

*USAPC Washington Report*  
Interview with Dr. C. Fred Bergsten  
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**USAPC:** You have said that China’s surplus is becoming the central global imbalance and urged Beijing not only to promote domestic-led growth, but also to allow the *renminbi* (RMB) to appreciate another 30 percent. To realize the latter, you have proposed an “Asian Plaza Agreement.” Why is it important to pursue RMB revaluation through a regional agreement?

**Bergsten:** There are two reasons. First, the rest of Asia is very important to overall global adjustment. Reducing China’s surplus, as substantial as it is,<sup>1</sup> would not be enough. Japan, Taiwan, Hong Kong, Singapore, Malaysia, and the other member nations of ASEAN<sup>2</sup> are piling up surpluses and currency reserves that are at least as big as China’s. So Asian nations are important in the aggregate to realize the sort of global rebalancing that is of interest to the United States.

Second, there are practical political reasons for pursuing currency revaluation through a regional agreement. I do not have much sympathy for China’s resistance to a more fast-track appreciation of the RMB. But I can understand China’s concern about the net impact of its competitive position against its Asian neighbors if Beijing goes it alone in revaluing the RMB.

If China all of the sudden decided to appreciate the RMB by 30 percent and the rest of Asia did not appreciate their currencies at all, China would lose much of its competitive position, not only against the United States and the EU which is the objective of the exercise, but also against its Asian neighbors. I have more understanding of that concern, particularly since, as I said earlier, several other Asian nations are running substantial surpluses. Economists refer to this as a “collective action” problem.

That is why what I loosely refer to as an “Asian Plaza Agreement” would be highly desirable. We need some method that would assure the Chinese that if they appreciate the RMB by 30 percent, the other Asian nations also will revalue their currencies by roughly 30 percent. That is important substantively because if China and the other Asian nations all revalue their currencies by about 30 percent, the trade-weighted average increase of the RMB and the other Asian currencies would be only 12-15 percent.

That would produce an outcome favorable to all parties. There would be a big increase in the value of Chinese and Asian currencies against the dollar. But there would not be nearly as much of an increase in the exchange rate that counts most for them – the average currency value. This is why *de facto* cooperation between various Asian nations on currency adjustment is very important.

I loosely refer to this approach as an “Asian Plaza Agreement,” but a big, formal meeting is not necessary to achieve regional cooperation on currency revaluation. This could be realized

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<sup>1</sup> China’s current account surplus is expected to reach about \$400 billion in 2007, \$450 billion in 2008, and \$500 billion (11 percent of GDP) in 2009. See C. Fred Bergsten, “Global Imbalances and Currency Misalignments,” speech at the World Economic Forum, Davos, Switzerland, January 2008, available at [www.petersoninstitute.org/](http://www.petersoninstitute.org/).

<sup>2</sup> The Association of Southeast Asian Nations (ASEAN) is composed of Brunei, Burma, Cambodia, Indonesia, Laos, Malaysia, Philippines, Singapore, Thailand, and Vietnam.

through very informal consultations. It also could be an outgrowth of recent initiatives aimed at forging more cooperative monetary relationships in Asia.

**USAPC: But how do we convince China to participate in such an agreement? At the December 2007 meeting of the U.S.-China Strategic Economic Dialogue (SED), Chinese officials seemed to dig in their heels in resisting more rapid appreciation of the RMB.**

**Bergsten:** It is difficult to know the correlation between what Chinese officials say and what they do. In that same late 2007 to early 2008 period, there was in fact a substantial increase in the rate of RMB appreciation. Only the Chinese know whether they allowed the appreciation in response to pressure from the United States or the EU – Brussels sent a mission to Beijing at about the same time as the SED – or because other developing countries, such as India and Mexico, are also beginning to complain about the undervalued RMB.

Internal factors also may have affected the appreciation. Inflation has picked up quite a bit in China. A stronger currency is a very effective tool to use to fight inflationary pressures. Some combination of all these factors may have influenced Beijing's decision to allow the RMB to rise more rapidly.

So notwithstanding the negative comments of certain Chinese officials at the SED, the government's actions have been modestly encouraging in that it has allowed the exchange rate to rise quite a lot faster during the last three or four months. It is hard to know if the appreciation will continue and how far the RMB will rise, so we should not be overly enthused by this development. But we should give credit where credit is due, and Beijing certainly has speeded up the pace of RMB appreciation. That is highly desirable and encouraging.

