



# Washington REPORT

*News and analysis from Washington, D.C. about key issues in U.S.-Asia Pacific Relations*

Volume 3 July 2009

## Asia Pacific Economies Must Remain Focused On Rebalancing Economic Growth

**Dr. Eswar Prasad**

*The U.S. Federal Reserve anticipates that the American economy will begin to improve later this year. Experts also foresee an upturn in China's economy by the year's end, which, in turn, may help to pull up other Asian economies. But the outlook for a sustained recovery is uncertain unless economies on both sides of the Pacific remained focused on rectifying the underlying imbalances that have fueled the crisis, says Dr. Eswar Prasad of Cornell University and The Brookings Institution. He urges Asia Pacific economies not to be tempted by stop-gap solutions, but instead to undertake politically difficult yet essential reforms aimed at re-balancing growth.*

*Dr. Prasad delivered these remarks at the 18th General Meeting of the Pacific Economic Cooperation Council (PECC) on May 13, 2009 in Washington, D.C., which was hosted by the East-West Center.*

I'm going to talk about three issues this morning. First, the tensions facing the world economy today, and there are a variety of these. Second, the implications of these tensions for the world economic recovery and global macroeconomic imbalances. And third, the possible resolutions for these tensions.

If one thinks about the various tensions facing the world economy, one can consider these within the context of systematically important economies like the United States and China. These two economies, in fact, will be my prime metaphors for the broader world economy.

**Tensions in U.S. Economy**—In the United States, there are some very difficult tensions facing the economy

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## Senate Considers Broader Impact Of Climate Change Bill

China is willing to commit to mutually verifiable reductions in carbon emissions, but the United States must lead the way by enacting its own climate change regime, Senator John Kerry (D., Massachusetts) said at a recent hearing focused on climate change proposals before the Senate.

President Obama praised the energy bill passed by the House of Representatives on June 26 as an "extraordinary first step" in the campaign to combat global warming. The core of the sweeping, 1,400 page bill

is a provision creating a "cap-and-trade" system, which would set limits on greenhouse gas emissions and gradually tighten those limits over the next 40 years. Major carbon emitters would have to reduce their emissions or buy "allowances," which would be traded like commodities.

**"Supermajority"**—The focus has turned to the Senate, where most observers anticipate a tough battle. The dynamics of getting this bill through the upper chamber are more complicated given the political reality

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## Prasad Remarks

right now. There is a desire to get the financial system revived and, at the same time, jump-start the economy through macroeconomic stimulus.

Naturally, monetary and fiscal stimulus are much less effective if the financial system is not working well. And, unless the stimulus leads to rapid macroeconomic recovery, it will be that much harder to get the financial system back on its feet. So these two will have to go together but this nexus also poses a serious risk to the recovery if either one falters.

**Private Consumption**—Ultimately, private consumption will be the key to a sustained recovery. The reality is that the government by itself cannot pull the economy along. Governments need private consumers to do what they previously admonished them for doing, which is consuming too much and saving too little.

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*The reality is that government by itself  
cannot pull the economy along*

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Now, the U.S. private saving rate has gone from essentially zero percent of current disposable income to almost 5-6 percent. In terms of rebuilding private-sector balance sheets, we are making some progress. But, unfortunately, this process of balance sheet rebuilding is not easy to square with our hope that the American consumer will start consuming again and pull the economy up.

**Looking for Export Markets**—When one projects this on a global scale, things become more complicated. If one looks around the world for sources of strength—and given the fact that many markets in the world, including advanced countries such as Germany and Japan, plus many of the emerging markets, are still looking to exports as a driver of growth—the question then becomes which country is going to absorb these exports.

The United States seems to be the one economy that the world is still expecting will absorb these exports. This obviously creates a tension as reliance on U.S. imports to jump-start the world recovery would slow down recovery in the U.S. and could also raise trade tensions.

