Center for Strategic & International Studies
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Statement of Ambassador Richard McCormack to the United States China Economic and Security Review Commission:*

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This morning I have been asked by the commission to touch briefly on some of the implications of the U.S. current account deficit, including that part of the deficit generated by our present and prospective trade with China, and note some of the related potential U.S. vulnerabilities.

This year, America's current account deficit exceeded 600 billion dollars, of which more than l60 billion comes from our imports from and through China. By end of this decade, if the current trend lines continue, this debt will accumulate at a rate of more than a trillion dollars per year, nearly ten percent of our GDP. (See attachment l)

There are three relevant issues that need to be addressed: Each one of these issues deserves deeper analysis than is possible in this brief summary today.

l. Are current accounts deficits on present and prospective levels a problem for the United States?

2. If so, how can these issues be addressed with least possible damage to the American and global economy?

3.What are the economic and security implications for the United States of our growing interaction with China?

Present and projected U.S. current account deficits cannot continue indefinitely; and as my old friend Herb Stein noted long ago, they won't. But the present and projected current account deficits, and the economic measures needed to service and sustain them, pose problems and potential mid term dangers to the American economy, the Chinese economy, and the broader global economy.

U.S. external debts generated largely by trade deficits now amount to more than three trillion dollars. These debts obviously entail substantial interest and other service charges. At a 5% nominal interest rate long term, each trillion dollars of this foreign debt and other service charges will require 50 billion dollars annually, on top of our future import costs.

The short term consequences of recycling of part of our trade deficit through Asian central banks and back into the U.S. bond market, undoubtedly helps keep current bond rates lower than otherwise would be the case.

The longer term consequences of this vast trade deficit, however, are likely to be very different. Accumulating foreign debt and ever-expanding current account deficits are likely to result in higher future U.S. interest rates. It is also likely to put ever increasing pressure on the dollar itself, which will add to the risk premiums that some investors will demand from us.

We are already finding it difficult to attract the necessary two billion dollars a day from the private sector to sustain our current account management, and are growing more and more dependent upon Asian central banks for this purpose. This entails potential political and well as economic vulnerabilities, which will expand as the U.S. dependence on Asian central banks rises.

America has an absolute requirement, over time, to buy less from abroad, sell more overseas, or some combination of the two. More and more of the fruits of our work and productivity will otherwise go to our foreign creditors in interest payments and other financial transfers. This ultimately could impact living standards here, depending on the ultimate size of our accumulating external debts. Our current account deficits deeply trouble many people, including the nation's premier long-term investor, Warren Buffett, who famously sold the dollar short two years ago, and profited from it.

Present global competitive conditions, including existing currency ratios, will make it difficult to convince investors to create the capacity to generate and market more tradable goods and services on the scale the U.S. needs. This will limit our ability to work our way back to a healthier current account balance. We need to improve these competitive conditions with a multifaceted macro and micro economic program that also includes changes in the existing relative currency ratios between the dollar and a number of Asian currencies, including China's.

The longer we delay this addressing this problem, the greater the debt accumulation and the long term service charges will be.

It also means more painful adjustment overseas when the American market is no longer as available to exporters as has been the case under current competitive conditions. A significant and sudden depreciation of the dollar, triggered possibly by a major shock to financial markets, or loss of market confidence in U.S. macro economic management, is only one of several possible factors that could limit future access to the U.S. market. This will generate massive excess capacity problems in Asia and elsewhere that could eventually strain local, regional, and global financial systems.

Again, the longer we delay this adjustment, the more painful it is eventually likely to be for all involved. The eventual deflationary impact in Asia and Europe of the excess capacity will also be greater, as well as the eventual financial consequences from more bankruptcies.

The great value of market economics is that price signals encourage rational allocation of capital and labor. It also facilitates gradual adjustments that carry with them the least negative political and economic consequences for impacted societies. Large scale intervention in the markets by governments blunt and delay the impact of the normal functioning of the market. Interventions in currency markets, directed concessionary loans by state run banks to state owned enterprises, gross disparities in purchasing power parity of the currency, and similar market distorting practices can create unsustainable conditions, subject to sudden crisis.