**USAPC: You also proposed establishment of a Substitution Account at the International Monetary Fund (IMF) to help ensure that currency realignments proceed in an orderly manner. Please elaborate.**

**Bergsten:** A Substitution Account at the IMF helps address the immediate problem of avoiding the dollar going into a free fall caused by, for example, sudden and substantial movement of dollars into euros. But a Substitution Account also would address a long-term systemic problem.

Creation of the euro fundamentally changed the world monetary system. The dollar was the dominant currency for the last century for the very simple reason that it did not have any competition. There was no other currency based on an economy anywhere close to the size of the U.S. economy. Historically, the international role of a currency tracks pretty closely the economy of that currency in terms of global output, trade, and so forth. There was no national economy anywhere close to the size and strength of the U.S. economy.

I worked closely with former West German Chancellor Helmut Schmidt during the 1970s and 1980s when the deutsche mark was the world's second most important currency. Chancellor Schmidt always told me that the deutsche mark would never challenge the dollar because West Germany was about the size of the state of Oregon. He was right. West Germany had a GDP that was about one-quarter of U.S. GDP, and the deutsche mark never achieved a global market share of more than about one-quarter that of the dollar.

All of that changed with the creation of the euro. The EU is about as big as the United States economy. It has financial markets that are about the same size as U.S. financial markets.

EU financial reserves are larger than ours. Consequently, for the first time in about 100 years, there is a real competitor to the dollar.

Inexorably, I believe the euro will move up alongside the dollar as a global currency. So when people question where else to invest their money if not in dollars, there is a new answer – euro financial assets. And, indeed, more and more people are doing just that. The euro already is a more widely held global currency than the dollar. More private bond issues currently are floated in euros than in dollars.

This means that big wealth holders, such as sovereign wealth funds, central banks, private investment funds, and pension and hedge funds, increasingly will diversify their portfolios into euros. That, in turn, will put downward pressure on the dollar and upward pressure on the euro, which may or may not be consistent with the needs of global adjustment in the short-to-medium run. The dollar could overshoot on the downside and the euro could appreciate excessively, which would cause competitive and other economic problems for the Europeans.

In my view, it would be desirable to have an off-market alternative for official financial entities that want to move from dollars into euros but do not want to destabilize currency relationships by using exchange markets. If the IMF set up a Substitution Account that would enable financial institutions to deposit dollars for Special Drawing Rights (SDRs), we would have a way out of the dilemma.

This proposal was very actively negotiated in 1979 and 1980, which was the last time there was a big movement out of the dollar into other currencies. I was Assistant Secretary of the Treasury then, and headed the last round of the negotiations, and it came very close to being adopted.

But this time there is much greater risk because of the creation of the euro. In the late 1970s, there was movement from the dollar into the DM, and the yen, which were national currencies. Now the prospect of movement from dollars to euros is far more serious and potentially destabilizing. This makes a strong case for taking another look at the idea of an IMF Substitution Account.

**USAPC: How does the recessionary outlook for the U.S. economy affect prospects for rebalancing global accounts and revaluing currencies?**

**Bergsten:** The outlook is quite bearish for the dollar. The recent downgrading of U.S. growth prospects could mean lower corporate profits and therefore a less attractive U.S. stock market. The Federal Reserve is reacting to those prospects by reducing U.S. interest rates, which in turn makes U.S. yields even less attractive to investors. The Europeans, in comparison, are downgrading a little bit, but not nearly as much. The EU central bank has not reduced interest rates at all.

Thus, the growth differential is moving against the dollar, the interest rate differential is moving against the dollar, the current account imbalances, while declining a little bit against the U.S. deficit, are still way too big, and there is the portfolio diversification I mentioned earlier stemming from the rise of the euro. These are four major factors that create conditions quite bearish for the dollar. And the recent changes in the economic forecast certainly add to that downward pressure.

**USAPC: Do you think the United States could enter a decade-long slump like Japan experienced in the 1990s?**

**Bergsten:** No. I do not think there is any risk of that. The underlying productivity growth of the U.S. economy is much greater than Japan's was at that time. Moreover, the U.S. economy is far more resilient and able to adjust as compared to the Japanese economy.

The Japanese banks were in denial for years and did not really admit the problem let alone do anything to counter it. U.S. banks, in contrast, already have taken big write-downs and there undoubtedly will be more to come. U.S. banks have been out shopping for new capital from sovereign wealth funds and other sources so they can recapitalize.