**Chinese/Indian Growth**—If one thinks about systematically important countries, such as China, India, and many of the other emerging markets in Asia, basically, they have been able to hold their own and maintain relatively good growth rates. The IMF is projecting negative growth in the advanced economies in 2009 and essentially zero growth in 2010. But the emerging markets, especially those in Asia, look quite good by comparison in

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## Congressional Watch

**Foreign Relations Authorization Act for Fiscal Years 2010 and 2011**—On June 10, the House voted 235–187 to approve legislation authorizing about \$20 billion in FY2010 and FY2011 each to strengthen U.S. foreign policy efforts. The bill places considerable emphasis on enhancing the U.S. Department of State’s in-the-field capabilities by providing more resources to expand the corps of Foreign Service Officers. But the legislation also includes the following provisions relevant to U.S.-Asia relations:

- A requirement that the United States oppose any international climate change treaty that would weaken intellectual property rights related to “green” technology;
- Increased resources and training to enable more effective enforcement of U.S. intellectual property rights, in general, especially in countries identified by the United States as lax in enforcing those rights;
- A provision expressing the sense of Congress that the president must elevate the role of the United States in the Asia-Pacific Economic Cooperation forum (APEC) and that U.S. small businesses will add substantial benefit to APEC discussions; and
- A provision expressing the sense of Congress the U.S. Secretary of State should return Vietnam to the list of “Countries of Particular Concern” owing to its continued, severe violations of religious freedom.

The bill currently is pending in the Senate. It is unclear when the upper chamber will act on this bill.

**Pakistan Enduring Assistance and Cooperation Enhancement (PEACE) Act**—On July 11, the House voted 234–185 to approve a bill aimed at “creating a more positive framework for U.S.-Pakistan relations.”

It subsequently was appended to the House-passed Foreign Relations authorization bill. Among other provisions, the bill would provide duty-free access to the U.S. market for certain products produced in designated Reconstruction Opportunity Zones (ROZ) in Afghanistan and Pakistan. The ROZ program would last through Fiscal Year 2023.

**State Department/Foreign Operations Appropriations for FY2010**—On July 9, the House voted 318–106 in favor of a bill making \$48.8 billion in appropriations for the State Department, foreign operations, and related programs for FY2010. That same day, the Senate Appropriations Committee approved its version, appropriating \$48.7 billion for State/foreign operations in the next fiscal year. At press time, the full Senate had yet to vote on the legislation. In any event, there are substantive and budgetary differences between the two bills, which will have to be reconciled in conference.

Notably, though, both bills include important climate change provisions. The Senate provides \$1.2 billion to support bilateral and multilateral programs to combat climate change. The House version directs the Secretary of State to ensure that any international climate change accord includes intellectual property protections prior to the obligation of funds for the Clean Technology Fund and the Special Climate Fund.

**Currency Reform for Fair Trade Act of 2009**—Sen. Debbie Stabenow (D., Michigan) introduced a China-targeted bill on May 13 aimed at providing “a clear definition and methodology of currency manipulation which will help prevent foreign countries from gaining an unfair competitive advantage at the cost of U.S. jobs.” Rep. Tim Ryan (D., Ohio) introduced the House companion that same day. Insiders do not anticipate that the bills will advance owing to much weaker support for such punitive measures in this Congress.

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terms of their prospects for output growth.

The Chinese stimulus package, for instance, has been effective at maintaining healthy GDP growth. The downside is that a lot of the stimulus has been through investment, which is still being financed through the banking system. In my view, this ultimately will lead to the buildup of a fair amount of excess capacity in industries where there is already excess capacity.

So in terms of pushing out this excess capacity, which the Chinese economy simply is not going to be able to absorb in the medium term, and generating employment growth, which even during the boom years of the 2000s was only about 1 percent, China will still need rapid growth in exports. This also creates a very fundamental global macroeconomic tension.