Today, unsustainable conditions have created a vast global economic imbalance in trade and payments. To keep this game going in the face of vast and growing U.S. payments deficits, the U.S. increasingly relies on the recycling of the U.S. trade deficit with Asian central banks buying U.S Government bonds and other dollar instruments. Cash rich commercial entities subject to official administrative guidance supplement this process. This poses some of the same potential dangers that the 1970s recycling of petrodollars inflicted on the global economy. It creates the illusion that current consumption and investment patterns are more sustainable than in fact is the case.

It also results in the creation of more manufacturing and export facilities in Asia than the U.S. economy can accommodate in the mid term.

Just as the commodities boom of the l970s turned into the commodities bust of the l980s because of overinvestment, over production, monetary policy errors, stagflation and eventual recession, so too is today's overinvestment likely to result in a deflationary situation in China and in certain global markets later in this decade. Consider the 40% decline in semi conductor prices in the past year alone, far beyond the earlier secular trend, as an example of what may well happen in other sectors of the trading system later in the decade.

Consider the Japanese bubble economy in the l980s, driven by excessive monetary growth, asset inflation, and investment in production capacity. It ended dramatically in l990, followed by a disastrous sustained deflation and economic stagnation that included the loss of literally tens of trillions of dollars in vanished land and stock wealth. This trend has lasted fifteen years, and there is as yet no certain end in sight to Japan's economic problems. Japan has also accumulated a vast public debt well in excess of the OECD's estimate of l70 % of GDP, when vast contingent liabilities are also factored in. This large debt is today manageable because Japanese interest rates are themselves unsustainably low, about l percent in nominal terms. Still, debt service charges already consume about 20% of Japan's annual government budget. Consider the staggering future burden when interest rate charges inevitably rise in the years ahead.

There are many instructive lesson to be learned by examining the causes and consequences of the Japanese boom, bubble, and bust. For those of you who are interested, I have brought with me a paper on this subject I published in l992, with a diagnosis and projection. It has stood the test of time. (See attachment 2)

We could easily witness another such bust in Asia in the years immediately ahead. Weakness in the Chinese banking system and persistent signs of over capacity in production and real estate are clear warning signals. Look, for example, at the default rate on loans to Chinese auto purchasers. Of the 22 billion dollars of auto loans to Chinese consumers since 2002, more than 50% have already defaulted. I emphasize that these are official Chinese statistics, which are unlikely to overstate the actual size of the default rate.

A huge auto industry, mainly built by foreign capital and technology, was thus created to serve this apparently vast domestic consumer market. Undoubtedly an increasing part of the production of China's car industry will soon be directed to the already saturated global export market. It is a typical example of the way that state banks have directed loans to stimulate targeted sectors of the economy, with little apparent thought for the accumulating banking losses.

We need to study carefully the lessons of Japan's bubble and banking debacle as we consider the future in China. No two economic bubbles are exactly the same, but there are enough similarities here to warrant concerned attention.

OTHER POTENTIAL DANGERS

Strains and stresses from the growing global economic imbalances are becoming ever more apparent. The IMF's 2005 World Economic Outlook recently devoted a large section to this worrisome set of problems. I commend this analysis to all of you.

Within the past few months, there have been threats by some central banks to diversify reserves out of the dollar and into the Euro. Malaysia and Singapore have both acted to reduce dollar exposure. China and Japan have not yet done so, and have accumulated reserves of 600 and 900 billion dollars respectively.

You have asked me to address possible contingencies related to these growing current accounts vulnerabilities, increasing dependence on Asian central banks and cooperating national entities to recycle them, and broader issues relating to China's political economy.

The issue of how China's state owned enterprises and powerful bureaucracy deploy their growing market and investment power for political and strategic purposes on the regional and global stage is a subject beyond the scope of this paper. The gradual diplomatic isolation of Taiwan, however, was advanced by just such an exercise. There are other less well-known examples. More of this can be expected in the future. China has shown in the past that it is capable of long term economic planning to achieve strategic and political objectives outside of China's borders. This also includes activities in the Western Hemisphere and the Middle East. How America should react to these trends and potential long term challenges goes beyond the scope of this paper. It is a subject for collective analysis by our best strategic minds. Our response should not, however, be driven by paranoia, naivete, or short-term commercial interests. It needs to be formulated by top professionals who understand both economics and broader national security considerations and who have full access to classified information.

