere.

Now, we could attempt to address the trade deficit in the same way by ratcheting up interest rates and driving the economy into recession. The question is why would we engender that kind of economic misery to change a statistic that has nothing to do with either China's our own competitiveness or lack thereof?

The second point is that we do know what really drives the deficit and, to the extent it does reflect weaknesses in our approach to economic policy, those weaknesses are domestic, rather than foreign. Unfortunately, we do not seem capable of facing them for what they are – home grown – or appear willing to tackle them.

The current account deficit reflects the difference between our production and our consumption. We are borrowing to consumer more than we produce. We can either cut consumption or increase savings to address that gap. China's relative competitiveness has nothing to do with that equation.

Now, where do we stand in terms of that equation? We have a tax code that provides a deduction for interest payments and subjects income generated by equity investment to what amounts to double-taxation. In other words, the tax code favors debt – indeed, provides an economic incentive to go into debt, rather than save.

At the same time, we have massively under funded pensions and health care funds, which imply another significant liability and financing need on our national balance sheet. The looming crisis in Social Security adds another dimension to that problem because it too represents future financing needs. The same holds true for the lack of budget discipline in the Federal government.

We are swimming in debt that has nothing whatsoever to do with China. That debt represents a drag on our economy and our competitiveness, but it is absolutely home grown. In short, we have the means to reduce the trade deficit in our own hands and it does not involve raising tariffs on Chinese goods that would hurt folks on the low end of the income ladder in the United States most. But, we do nothing to tackle the underlying problems in the tax code, the federal budget, Social Security and other entitlements, or the pension system, both public and private, that would restore some balance to our national accounts.

Yet, we wonder why we have a heavily leveraged economy and tend to blame foreign unfair trade practices for the ostensible result, the trade deficit.

Significantly, all this seems much more obvious and transparent to the Chinese in Beijing than it does to us here in Washington. It is not lost on Chinese economists what our situation is financially. You can imagine how seriously they take our complaints about our trade deficit as a result. They do so because they are concerned that we might shift markedly toward protectionism, but not because the argument about the trade deficit holds any economic merit. That was borne out again and again in my own discussions with the Chinese in the context of the JCCT.

None of which is to say that there are not massive distortions in the Chinese economy and that those distortions do not have deleterious effects on the United States and its economic prospects. My point is that focusing on and perpetuating mythology obscures the nature of those distortions, misleads the American public, and distorts the political debate about what to do about the real economic challenges we face.

The Commission could do an enormous amount of good by debunking that mythology and focusing Congress' and the Administration's attention on what really matters.

Thank you.