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Before the Committee on Finance

United States Senate

March 29, 2006

U.S. – CHINA ECONOMIC RELATIONS REVISITED

Mr. Chairman and members of the Senate Finance Committee,

It is a great pleasure for me to appear before this Committee once again. I welcome the opportunity to discuss U.S.–China relations — particularly in advance of the important visit of President Hu to this country in mid-April.

I can recall the first discussion I had with this committee on the subject of U.S.-PRC relations in the early 1970s, when we were just beginning to normalize ties. At the time, I was a staff member for economic policy on Henry Kissinger's NSC Staff and was asked to come up to the Committee to brief members on our nascent economic opening with China prior to President Nixon's trip. We used small economic steps to signal the Chinese that we were interested in normalization of relations. The first signal we sent was to permit American citizens to bring in to the U.S. $100 worth of Chinese products — so long as they were not purchased in China. That was roughly 30 years ago — and at the time it was considered a major step and was very controversial here.

How far our relationship has come since than — and how dramatically our trade and investment flows have expanded! It is easy to forget how remarkable the changes in China have been — and that hundreds of millions of people in that country are now far better off as the result of China's reforms. It is also easy to forget just how much China's economy has opened since that time and how beneficial to the U.S. and the rest of the world the surge in Chinese prosperity has been! So as we focus on the problems that our two countries face in their economic relationship today, it is also useful to put them in perspective — and recall the enormous progress that has been made.

Adjustment to the rising economic, financial and political power of China poses a number of challenges. The economic rise of China has had a profound and pervasive impact on the U.S. economy and the global economy — in trade, commodity markets, the oil market, finance and manufacturing. China has risen to the position of a world economic power more rapidly than any other country in history (although it is worth recalling that China was the biggest economy in the world roughly 200 years ago, so this is really a "comeback" rather than something new).

The U.S. and other nations have been faced with the need to adjust at a very rapid pace to the opportunities and competitive challenges that China's rising economic power poses. And Chinese officials are faced with a similar need to adjust to the fact that international economic power carries with it international responsibilities. It is worth noting that this is not the first time the established power structure in the world has been faced with the challenge of a rising new power: Germany in the late 1880s, the United States in the early 1900s, post-war Japan in the 1970s, and now China in the early 21st Century.

There are those in our government and country who see China as a long-term security threat and a near and long-term economic threat; if we treat our relationship with China based on the assumption that this is inevitable, we will in fact be contributing to that outcome. If, instead, we attempt to develop bilateral and multilateral policy and institutional linkages that serve our mutual interests by enhancing China's efforts to sustain growth and job creation while enabling U.S. companies to benefit from the growing opportunities in China, and by ensuring that China plays by the market based international rules that the U.S. and its other major trading partners adhere to, then tensions can be better managed and the prospect of a win-win relationship can be improved.

One key U.S. objective must be to find ways for our citizens to benefit further from the opportunities afforded by China's growth while also ensuring that China uses its growing economic influence, in cooperation with the U.S. and other major economic powers, to shape a more balanced and open trading and financial system that all sides perceive as fair, and that provides an opportunity for market forces to work smoothly and without excessive government intervention.

NEGOTIATING AND WORKING WITH CHINA

Before I get to the heart of my testimony, I thought that it would be useful to reflect on a few personal experiences I have had in working with, and negotiating with, Chinese officials for over 30 years, and share a few points emerging from that which might be relevant today.

BE CANDID IN ASSERTING U.S. INTERESTS AND OBJECTIVES, BUT AVOID PUBLIC LECTURES — Candor in personal and professional relationships vis-à-vis China is essential; the Chinese typically are very candid with us and we show them respect and get better results if we are candid with them. If we have concerns or issues, we should by all means raise them clearly and assertively with their officials and leaders. They do it, and so should we. But there is a difference between forcefully raising concerns in public — and certainly in the form of public lectures — and doing so in private conversations and negotiations. Public criticism and lectures have been demonstrably ineffective in persuading senior Chinese leaders to alter policy. The recent National Strategy Report, for instance, states that China "must" do this or "must" do that. Quite apart from the merits of the substance, that tone is unlikely to produce results. Typically, private negotiations and pressure — in which points can be strongly, but less highhandedly made, in support of U.S. interest — have worked a lot better.

STRATEGIC COHERENCE AND POLICY PRIORITIZATUON — U.S. policy toward China is not likely to achieve significant results if it lacks strategic coherence. Every agency cannot achieve everything it wants at the same time. The laundry list approach has rarely worked. An absence of prioritization — and one central figure or agency in the administration to convey those priorities — weakens the U.S. position. Nor can the U.S. conduct an effective policy by responding to every U.S. domestic pressure group that wants the U.S. government to take some sort of action against China or obtain China's agreement to its desired objective. A long-term strategy that focuses on the priorities that are most central to America's national interests will work far better that pursuing the issue du jour or raising a lot of issues all at once without making clear our priorities.