**Reserve Accumulation**—One other aspect of the export-led growth model concerns reserve accumulation, which has slowed recently. But if one regards reserve

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accumulation as a process of self-insurance, again, we have a tremendous paradox developing. Two trillion dollars of foreign exchange reserves in China, \$300 billion in India, \$500-600 billion in Russia before the crisis hit—these seemed like staggering amounts based on standard notions of reserve adequacy for instance, relative to the level of imports or short-term external debt.

Yet, within a period of about three months, India lost about a quarter of its reserves.

Russia went from \$600 billion to \$480 billion in a similar

period. All of a sudden, the notions of reserve adequacy have changed and emerging markets feel they need a lot more reserves to protect themselves from crises.

**Changes in International Financial Markets**—One could argue that an institution like the IMF [International Monetary Fund] should provide this insurance, and I'll come back to this issue. But there have been fundamental changes in international financial markets that affect the role of the IMF.

First, the amount of resources needed from the IMF has increased enormously. Second, money provided by the IMF used to be a signal to private investors. A country would receive money from the IMF and, based on the macroeconomic policy measures agreed to as part of the IMF loan, private capital inflows would soon follow. That has changed; private capital does not seem to follow IMF funding as surely anymore.

Thus, all of a sudden, even the ability of the IMF to insure countries, especially the very large countries, is in question. Consequently, we face this even more paradoxical situation in which countries that had built up large stocks of reserves have an incentive to accumulate even more reserves in order to self-insure.

**Possible Worsening of Imbalances**—Although some economists maintain that global imbalances already are adjusting, I do not see that as a certain outcome as we come out of this recession. In fact, I see a potential risk that once the recovery is underway, global imbalances could perpetuate or perhaps become even worse.

This is because the United States again will find itself becoming the consumer of last resort and the Asian economies will continue to rely on exports to a significant extent, not just to generate employment growth, but also



Prof. Eswar Prasad, Tolani Senior Professor of Trade Policy, Cornell University & Senior Fellow, The Brookings Institution

to increase self-insurance. I see many of these tensions potentially becoming a great deal larger in the medium term.

One hopes that we have learned our lessons. Even with large global macroeconomic imbalances, perhaps we won't end up with another cataclysmic outcome like the one we are in the midst of right now. Perhaps with better financial market regulation and more coordinated international financial regulation, one can make progress in fortifying our economic systems against collapse. But the rules of the game are not clearly defined, either in terms of how to deal with macro imbalances or a more effective regulatory framework, so I remain far from sanguine.

**Consideration of Reforms**—What is the ultimate solution to many of these problems? The crisis provides an opportunity to think about fundamental reforms in a variety of dimensions. The big question in my mind is whether in the process of trying to get out of the crisis, we essentially use stop-gap solutions that solve the immediate problem but create bigger problems down the road.

The scenario I've described is essentially one where the short-term problems are solved—the United States begins growing again and the rest of the world breathes a sigh of relief and begin to grow again, too—but the fundamental tensions would remain festering.

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*The real core issue that ties all of this together is the financial system*

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**Importance of the Financial System**—Re-balancing growth in the Asian economies, especially China, is one important component of the eventual solution. So how does China re-balance its growth towards domestic demand and private consumption-led growth rather than relying on investment- and export-led growth? To me, the real core issue that ties all of this together is the financial system.

There is a notion that the western financial model has not worked very well, either in terms of innovation or regulation, and that has led us to where we are. However, I am very encouraged by the statements of the policymakers in China, India, and other emerging markets who, it seems to me, are dealing with this in a more mature way.

They are saying things like, "This is not a sign that financial development should not go forward. Rather, we need a more back-to-basics approach to strengthen banking systems. We must make sure that our banking systems work more efficiently to intermediate both domestic and foreign capital into productive domestic investment. We must provide more insurance mechanisms within the country through the widening of the social safety net so households do not feel they need to increase precautionary savings to such a large extent." And, of course,

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## Climate Change Bill

that supporters must secure a “supermajority” of at least 60 votes to fight off attempted filibusters and ensure passage. Insiders are skeptical that the Senate’s energy leaders will meet this goal without intensive horse-trading on a range of heretofore divisive issues, such as support for greater offshore oil and gas exploration or new funds for the development of “carbon-free” nuclear energy plants.