On a micro level, the U.S. could become vulnerable to economic and political pressures from abroad as currency reserves continue to accumulate in China and elsewhere in Asia. In particular, China's decisions as to how to allocate their vast and growing reserves will increasingly impact global financial markets, including currencies and interest rates. In today's massive derivative markets, sudden unwelcome changes in reserve allocations away from the dollar could be highly disruptive, in certain unlikely but possible scenarios. Think, for example, of the short-term economic turmoil that could occur in the months prior to a Presidential election, if China wanted to influence the result of that election. No official announcement of reserve reallocation would be necessary. I raise this, not because I think it is likely to happen, but because it is one possible problem.

Think also of the consequences for Europe's export competitiveness in the dollar zone as reserves are shifted from dollars into public and private assets denominated in the Euro. Think of the leverage the private threat to do this could later have on European freedom of action. Of course, there are counter measures that European leaders could take, but they would not be cost free.

Should there be tension between China and the United States in the decade ahead over Taiwan or any number of other potential flash points, disruptive changes in the way China manages its huge financial reserves could be an additional stress point at a very unwelcome moment. To be sure, such disruptive activity on the part of China would be very costly to it, both in terms of the market value of its assets and in its longer term relationships with its largest market, the U.S. If we were once bitten, we would undoubtedly take measures to reduce future vulnerabilities. Thus, I consider the likelihood of disruptive Chinese deployment of its dollar assets to be unlikely. But it is not impossible.

Consider what happened in l956 between America and its closest ally, Great Britain.

You will recall from your history that in l956 the British and the French invaded Egypt to prevent President Nasser from seizing Europe's vital trade life line to Asia, the Suez Canal. Their powerful armies quickly cut through the Egyptian military defenses.

Unfortunately, our allies lied to the American Government about their intentions, and when the invasion began unexpectedly, President Eisenhower was furious.

The President picked up the telephone, called the British Prime Minister, Anthony Eden, and informed him that if the military operations against Egypt did not cease forthwith, all American support for the vulnerable British pound would terminate immediately.

This caused a humiliating collapse of the whole military operation, and forced the resignation of the British Prime Minster. Never again did the world refer to Britain and France as Great Powers.

Remember, the United States threatened to use its leverage against the vulnerable currency of its closest ally, Great Britain. Will China be more restrained when the chips are down in the middle of a possible major confrontation ten years from now? One cannot be sure.

We also have no idea what will happen politically in China over the next quarter of a century. It is possible that the current system will continue in place or gradually evolve in a more democratic direction. That system, however, is now under pressure, with riots in many parts of China every year against local abuses. What will happen to that system during a major financial crisis, if unemployment rises and many banks are unable to meet depositors' demands for cash? Presumably China's vast foreign exchange reserves could be deployed to meet a banking crisis, but the frequent concerns expressed about the banking system's weakness suggest that it remains a troubling issue for China's top planners. (Any sudden draw down of China's U.S. bond holdings to address an internal financial crisis would also, of course, impact U.S. interest rates and currency markets.)

The long history of China tells us that there are periodic struggles among the various power centers: between the court in Beijing, the bureaucracy both in the capital and in various provincial centers, the rich merchant classes of the coastal provinces, the peasantry, and the military. Over the course of each century, no complete or permanent victory by any of the contending classes ever occurs. Relative power constantly shifts due to incompetence, corruption, invasions, extortionate taxation, etc. that create grievances or opportunities. The mandate of heaven is not a permanent possession of any emperor or dynasty.

Thus, none of us have the faintest idea who or what kind of system will govern China in the decades immediately ahead. One assumes that self interest will produce rational decisions. But the cultural revolution was hardly an act of enlightened national interest. It did serve the power interests of a leader who perceived that his grip was slipping. The idea that foreigners are going to manage China's political transition may be a mere hopeful conceit. Even assuming reasonable prudence in avoiding needless provocation on our part, the ability of foreign actors to influence the internal political dynamic in a nation of l.3 billion people is limited.