DON'T EXAGGERATE CHINA'S IMPACT — China accounts for 15% of U.S. imports and imports overall are 14% of GDP, implying that Chinese imports are equivalent to 2% of U.S. GDP. And, as a recent report by the China Business Forum notes, "While the bilateral trade imbalance with China has been rising dramatically in absolute terms, China's share of the overall U.S. current account deficit has remained fairly constant, at around 20 percent for more than a decade." This is because U.S. trade and current account deficits are increasing with almost all regions of the world as well — not just China. Indeed, "the increase in China's share of U.S. imports from 2000 through 2004 was offset by declining shares of other East Asian exporters, reflecting a profound shift in production patterns by Asian and other multinational firms operating in the region." Moreover, while it is also true that although trade with China has resulted in a loss of output in a number of manufacturing sectors, it has boosted output in a number of other sectors; the impact on job displacement is also focused heavily on the manufacturing sector — and it is important to find ways to assist people thus displaced and to ensure that those job losses are more than offset by job gains in other sectors.

However, the criticism that Chinese imports are responsible for large scale job loss in this country is misplaced. First, the U.S. has been losing manufacturing jobs for decades, well before the increase in trade with China even began. In addition, the U.S. economy typically is subject to a very high churn rate as companies down size or close, new companies start and older ones add more employees. This churn began during the time of Alexander Hamilton — and is natural in a dynamic market economy. It has speeded up recently as the result of rapid technological change and the rise in import competition as well as the need to shift human and capital resources to activities that produce higher returns. But the U.S. economy is now creating more jobs than are lost. In any case, the effect of trade with China in employment in the US is relatively small compared to the effect resulting from domestic technological change and the normal flux in our economy.

This is not meant to suggest that U.S. policy makers should be complacent or indifferent about the plight of people who are displaced. Indeed I am deeply concerned that we as a nation are not sufficiently aware of the growing difficulties of low and middle income workers who face concerns about job insecurity due to foreign competition and technological change, health insurance insecurity, doubts about the future of social security, social and similar factors. Means should be found to address their concerns, or we will end up with a very divided society with some seeing trade and technological progress as their friend and others seeing them as their enemies.

RECOGNIZE THE DIFFICULT NATURE OF CHINA'S DOMESTIC CHALLENGES — We must recognize that China faces enormous internal challenges — a 150-200 million person floating work force, terrible environmental problems (due in part to the stripping of land, inadequate water supplies and the extensive use of coal), great income disparities, especially between rural and urban China, the need to create a lot of jobs in order to preserve social stability, and the lack of a broad scale social security and healthcare system etc. Putting U.S. requests and negotiating objectives relating to economic policy reform in a context that recognizes these challenges, and framing our requests and objectives in such a way that the Chinese government sees the benefits of these measures in helping to address these pressing domestic issues (or at least demonstrates an awareness of them) has a better chance of succeeding than failing to make this connection. For example, working with the large numbers of Chinese who are developing intellectual property of their own — and will be able to create needed domestic jobs using their intellectual property — can enhance the chances of obtaining more meaningful reform in this area. Putting requests for banking reform in the context of shifting more resources to the private sector, which will in turn enable it to create more jobs, also makes good negotiating sense.

USE INTERNATIONAL INSTITUTIONS TO SHARE RESPONSIBILITY AMONG STAKEHOLDERS IN THE GLOBAL ECONOMY — Chinese authorities have demonstrated a strong interest in working with and in multilateral institutions — and have joined virtually every international institution for which they are eligible. China is far more open to trade and foreign investment than were Japan and South Korea at similar stages of their development. This active global engagement should be welcomed by the U.S. — and these institutional arrangements should be utilized by the U.S. — as a way to encourage China to assume the responsibilities that a large economy has to the world economy as it derives benefits from the trade and investment relations it enjoys in the world economy. Even those institutions, such as the East Asian Summit, which the U.S. is not a part of, can provide constructive fora for integrating China into the global economic system. The U.S. should also strengthen groups such as APEC, which bridge the Pacific and can provide a useful forum for discussion and consensus building. Bringing China into the G-8 is also a worthwhile idea — and in my judgment overdue. And the two countries should work together to successfully conclude the Doha Round — the success of which is extremely important to both nations.