**Committee Roles**—Adding further complexity to the Senate debate will be the comparatively higher-profile roles played by the Senate Foreign Relations, Finance, and

Agriculture Committees in deliberations with the lead panel, the Environment and Public Works Committee. Senator Kerry (D., Massachusetts), who, as chairman of the Senate Foreign Relations Committee is a key player in the debate over energy legislation, remarked on July 8 that “while the Senate will hew closely to [the bill passed by] the House, we have some notions of how to improve it.”

**Trade Impact**—Such “improvements” could affect key provisions of the House-passed bill that some experts—and President Obama himself—have maintained could run afoul of U.S. obligations under international trade law. These provisions are aimed at easing the transition of

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### Regulatory Update

**“Surge” of Chinese Passenger Vehicles and Light Truck Tires Imports**—On June 18, the U.S. International Trade Commission (ITC) ruled 4-2 that some \$1.7 million in imports of passenger vehicles and light truck tires from China represented a “surge” actionable under Section 421 of the Trade Act of 1974. By this ruling, the ITC determined that the items were being imported into the United States in such increased quantities or under such conditions as to cause or threaten to cause market disruption to U.S. producers of these products.

Pursuant to law, on July 9, the ITC submitted a report to President Obama, which proposed as a remedy that the chief executive for a three-year period impose duties on these products, in addition to the current rate of duty, in the amounts of 55 percent, 45 percent, and 35 percent. The report also included the dissenting views of the two commissioners who disagreed with the “surge” finding. Later this year, President Obama ultimately will decide whether to provide relief to U.S. producers and the type and amount of relief.

**U.S./EU WTO Case Against China’s Export Restraints on Raw Materials**—The United States and the European Union on June 23 formally requested World Trade Organization (WTO) dispute settlement consultations with China regarding the latter’s export restraints on numerous important raw materials. The complainants charged that China imposes quotas, export duties, and other costs on exports of bauxite, coke, fluorspar, magnesium, and other key inputs for various downstream products in the steel, aluminum, and chemical industries around the world. Because China is the leading world source of these raw materials, the export restraints have the effect of increasing world market prices for these inputs to the detriment of U.S. and European industries.

Washington and Brussels filed the complaint after two years of unproductive consultations with Beijing on this matter. It may take several more years for the WTO dispute settlement proceedings to play out. “Before everyone writes that tensions are escalating between the U.S. and China, remember: WTO disputes are a normal part of the relationship among mature trading partners,” U.S. Trade Representative Ron Kirk said in announcing the action. See <http://www.ustr.gov>

**U.S.-Japan Regulatory Reform Initiative**—The United States and Japan on July 7 released an 86-page document detailing the results of their work under the U.S.-Japan Regulatory Reform and Competition Policy Initiative (see <http://www.ustr.gov>). For the past eight years, the two nations annually have exchanged recommendations under this Initiative. Some of the key areas of progress seen in Japan identified in the report include (1) expedited regulatory reviews for pharmaceuticals and medical devices, (2) strengthening copyright protections for music and motion pictures, and (3) improving customs treatment for high-value items sent via international postal express service, among others. U.S. Trade Representative Kirk noted that normalizing trade for U.S. beef and securing a level playing field for U.S. insurance providers remain of serious concern to the United States.

Japan cited progress the United States has made in bringing its antidumping laws and regulations into conformity with WTO rules. Tokyo also noted efforts undertaken by Washington to educate and engage with Japanese authorities about post-9/11 customs procedures and changes to the U.S. visa program. Other issues of interest to Japan include consultations aiming at harmonizing the two nation’s patent and standards systems and rationalizing e-waste disposal rules.

## Climate Change Bill

mature, energy-intensive industries to alternative energy sources by, among other things, imposing a tariff on goods from countries profiting from more lenient carbon emission restrictions.