Policy in Japan reacted very sluggishly and in some cases counter-productively. However, in the United States, we already have had a very strong policy response. The Federal Reserve has been easing interest rates and the president and Congress have agreed on a fiscal stimulus package. Within six months of the initial outbreak of the financial and economic crisis last year, we have broad acknowledgment of the problem and both micro- and macro-adjustments in the works. I would say that all bodes well for avoiding anything like Japan's economic stagnation.

**USAPC: Have U.S. economic and financial problems undermined our credibility in global economic and financial forums? I understand some Asian governments bridle when U.S. officials try to discuss financial reform on grounds that the United States is in no position to offer advice.**

**Bergsten:** Asian officials would not want to receive U.S. advice anyway. It is no secret that quite a few Asian nations still feel burned by the U.S. refusal to offer timely assistance during the 1997-98 financial crisis.

Maybe American credibility has declined somewhat. But the U.S. economy has been growing rapidly for the past 20 to 25 years. The U.S. economic record in the recent past – particularly in the last decade – has been quite good.

The United States has been pulling away from the other industrial countries. There was convergence until the early 1990s, with Europe and Japan beginning to catch up with the United States. But since that time, the United States has been expanding its lead over Europe and Japan in terms of per capita income and productivity growth. So despite current economic and financial problems, the U.S. record really is quite good.

At the World Economic Forum in Davos, Switzerland this past January, for example, participants were still hanging on every word about the prospects for the U.S. economy. I believe in reverse coupling; not only does the rest of the world not depend so heavily on the United States, we now are being held up by the strength of the economies in the rest of the world, particularly in emerging markets in Asia. But many countries at least perceive themselves as still being very dependent on the United States and very much driven in their own results by U.S. economic activity.

It is important to remember that the United States has made huge policy errors during the past 50 years. In the late 1970s, for example, we had double-digit inflation and 20 percent interest rates. We also have gone through terrible periods when we became the world's largest debtor country. The dollar declined steadily in different periods. Personally, I think President Bush's tax cuts were a huge error because they threw us back into budget deficits and international debt.

Despite all those things, the economy has done very well on balance since the mid-1990s till about one year ago. I do not think our current difficulties, as bad as they are, will undermine U.S. economic leadership. There are countries that like to rub salt in our wounds about these policy errors. At the same time, though, they worry very much about the effects of U.S. economic problems on them. Critics would be advised to be careful what they wish for.

**USAPC: As you mentioned earlier, there as been a significant increase in Sovereign Wealth Fund (SWF) activity in the United States. Some analysts argue that the potential challenges posed by increased SWF investments are more a reflection of our own economic problems. Do you think we should develop new regulations to address potential SWF impact on U.S. economic interests?**

**Bergsten:** The United States has put itself in a position requiring money provided by SWF investments. We are heavily dependent on foreign financing for our economic welfare. We must attract \$7 billion of foreign capital every working day to keep our interests rates at a moderate level and our exchange rate from collapsing.

Only at our peril would we erect significant barriers to foreign capital. In fact, we are very lucky that these SWFs are sources of large amounts of money, particularly for banks looking to recapitalize in the wake of the sub-prime mortgage crisis.

Current SWF activity is not unlike the recycling of the 1970s after the earlier oil shocks. Except then, much of recycling went *through* the banks, while now much of it goes *to* the banks to keep them afloat.

If all goes well, the CFIUS [Committee for Foreign Investment in the United States<sup>3</sup>] review of SWF investments will be carried out in a judicious and balanced way. On February 20, CFIUS effectively derailed the planned acquisition of 3Com by Bain Capital Partners and Shenzhen Huawei Investment & Holding Co. 3Com is not a SWF; the company makes various computer network infrastructure products. Nevertheless, there is some concern that other potential foreign investors may interpret this decision as indicative of a protectionist trend in the United States.

Congress has become more sophisticated in considering SWF and other foreign direct investment. Two years ago, in contrast, U.S. lawmakers vehemently opposed CNOOC's [China National Offshore Oil Corporation] bid for Unocal and the sale of port management businesses in six major U.S. seaports to Dubai Ports World. Those reactions, indeed, could be construed as domestic opposition to foreign investment.

However, judging by the lack of political rhetoric from Capitol Hill about the CFIUS decision on the 3Com case, U.S. lawmakers apparently have learned that we need the money and they had better not take actions that would deter such investment. It is significant that Members of Congress allowed the 3Com review to be carried out quietly and did not launch a broadside attack like they did in 2006.