THINK TWICE ABOUT THE IMPACT THAT MEASURES BEING PROPOSED VIS-À-VIS CHINA WILL HAVE ON THE U.S. — Attempting to isolate China or impose barriers around the U.S. to punish China or to compel policy changes is likely to be harmful to our own economy, as well as to China's economy. The U.S. and Chinese economies are closely linked by trade, investment ties, company supply chain linkages and capital flows. This is not to argue that we should not assert our interests and be prepared to use international trade rules and our domestic laws and sources of trade relief when warranted. It is to warn that heavy handed uses of blunt instruments could do great damage to millions of American consumers, home buyers who depend on low mortgage interest rates, businesses and jobs that depend on increased sales in China and growth opportunities in China, our capital markets and many other parts of our economy and society.

Legislative actions that may initially look appealing might end up doing a lot of damage to the US economy. Beware of the boomerang affect in trade policy. We have seen it all too frequently. The US is, after all, the nation with the greatest economic, political and strategic interest in an open and rules-based global economic system; we should steer clear of measures which damage that system.

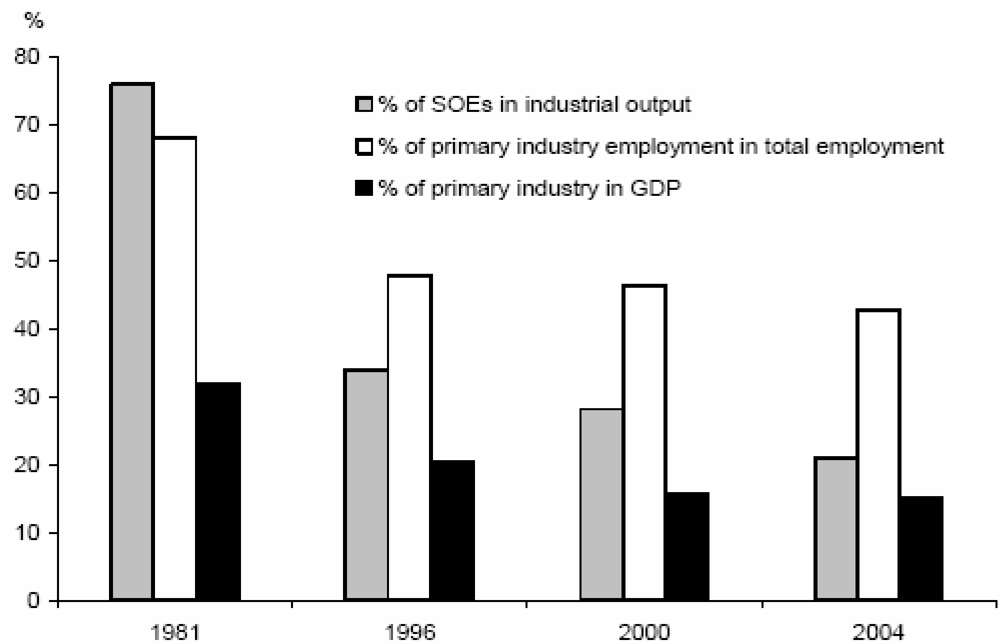
REMAIN ACTIVELY ENGAGED IN ASIA — Many of the initiatives China currently is taking are moving in the direction of making it the centerpiece of an economically integrated Asia. It is not likely that other Asians would want this to occur to the exclusion of the U.S.; indeed virtually all other Asian nations would not want to marginalize the U.S. for economic, political and security reasons. But there are strong feelings in much of the region that the U.S. is so preoccupied with Iraq and the War on Terrorism that it is neglecting the Asian development, trade, financial and economic agenda, or at least is not very enthusiastic about it. President Bush has emphasized his support for an annual summit with ASEAN. That is a good idea. We need to build on that and many other regional and international groupings to demonstrate commitment and staying power in the Asian region.

A BRIEF LOOK AT CHINA'S ECONOMIC TRANSFORMATION

China's extraordinary growth performance over the last three decades has been underpinned by two historical transformations in that country — from an agrarian to an industrial society, and from a central-planned to a market-based economy.