Obama said June 28 that the United States “should be very careful about sending any protectionist signals at a time when the global economy is still deep in recession.” He encouraged lawmakers to consider other ways of getting countries to accept limits on carbon emissions rather than “using a tariff approach.”

**Senate Finance Hearing**—Senate Finance Committee Chairman Max Baucus (D., Montana) convened a hearing on July 8 for that express purpose. Although Senator Kerry chaired the hearing in his absence, Baucus issued a subsequent statement expressing optimism that the committee could craft legislation that strikes a balance between helping industries transition to a greener economy and complying with international trade rules.

Judging by the dialogue between committee members and witnesses, however, it will continue to be difficult for senators representing economically depressed areas to compromise on politically expedient protections for industries dependent on fossil fuels.

**Carbon Leakage**—Committee members focused a good portion of the hearing examining the trade implications of provisions in the House-passed bill that are aimed at addressing “carbon leakage.” This term refers to the (1) loss of market share by U.S. industries that comply with emissions caps to foreign competitors that do not, and (2) the decision of affected U.S. industries to move their operations offshore to evade the emission restrictions.

To remedy these impacts, the House bill would provide emission permits (also referred to as “free allowances”) to affected industries—for example, the steel, glass, or cement sectors—that would be eliminated over time. As mentioned, House lawmakers also inserted a provision requiring the president, starting in 2020, to impose a “border adjustment,” or tariff, on certain goods from countries that do not share the same level of commitment to reducing greenhouse gases. The president could waive the tariffs only if Congress approves that action.

**WTO Suits**—Virtually all of the witnesses agreed that enactment of either or both provisions could be problematic for the United States. Gary Horlick, a former Commerce Department official and lawyer specializing in international trade, said that permit allocations, depending on the details of the design, could be challenged in the WTO as an “actionable” subsidy. Furthermore, the permit system could negatively affect globally integrated industries, such as the auto sector, given the uncertainty

### Member Op-Eds

Beginning with this issue, *Washington Report* regularly will feature op-eds by USAPC members.

This month’s column highlights commentary by Dr. C. Fred Bergsten, Director of the Peterson Institute for International Economics. Dr. Bergsten outlines policy suggestions for President Obama in anticipation of the President’s long-awaited speech on trade policy.

- **“Obama Needs To Be Bold On Trade,”**  
by C. Fred Bergsten, Peterson Institute for International Economics, *Financial Times*, June 23, 2009  
Available at <http://www.petersoninstitute.org>

*USAPC members are encouraged to alert USAPC Director Mark Borthwick about published or forthcoming opinion pieces that they feel would be of interest to Council members and the broader readership. Contact him at [borthwim@eastwestcenter.org](mailto:borthwim@eastwestcenter.org).*

about whether foreign parts suppliers can secure permits.

Eileen Clausen, president of the Pew Center on Global Climate Change, added that issuance of permits does not necessarily guard against carbon leakage or loss of jobs since a firm could choose to maximize profits by selling its permits and reducing production. Horlick proposed that the permits be based on an industry’s level of energy intensity rather than on trade factors.

**Border Adjustment**—The witnesses also pointed out that the border adjustment provision risked provoking (1) reciprocal action by U.S. trading partners on American exports that do not meet a particular country’s emissions restrictions and, in all likelihood, (2) adjudication of a WTO challenge.

“The devil is in the details of a border measure,” Horlick said. “A VAT-style tax, imposed identically on domestic and imported goods, should pass muster, but after that it gets very difficult to design a border tax that would pass muster as we have seen in prior WTO litigation.” Clausen added that the House-passed bill does not include sufficient presidential discretion to measure other countries’ effectiveness at reducing emissions in comparison to U.S. efforts.