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<sup>3</sup> The Committee on Foreign Investment in the United States (or CFIUS) is an inter-agency committee that reviews the national security implications of foreign acquisitions of U.S. companies or operations. It is chaired by the Treasury Secretary and includes representatives from 12 U.S. agencies, including the Departments of Commerce, Defense, Homeland Security, and State.

But having said that, I must report that when I spoke with a number of SWF officials at the Davos conference, they were rather agitated. They complained about demands for voluntary compliance to a code of conduct and the need for greater transparency. They felt they were viewed as guilty until proven innocent. However, to date there is no indication that any SWF has behaved in a way that would raise security-related concerns. So, understandably, SWF officials wonder why their activities cause all this anxiety.

These concerns will have repercussions. As I said before, there are other places for SWFs and other foreign investors to put their money. They could put a great deal of money in Europe or emerging Asian economies. The United States is certainly not the sole location for SWF or other foreign investments. We should be careful not to bite the hand that feeds us.

**USAPC: So then you don't think that China's SWF activity should be subject to different standards or rules for investing in the United States? Given the political differences between the two countries, some lawmakers have suggested that we should develop new rules governing Chinese investment in the United States**

**Bergsten:** No. The Peterson Institute did a study on that issue a few years ago. We concluded that it would be a big mistake for the United States to subject China's investments – or those of any other specific country – to separate regulations. The CFIUS process is adequate to address the national security implications of any potential foreign investment.

**USAPC: A good deal of the American public has lost faith in the economic benefits of an open trading system. How does one restore that faith? Will a revamped Trade Adjustment Assistance (TAA) program help? A more muscular enforcement of trade remedy laws?**

**Bergsten:** I think there are three things that would help to restore public faith in an opening trading system. The first is simply educating the public and their elected officials about the benefits of trade. The Peterson Institute's aggregate analysis indicates that the U.S. economy is \$1 trillion richer annually and every average American has benefited very substantially from trade and globalization -- \$10,000 per household per year. However, most people do not know this even though the Treasury Secretary, the U.S. Trade Representatives, and even certain enlightened Members of Congress quote these impressive figures.

In addition, it is necessary to find anecdotes to support the aggregate figures. Critics of globalization will say, "Look at that plant. It's moved from Ohio to Mexico!" That sounds much worse than data about the overall benefits of trade and globalization to the U.S. economy.

It is important to counter the anti-globalists with equally compelling stories, such as, "Look at all the wonderful new jobs in South Carolina as a result of the BMW plant" or "Look at the fact that clothing prices are 30 percent cheaper because much of it is imported from China." Many lower income Americans, in particular, are much better off thanks to clothing and other imports from China.

The Peterson Institute, in fact, has a project underway that will compile stories that illustrate the positive benefits of open trade and investment. The stories will make clear that not only the country as a whole, but "Joe Six-Pack" is better off as a result of globalization.

Second, however, the United States has done a terrible job of dealing with the losers from trade – those individuals who lost their jobs as a result of globalization. The Europeans, in

comparison, have excessive safety nets and welfare programs for workers and therefore not nearly as much protectionist pressure.

The U.S. unemployment insurance system is grossly inadequate. It only covers about one-third of the workers who are unemployed, and those workers only get about one-third of the income they had been earning.

On top of that, the Trade Adjustment Assistance program falls far short. The TAA program is funded at about \$1 billion a year despite the \$1 trillion per year benefit of trade to the U.S. economy. TAA is administered haphazardly and half-heartedly by the Labor Department. Most administrations have treated TAA as a stepchild. TAA does not even cover services workers who may have lost their jobs through foreign outsourcing.

Senate Finance Committee Chairman Max Baucus (D., Montana) declared at our Institute in January that he will not let any trade legislation out of his committee until Congress passes his bill to expand and overhaul the TAA program. I see his point. Until we are positioned to deal with the downsides, costs, and losers of globalization, it is very hard to counter the political anxieties. We need programs that deal effectively and compassionately with trade-related dislocation, but also are politically powerful.

The third thing is to develop more sensible trade policies themselves. You mentioned using trade remedy laws more aggressively. That would help to enhance the credibility of the administration. While I would not advocate a moratorium on trade negotiations -- it is very important to keep the "bicycle" of liberalization moving forward -- I think we might turn our attention to different issues, different countries, or different mechanisms that have more political appeal as well as produce economic benefits.

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