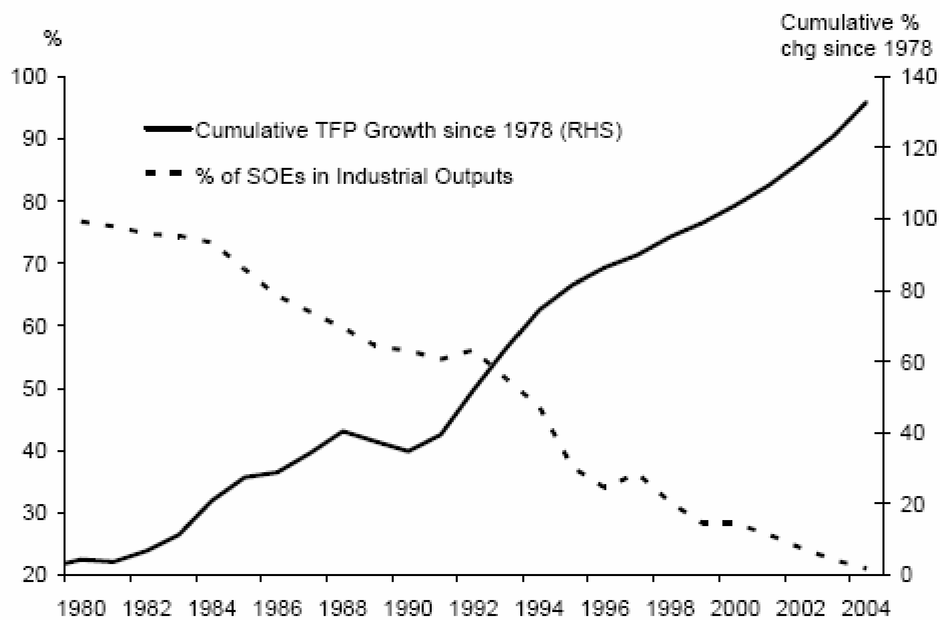
It is the unique path China has chosen for the second transformation that has distinguished its story from any other growth experience the world has witnessed before. A sharp and sustained increase in productivity post 1978 has been the driving force behind China's fast growth, and it has benefited from a unique "reform dividend" originating from policy efforts that have gradually but consistently scaled back the government's role as a central planner.

Twin transformation in China: declining roles of the SOEs and the agricultural sector



Source: CEIC, Goldman Sachs Research estimates.

Extraordinary improvement in economic efficiency coincident with the decline of SOE's share in the economy



Source: CEIC, Goldman Sachs Research estimates.

Therefore, the real epic China story is not about how an inefficient economy could continue to grow so fast, but rather how China could have gradually but consistently reduced the inefficiencies in the system. Reforms that have progressively given greater rein to market forces in resource allocation are at the heart of China's success. Of equal importance is the leadership's pragmatism in executing these changes.

Foreseeing further sizable gains in "reform dividends" from China's WTO membership-related changes, the next several years could be a "sweet spot" of growth and efficiency improvement. Looking beyond the medium term, when China's per capita annual income will likely cross the $3,000 mark, however, there are fewer certainties, and greater challenges.

The challenges are primarily in the areas of heretofore "postponed," but very much needed internal social and economic reforms. For example, a high priority for the Chinese government is to narrow the growing income and wealth disparities between rural and urban China, and between coastal China and central and western China, that have developed over the last ten years. Such disparities have been a key factor precipitating outbreaks of serious rural unrest and violent incidents. The government of President Hu and Prime Minister Wen is attempting to address these disparities by focusing on rural development, eliminating rural taxes, improving the security of land tenure, moving production westward, building more infrastructure in central and western China and protecting the interests of rural farmers, the unemployed and migrant or floating workers. These have attained a high level of urgency and priority in recent moths as rural discontent rises.

THE GLOBAL ADJUSTMENT PROCESS

These internal macro-economic shifts will, over the medium term, help reduce the U.S.–China imbalance. The Chinese economy is more robust than the earlier statistics suggested: it is larger and growing faster than most observers have thought. Recent figures released by the PRC indicate that the average real GDP growth rates for China in the past 27 years is 9.6%. Never before has an economy achieved such high growth rates for such a long period of time, including the Asian Tigers. The size of the Chinese economy, even measured in current U.S. dollar (USD) terms, is likely to have surpassed that of Britain and leapt to be the fourth largest economy in the world by the end of 2005.

As noted, the key driver for China's extraordinary growth performance in the past three decades has been productivity growth, generated by sustained structural reforms; such productivity growth is likely to continue as long as reforms continue. And indeed 8%-10% real growth per annum could be the norm for China in the next few years if, as anticipated, China steps up its efforts to deregulate and open up further its economy to fulfill its WTO membership-related commitments. Recent data also show a healthier picture of domestic demand balances between investment and consumption.