**International Agreement**—Horlick said these risks underscore the importance of concluding an international climate change agreement that harmonizes the emissions-restricting regimes throughout the world. “We need a regime under which there is the same documentation and categorization rather than every country doing their own thing—one country issuing permits, another using border

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### U.S., Asian Officials and Experts Explore Policies for Economic Recovery at the 18th PECC General Meeting

The East-West Center and USAPC hosted the 18th General Meeting of the Pacific Economic Cooperation Council (PECC) in conjunction with USAPC's annual Washington Conference on May 12-13, 2009 in Washington, D.C. Entitled, "Economic Crisis and Recovery: Roles for Asia-Pacific Economies," the conference focused on the global financial crisis, its economic and political impact in Asia, and how Asia Pacific cooperation can help to resolve the crisis.



**Key Speakers**—It featured a keynote address by U.S. Deputy Secretary of State James Steinberg, special luncheon speeches by Mr. Jim Adams, World Bank Vice President for the East Asia and Pacific Region, and The Honorable Mari Pangestu, Minister of Trade of Indonesia, and seven different panel discussions by prominent American and Asian experts.

**Overview**—The speakers offered mixed views about whether the worst of the crisis was over, but most agreed that the fiscal stimulus packages implemented by key governments in the region were making positive impacts. They warned the Asia Pacific economies not to derail a nascent recovery by returning to export-led growth models and resorting to protectionist remedies. Structural reforms are imperative to create a sustainable economic recovery, the speakers emphasized. Noting the emphasis on green and clean technologies in a number of the region's stimulus packages, some of the experts expressed optimism that these economies could play a leadership role in global climate change negotiations and collaborate with the United States on the development of green technologies.

**Conference Materials**—The complete agenda, speaker information, and a detailed record of the conference discussions and presentations will be available at <http://www.pecc18.org> later in July.

**PECC Survey of Opinion Leaders**—Also at the General Meeting, PECC unveiled the results of a survey of more than 400 opinion leaders from 25 Asia Pacific economies, which was conducted in April 2009. Notably, when asked their views of the fiscal stimulus and recovery packages of major economies, more than 60 percent of respondents indicated they were "satisfied or very satisfied" with China's efforts, while only 46 percent said they were "satisfied or very satisfied" with the U.S. stimulus package. See <http://www.pecc.org> for the complete survey.

#### Asia Pacific Economic Cooperation forum (APEC):

- **APEC Business Advisory Council Meeting, II**—The APEC Business Advisory Council (ABAC), composed of prominent business representatives from throughout the Asia Pacific, met in Brunei on May 11–15 for their second meeting of 2009. Their goal later this year is to present APEC leaders recommendations focused on addressing financial protectionism and trade financing problems as well as improving H1N1 pandemic preparedness.

- **APEC and ASEAN Explore Synergies**—On June 11, Amb. Michael Tay, executive director of the APEC secretariat, led a delegation to Jakarta, Indonesia for meetings with Surin Pitsuwan, secretary-general of the Association of Southeast Asian Nations (ASEAN), and his staff. The purpose of the meeting was to exchange information about what each organization was doing to accelerate economic and social development in their respective member nations and identify areas in which collaboration between APEC and ASEAN "can generate genuine and practical benefits."

#### Key Official Meetings: July–August 2008:

- **President Obama** joined other leaders of the G-8 nations for a summit that focused on setting targets to limit global warming and tackling the global economic crisis, among other issues, July 8–10, L'Aquila, Italy.

- **Japanese Emperor Akihito and Empress Michiko** visited the United States, July 14–16, Honolulu, Hawaii.

- **U.S. Secretary of State Hillary Clinton** will meet **Indian Prime Minister Manmohan Singh** and attend the 16th ASEAN Regional Forum, July 19 and July 22, in New Delhi, India and Phuket, Thailand, respectively.

- **U.S. Trade Representative Ron Kirk** likely will attend the annual APEC Meeting of Ministers Responsible for Trade, July 21–22, Singapore.

- **U.S. Secretary of the Treasury Timothy Geithner** and **U.S. Secretary of State Hillary Clinton** will host **Chinese Vice Premier Wang Qishan** and **Chinese State Councilor Dai Bingguo** for the inaugural meeting of the U.S.-China Strategic and Economic Dialogue, July 27–28, Washington, D.C.