In many parts of the world, when the power relationships shift, whether in a joint commercial venture or on a contested border, pressures can develop for a change in the status quo.

If we wish to preserve our current global role, we need to make sure that we also keep a sharp eye on the essential power factors. The military equation is, of course, central. We also need, however, to make sure that the American economy remains an element of national strength, not the weak link in our armor, as was the case with Britain in l956.

We also need to be mindful of former Secretary of State Kissinger's recent warnings about allowing our manufacturing capacity to deteriorate dangerously. People may disagree with the former Secretary of State, but nobody ever called Henry Kissinger an alarmist or a fool.

If we are wise, we will begin now to consider measures to allow a gradual turn around in our current account deficits, and begin to create the necessary conditions for the production of more U.S. tradable goods and services for domestic and export use. Current trends are problematic for the long-term health of the American economy.

Ironically, current conditions are also problematic for the mid term health of the Chinese economy. Buying up surplus dollars by the People's Bank of China is causing an excessive growth in the money supply, which in turn, is causing overheating and over investment.

The Achilles heel of the Asian development model, an export led process accomplished in part by various forms of State capitalism, has always been over leveraging of finance. This eventually produces banking and financial crises. China is unlikely to be the exception to this rule.

The current global imbalances and the conditions that produce them are also dangerous for the world. The sustained and explosive annual increase in exports from and through China, running at a 30-40 percent annual compound rate, is helping create a backlash of protectionism in America, Europe, and elsewhere. In the U.S. there have been three million manufacturing jobs lost since 2000. The politics of this alone pose a threat to the global trading system as it now exists.

During the next global recession, these pressures working through democracies, will undoubtedly intensify.

There is also a broader danger to the world. China has suffered enormously in the past two centuries from foreign intrusions and exploitation. There is a sense of historic grievance in China that spills out into period outbursts. The recent demonstrations against Japanese interests in China are only the latest manifestation of this. Many Chinese strategists yearn for China to reassert what they believe to be China's rightful role in Asia and the world. This combination of xenophobia and strategic ambition is potentially volatile.

Thus, as we consider the imbalances growing in the global economy, and the role of China in this development, we also need to be mindful of the need to manage the adjustment with due regard for political and diplomatic considerations.

This is not going to be easy.

China, for example, is unlikely to allow more than a token currency appreciation without significant and real pressure from abroad. Pressure in democracies is generated by the speeches of elected officials, if private persuasion by the executive branch of government fails. The longer the Chinese delay, the louder and more pointed will be the speeches from an alarmed Congress. This will play into the press in China in a way not likely to improve U.S. China relations.

We need to make clear to China that we in fact welcome its modernizing economy, but urge them to pace their export emphasis in such a way that it does not kill the goose that lays the golden eggs either in China or in the world at large. The political and economic support base behind the current global trading system is today imperiled. There is a sense that exchange rate manipulations, directed loans to exporters that will never be repaid, and intellectual property violations are an unfair thumb on the scales of global commerce.

Engineering the necessary gradual reduction in present global economic imbalances is going to require careful planning by the world's major trading powers, including China and the United States. We need to minimize prospects that the dynamics of the adjustment could fatally poison the important relationship between the Chinese and American peoples.

That is going to be a major challenge for global statesmanship.

Equally importantly, the United States needs to develop a macro and micro economic strategy involving both medium and long-term measures to address its own competitiveness problems. Nobody is going to do this job for us. We must organize it and carry it out ourselves

It is important to recognize that while there is a macro economic element in the current global economic imbalance, there is also an even more important micro economic set of problems that need to be addressed by the United States. This includes currency problems involving several major Asian countries that make us less competitive in local and global markets. It includes large-scale violations of WTO agreements on intellectual property issues that deprive us of a return on our investments in research and development. It includes revamping the U.S. educational system as we did in the post Sputnik era to generate American scientists and engineers in large numbers. It includes avoiding self inflicted wounds, which is how many view the Airbus agreement in l992 that failed to block subsidized and virtually risk free development capital to Boeing's largest competitor. The list of other micro economic obstacles to U.S. competitiveness is extensive.