China: no landing

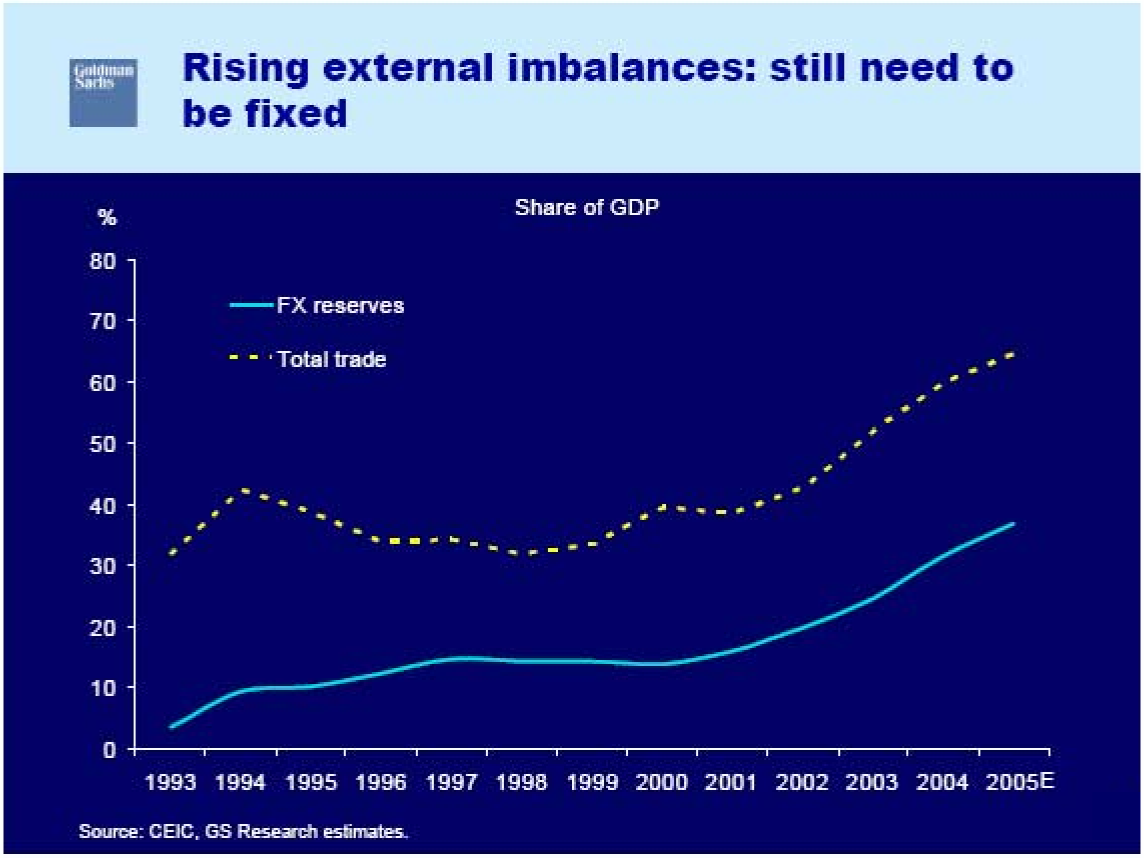
Summary Indicators

(percentage change, unless otherwise indicated)

	2004	2005E	2006E	2007E
REAL SECTOR				
GDP by expenditure (at 1990 prices)				
GDP	10.1	9.9	9.6	9.1
Private consumption	6.6	9.3	9.8	9.9
Fixed investment	12.1	10.6	10.0	9.0
Domestic demand	8.5	7.6	9.0	9.2
Net exports (contribution to growth)	2.0	3.1	1.4	0.6
Exports (G&S)	25.3	24.9	15.0	10.2
Imports (G&S)	22.1	20.6	14.5	10.8
Memo:				
CPI inflation (period average)	3.9	1.8	2.2	2.0
Current account balance (as % of GDP)	3.6	7.0	6.2	4.9

Source: Bloomberg, CEIC, GS Research estimates.

However, despite such shifts, recently released data point to continued large external imbalances for the Chinese economy. Such imbalances have been rising in the last few years.