## G20, Congress Boost IMF's Role in Economic Recovery

**G20 Action**—On April 2, the Group of Twenty (G20) industrial and emerging market countries called for the following actions aimed at enabling the International Monetary Fund to combat more effectively the global economic crisis as well as improve its governance:

- To triple the IMF's pre-crisis lending resources to \$750 billion;
- To support a new, \$250 billion allocation of Special Drawing Rights (SDRs);
- To reform country representation at the IMF to enable greater participation by emerging and low-income countries; and
- To authorize limited sales of IMF gold to provide concessional and flexible finance for the

**Congressional Action**—On June 16 and June 18, the House and Senate, respectively, approved the conference report for the Supplemental Appropriations Act of 2009. It included the following provisions to implement U.S. commitments under the G20 accord:

- To increase from \$10 billion to \$100 billion the U.S. share of the New Arrangements to Borrow (NAB). The NAB is the framework through which the IMF can rapidly raise money from members if supplementary resources are needed. The G20 called for increasing the NAB to \$500 billion;
- To increase the U.S. quota payment to the IMF to \$8 billion, which will allow Washington to maintain its current voting share of 16.77 percent;
- To approve a special one-time allocation of SDRs to those countries that joined the IMF since 1981. The special allocation provides the equivalent of \$33 billion in SDRs across the membership; and
- To authorize the sale of 13 million ounces of gold to fund an endowment, the return on which will help to cover the Fund's operational expenses.

House Republicans initially opposed the new, \$108 billion U.S. commitment to the IMF because of the risk to U.S. taxpayers that the NAB contribution, in particular, would not be repaid. House minority members ultimately approved the FY09 appropriations conference report, but amended FY10 legislation to sunset the NAB credit line by FY14. It is unclear whether the Senate will approve the sunset clause.

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## Prasad Remarks

diversifying financial income can be helpful in terms of stimulating consumption-led growth.

It seems to me that the financial system can be a mechanism for providing far more stability. But there is an international dimension to this, as well, as I alluded to earlier.

We still need to think about how countries are going to insure against the risks of balance of payments and capital account crises through an institution like the IMF, rather than maintaining a tightly managed exchange rate in order to build up more reserves.

**Reform of International Financial Architecture**—This leads to another issue, which is fundamental reform of the international financial architecture. The G20 has expressed all the right sentiments about reforming an institution like the IMF so that it not only has more resources, but also has more legitimacy and credibility among the emerging market economies.

On the resource front, we have made significant progress, with a number of countries already having committed to contribute to a massive expansion of the IMF's resource base. However, the legitimacy issue, which would entail changing the governance structure of the IMF so that emerging markets feel they actually can use this institution to insure them against serious risks, remains an important concern.

**Reforms in Developed Economies**—Much of the discussion of macroeconomic reforms tends to focus on emerging markets with the notion that they have played an important part, perhaps not in the proximate causes of the crisis, but in helping to lead the crisis into a more explosive outcome. But there also is a huge amount of reform that needs to be undertaken in the industrial countries.

In fact, many of the mantras we were invoking before the crisis still remain relevant. There is a need for significant structural reforms in Europe, where this crisis seems to have turned into an opportunity for backsliding on many issues such as labor market flexibility and product market deregulation.

In the United States, which has been the epicenter of the crisis, it is encouraging that the Obama Administration seems to be engaging in more introspection and is willing to admit that there were issues related to U.S. regulatory and macroeconomic policies that need to be addressed. Tackling the exploding levels of public deficit and debt will have to be key priorities in the United States once the recovery is on track.

**U.S. Leadership**—It is likely to be a long and rocky road ahead—in terms of resolving these short-term growth concerns and managing medium-term tensions—

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towards achieving macroeconomic and financial stability. The United States has a critical role to play in all of this. Washington needs to serve as an important model leader in pulling other countries along, not by lecturing them about what to do, but essentially leading by example. Thank you.