Taken individually, the impact of micro economic obstacles to U.S. competitiveness is often modest, but when added up, they constitute a massive barrier to the resolution of our unsustainable and growing current account problem.

Finally, remember the U.S. current accounts problem is not likely to solve itself unless there is a market related train wreck that forces sudden global adjustment The current account problem was, in part, caused by policy decisions and it can best be corrected by policy decisions. There are two alternatives to addressing the current account imbalance by corrective policy measures. One is to wait until the train wreck occurs. The other is to reconcile ourselves to a lower living standard in the United States, and a reduced security related role for us in the world at large. Unless this latter process occurs on a very gradual basis, it is hard to imagine the American electorate supporting such results.

The Baker/Reagan reforms of l985, supported by the first Clinton Administration, kept U.S. current accounts deficits under two percent of our GDP for a full decade. It was only the onset of the l997 Asian financial crisis, and the policy responses to it here and abroad, that gradually undermined the current account correction that President Reagan launched.

The world today is different than that of l985. In the first place, the U.S. current accounts problem is now twice as large as a percentage of our GNP as was the case when President Reagan and Secretary Baker became alarmed and move to correct it. Secondly, in retrospect, not all of the measures taken after l985 were effective. Their collective success, however, is undeniable. They turned the U.S. balance of payments trends around and sustained them for a decade. Today, however, our balance payments deficits are out of control.

The OECD has recently issued an alarm about the dangers of the growing global economic imbalances. Five percent of Gross Domestic Product (GDP) is the International Monetary Fund's benchmark for a current account problem that is unsustainable. The United States current account deficit is now at 6% of our GDP and most projections predict a rate approaching 10% by the end of the decade. This is a recipe for an American and global disaster.

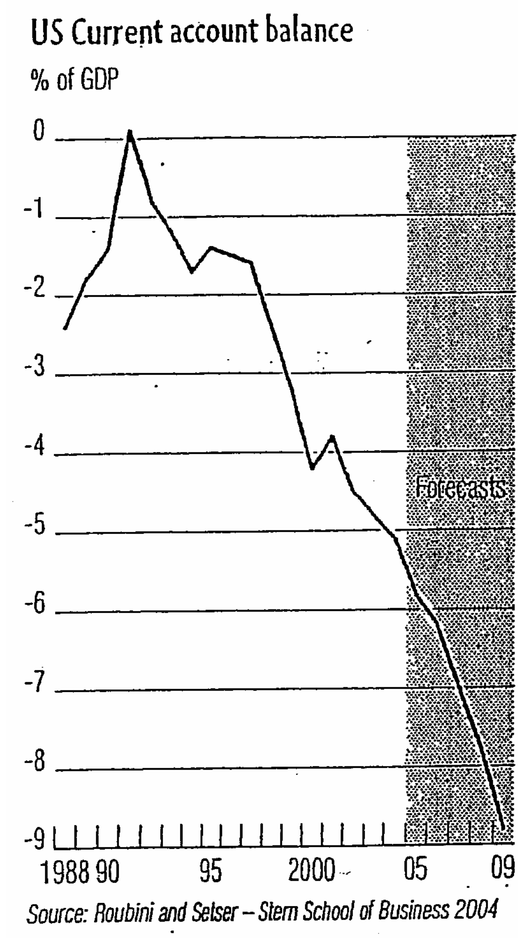
The longer we delay in finding a gradual solution to the global economic imbalance problem centered around the U.S. trade deficit, the more painful the eventual adjustment is likely to be for all concerned. The China related issues are only a part of a much larger macro and micro economic problem that the U.S., its G-7 counterparts, and the other major exporting economies, must address on an urgent basis.

Attachments:

l. The U.S. Current Accounts History and Projection: 1986-2009.

2. Strategies for coping with the Japanese financial crisis. Richard McCormack 1992.

3. Uncertainties in China's Economic Prospects and the Broader Problem of the Global Economic Imbalances. Richard McCormack CSIS April , 2005



(*Financial Times*, Wednesday October 13, 2004)