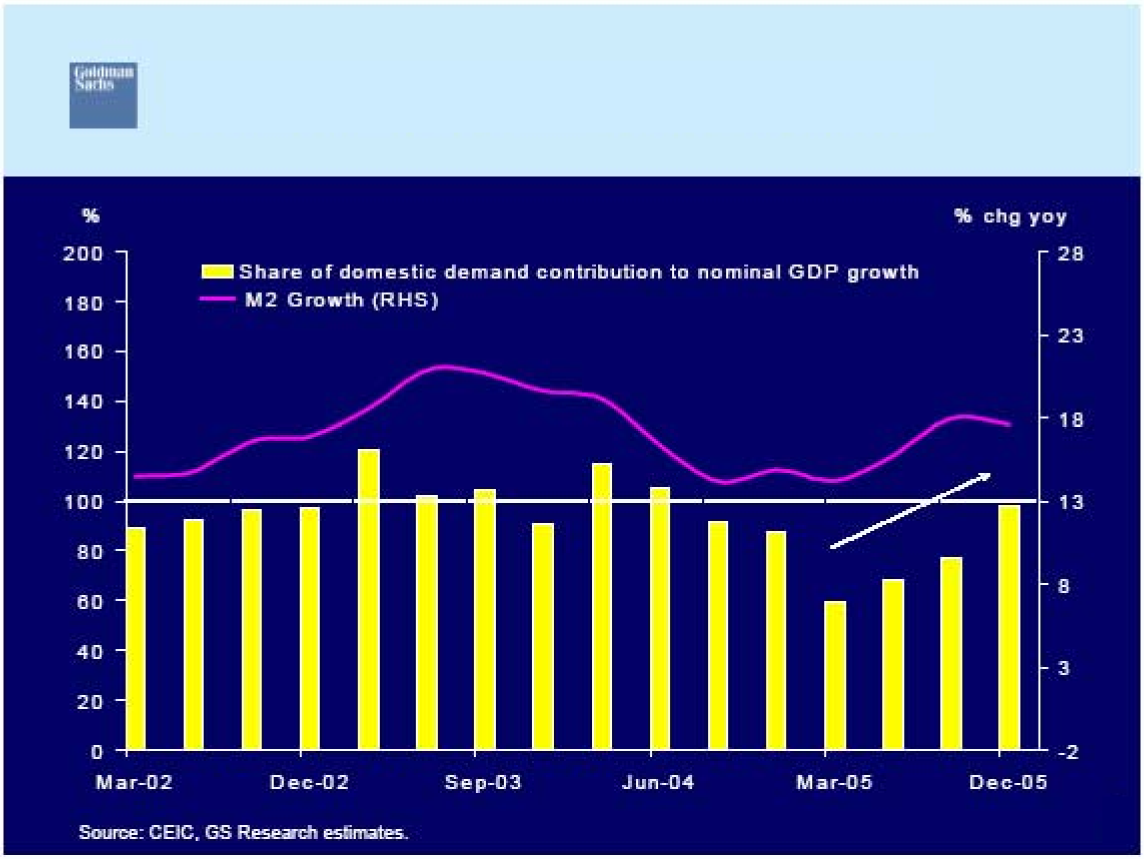
The good news is the macro policy setting in China has switched to address the external imbalance since mid-2005, with an initial revaluation of 2.1% to the CNY in July. More importantly, monetary, fiscal, and sectoral policies have shifted towards strengthening domestic demand. The newly-announced 11th Five-Year Plan has also established the promotion of domestic demand and the encouragement of investment focused on the domestic market as key policy objectives for the government in the next five years.

This macro policy shift is in stark contrast to the policy stance in 2004, which had a tightening bias against domestic demand and favored keeping the RMB peg. Recent policy adjustments — assuming they are sustained and strengthened — will help the economy, which remains robust and responsive to policy stimulus, to adjust on the right path, and thereby significantly reduce China's macro risks and gradually reduce its export dependence.

February imports posted strong growth. Imports grew by 29.6% year on year (yoy) in February, compared with 25.4% yoy in January. On a seasonally-adjusted; quarter-on-quarter (qoq) annualized basis, imports growth was 30.6%, up from 25.9% in January. Meanwhile, exports growth came in at 22.3% yoy in February, compared with 28.1% yoy in January. On a seasonally-adjusted; sequential basis, exports growth was 33.3% qoq annualized.

The trade surplus narrowed. Stronger growth in imports led the February trade surplus to fall significantly to USD2.5 billion.

Combined January-February data also show robust growth of 25.4% and 27.4% for exports and imports respectively. Our economists expect the strength in China's exports to be sustained amid strong global demand momentum. They also expect firm domestic demand to translate into stronger import demand. And these two months certainly cannot yet be taken as a trend.



CURRENT ISSUES

In keeping with the point I made at the outset about setting priorities, I would like to focus on a few key economic issues affecting U.S.–PRC relations.

ENERGY

The issue of energy presents a major geo-political and a geo-economic challenge. **Unless the U.S. and China can agree on a framework for energy cooperation, a series of mutually damaging confrontations is virtually inevitable**. To avert this, and turn a source of current tension and potential conflict, into a focal point for cooperation, President Bush and President Hu should establish a **U.S.–China Energy Partnership supported by a high level Joint Cabinet Committee**. I suggested this idea to several officials in the Administration and to the China Economic and Security Review Commission last fall — and I believe that the time is right to launch it during the coming summit.

Some observers have insisted that clashes between the U.S. and China over energy are inevitable. Chinese companies are buying oil properties and concluding long-term supply contracts around the world; some Americans fear these will divert supplies from the U.S. and international markets. A few of China's deals are in countries such as Venezuela, Iran and Sudan, with which the U.S. has strained or no relations. China's surge in oil demand is seen by some as a reason for higher prices. And China's increased coal production concerns U.S. environmentalists.

But the fact is that **the U.S. and China have many common interests in the energy area and thus many reasons to cooperate on energy**.

— The U.S. is the world's biggest oil importer. China is the world's fastest growing oil importer. High prices and supply instability harm both nations. Recent price increases primarily reflect sluggish world investment in production and refining, which both nations have an interest in correcting.

— Chinese, like Americans, are concerned about their environment; China faces enormous environmental problems, as anyone who has visited Beijing during the winter has experienced first hand. U.S. companies have great expertise in clean energy technology; their clean coal technology can be especially important to China, which has enormous coal reserves.

— The U.S. and China have a similar interest in open sea lanes for oil.

— Both nations also desire a secure business and legal environment for their energy investments in emerging economies as well as stable and growing supplies from world exporters.

At their coming meeting, Presidents Bush and Hu can begin this partnership by agreeing to cooperate in several areas:

— **A Joint Business-Government Commission on Clean Coal Technology**; that could help China develop and utilize its coal in an environmentally friendly way, boost U.S. exports of technology and equipment and help address global warming.

— Joint research on alternative fuels, which should also include representatives of Japan, would draw on the best talent in these three countries, could lead to breakthroughs in, or broader dissemination of, 0hybrid or non carbon-based technologies.

— Strengthen U.S.-China cooperation in the context of the International Energy Agency — a group of oil importing countries that seeks to minimize supply and price disruption. The U.S. should encourage China to join the IEA.

— Consultations with one another, and with other regional nations, to maintain open sea lanes; that could reassure China that the U.S. will not use its naval power to leverage China on oil.

— Strengthen established regional groups that include China, the U.S. and other Asian nations to address environmental and energy supply issues in the region.

Helping China to increase domestic energy output would slow the growth of its import dependence. The recent U.S.-India nuclear agreement had a similar purpose. Both would help to reduce imbalances in the global oil market and reduce upward price pressures. And cooperating on broader energy issues can produce greater stability in global energy markets and in the overall U.S.-China relationship. The alternative — frequent confrontation — benefits no one.

THE CURRENT ACCOUNT IMBALANCE

There has been a great deal of focus on the exchange rate between the dollar and the Chinese RMB. There are a number of good points to be made in favor of an RMB appreciation. But it is important not to raise hopes too high that it will happen soon or be dramatic. And, as former Federal Reserve Board Chairman noted before this committee in June, 2005, “some observers mistakenly believe that a marked increase in the exchange value of the Chinese RMB relative to the U.S. dollar would significantly increase manufacturing activity and jobs in the United States. I am aware of no credible evidence that supports this conclusion.” He went on to say that “an increase in the exchange rate of the RMB relative to the dollar would likely redirect trade within Asia, reversing to some extent the patterns that have emerged during this decade.”

Although I believe that an RMB revaluation is appropriate, I am inclined to agree with the central thesis of this analysis — but the key point to focus on is the word “significant.” Dr. Greenspan might be correct that the impact would not significantly increase manufacturing activity and jobs in the U.S., but it would help on both fronts and it is desirable for other reasons as well. Secretary Snow and Undersecretary Adams have made good arguments as to why this is so.

But we need to have realistic assumptions. Secretary Gutierrez recently warned Beijing against “gradualism” in responding to U.S. complaints; but the entire history of Chinese reforms over the last 30 years has been based on “gradualism” — to avoid big disruptions and big mistakes. So on the currency issue, U.S. expectations should bear this in mind — even as we push for greater flexibility in the exchange rate. U.S. officials should encourage a steady appreciation of the RMB, but it is highly unlikely to be a sharp or rapid appreciation. And we can urge a widening of the current 0.3% trading band — but not harbor unrealistic hopes that it will widen dramatically.

Nonetheless, the topic is a useful one to discuss with Chinese authorities at high levels. I note that Undersecretary Adams recently has had productive discussions in Beijing on this topic and that Senators Schumer and Graham had useful discussions in their visit.

THE IMPACT OF A FURTHER RMB MOVE

One of the benefits of an RMB appreciation from China's perspective is that it would improve domestic monetary policy management. Currency undervaluation continues to fuel a high level of liquidity creation, encourage overinvestment in traded goods sectors and, though inflation has not yet become a serious issue, risks triggering medium-term price pressures. A substantial (e.g. 5-10%) appreciation in China's real exchange rate over time could reduce the economy's aggregate trade surplus — and put China's economy on a more balanced domestic footing. Appreciation would also reduce the growing commodity price bill. And its negative impact on overall Chinese growth likely would be small.

The key impact for the U.S. of an RMB revaluation will come from a broader strengthening in Asian currencies, which, including China, make up 40% of the U.S. trade weighted dollar. Asian central banks and governments have been reluctant to allow their currencies to appreciate against the RMB, placing the burden of global adjustment on non-Asian economies. A change in Asian exchange rates would contribute to the process of global trade rebalancing.

For the U.S., the main transmission of an RMB appreciation would come from the impact of a decline in the dollar against this larger basket of currencies. An RMB revaluation would likely produce upward pressure on the yen, Taiwan dollar and Korean won. Some of that appreciation may already have occurred, with these three currencies already seeing some appreciation pressure fueled in part by anticipation of an RMB move. According to our analysis, a 5% decline in the U.S. Dollar trade-weighted index would boost U.S. GDP growth by 0.25%, largely through trade balance improvement. On inflation, the first-order effects would probably be quite small. Such a decline would lift U.S. inflation by only 0.1-0.2%.

U.S. bond markets would likely react negatively to the news of a CNY revaluation. The prospect of stronger and more balanced growth together with a rise in import price pressure would likely be a recipe for higher yields. As importantly, a substantial revaluation of the RMB and other Asian currencies is likely to see their central banks reduce purchases of U.S. Dollars for their currency reserves. The scale of any impact on global yields resulting from revaluation of the RMB or other currencies will be modest, however.

OTHER ASPECTS OF REFORM AND ADJUSTMENT

It is worth noting that an undervalued currency alone is not a prime reason for China's or any other nation's surge in exports. More importantly, China offers attractive investment environment that encourages massive investment, particularly foreign investment, in export oriented goods. Foreign companies produce over half of China's exports and have accounted for roughly two thirds of its export growth over the last ten years. A higher exchange rate can diminish the incentive of foreign and domestic companies to produce for export — but China will be a powerful exporter even with such changes.

So while addressing the currency revaluation issue, I suggest we will make more progress if we focus on encouragement of the kinds of domestic reforms that 1) would

further open the Chinese economy to imports of goods and services, 2) continue to boost and broaden internal consumer demand for goods and services in China, and 3) reduce the growth of investment in export-oriented products in favor of investment in products and services for the domestic market.

In some of these areas we might do better to move the dialogue from a bilateral to a multilateral framework to do so we should **take full advantage of the soon to be released WTO Trade Policy Review of China**. This argues the benefits of liberalization of the services sector — which could produce a lot more jobs in China as big manufacturing companies cut their workforces. And it recommends improving enforcement of intellectual property protection — which will increase the comfort level of foreign and domestic investors in high technology products. The report is also likely to reinforce the conclusion that the Chinese government has already come to — that it would be wise to deemphasize attracting investment in export-oriented, capita intensive manufacturing, and instead give higher priority to removing impediments to the expansion of investment in domestically-oriented sectors.

In this context, domestic financial reforms also would help to reduce imbalances. Improving the stock and bond markets would enable capital to go to its most efficient uses; that would avoid the continued buildup of excess production capacity in some key sectors; that excess capacity encourages companies to seek markets abroad and to compete at very low prices to secure those markets. I look at the exchange rate adjustment issue as potentially supporting this change, by reducing the incentive to export — and withdrawing an artificial inducement to do so — and increasing the incentive to invest in products that will be consumed at home.

In addition, the more efficient allocation of capital would help to ensure the continuation of China's growth and job creation. That efficiency depends on the correct pricing of risk through a dynamic and well regulated bank loan market and transparent and efficient capital markets. Foreign firms can act as catalysts for the development of China's capital markets; foreign institutions can bring in expertise, good practices and technological capabilities. Liberalizing ownership rules, improving the Qualified Foreign Institutional Investor Program, reducing capitalization requirements and similar measures all would be constructive.

USTR's PHASE THREE AGENDA

The Top-to-Bottom Review conducted by USTR, and recently released, contains a number of very thoughtful suggestions for moving forward in what the Report calls Phase 3 of our trade relations with China. Ambassador Portman and his colleagues have done a very thorough and thoughtful job in preparing this Report. I believe the recommendations the Report makes provide a sound framework for progress. I particularly commend the focus on encouraging further regulatory reform and strengthening the joint efforts between the two countries to address issues in that area. I also agree with the emphasis on effectively using the JCCT and APEC as will as increasing coordination with our other trading partners. I also support the emphasis on developing a "coordinated U.S. government interagency focus on specific priority trade goals." A strong roll for USTR as point agency is imperative — to sort out competing priorities in the trade community and to coordinate them within the cabinet and White House so there is greater focus on the key U.S. objectives and avoidance of the helter-skelter approach that dilutes the focus of U.S. policy.

WHAT THE U.S. CAN DO AT HOME

Insisting that China make a number of changes to boost market access and reduce the bilateral trade imbalance is altogether appropriate. But there is much that can be done in this country to reduce our trade and current account imbalances as well. As long at the U.S. has a very low household savings rate and a very large budget deficit we are going to have a very big current account deficit — the only question will be who it will be with. It does strike me as wise to address these imbalances at home as well. While that topic is beyond the scope of this particular hearing, it is an area in which this Committee has a distinguished history of leadership. If the current account imbalance we have with China were to be eliminated tomorrow, the overall U.S. current account deficit would still be exactly the same as long as the gap between domestic saving and domestic investment in this country is unchanged. Our dependence on foreign capital would also be unchanged.

I thank the Committee for inviting me to appear and look forward to your questions.