*[Excerpts of Question-and-Answer Period]*

**Soogil Young, President, National Strategy Institute of Korea:** [I would propose that] all Asian nations can continue to pursue export-led growth if only they also would import from each other and create an open market between themselves. We could be pursuing trade and then growth instead of an export-only strategy. What are your views?

**Prasad:** It is true that it is not trade or exports as a ratio to GDP or export growth to be concerned about, but the overall surpluses. And the concern, of course, has been that if you look at the Asian region as a whole, with China being a prime mover, it has been relying on final

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*Developing a corporate bond market in China would be a good way of creating more competition for the banking system*

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markets. Even though Korea is running a more balanced trade account than China, much of that is intra-Asia trade and final markets still seem to be outside the region.

It is difficult to resolve this because in the short-term the U.S. consumer has a very limited ability to step up. The crisis that many of us had anticipated, which was a dollar crisis with U.S. imbalances leading to a decline in the value of the dollar, has not happened.

Paradoxically, the country at the epicenter has had money flowing in because it's still seen as a safe haven, plus the dollar had in fact strengthened a little bit even in the latter half of last year. But to me, those are reflections not about U.S. strength, but about relative weakness of the financial systems in the rest of the world. Even though the U.S. system seems to be imploding, there is still this miraculous faith in the U.S. government and, at some level, in the U.S. financial system.

Ultimately, the U.S. financial system will revive and will be the place to park money. That is the imbalance we need to worry about—the fact that there is this imbalance in the ability of the financial systems to intermediate capital and to absorb foreign capital in many of the emerging market economies. That is a fundamental problem that

we will have to solve in order to deal with global imbalances as well as imbalances within each of these countries.

**Richard Cronin, Henry L. Stimson Center, Washington, D.C.:** Experts on China point out that 80 percent of the Chinese people, including small and medium-sized businesses, don't have access to bank credit primarily because they don't have collateral. Peasants don't own their land and therefore can't borrow against it. The same goes for businesses. How does China get moving without this really fundamental change?

**Prasad:** There are multiple distortions in the economy and we've talked about some of these issues in the context of other economies, such as a weak legal system, property rights, and so on.

So how does one get the financial system to move? There are macro angles, as well, to this. If you think of monetary policy within the framework of being a relatively tightly managed exchange rate, that gives you much less flexibility with monetary policy. This means that you cannot use price signals to direct the financial system to issue credit. So you have a problem there.

Even if one deals with all of these systems, there is a broader issue of how you change incentives in the system. There are aspects that need to be dealt with outside the banks.

For instance, developing a corporate bond market, which is an important priority of the Chinese authorities, would be a good way of creating more competition for the banking system. It would give smaller enterprises potentially more room to start generating their own funds and perhaps increase the level of transparency in the system, complimentary to what is occurring through the stock market.

It is also important to move forward with very basic derivatives. Currency derivatives are not exotic instruments, but exporters, importers, and firms ultimately need them.

In addition, there is the aspect of financial inclusion, which is becoming an important issue in many emerging markets and lower-income developing economies. The goal would be to get more of the population encompassed by the formal financial system to improve their access to credit mechanisms, insurance mechanisms, and so forth. This is all understood quite well, but it becomes very difficult to figure out where exactly to move first. But there is movement and I am encouraged by it. ♦

*Dr. Eswar Prasad is the Tolani Senior Professor of Trade Policy, Cornell University, and a Senior Fellow at The Brookings Institution.*

## Climate Change Bill

measures, and so forth,” he said. Horlick emphasized the importance of focusing greater attention on how these various individual country systems can be meshed so as to be practicable.

Clausen agreed, adding that the international accord should establish strong, equitable, and verifiable commitments by all major economies. This should be accompanied by carefully structured transitional measures that cushion the immediate impact of these changes on U.S. energy-intensive, trade-exposed industries but provide incentives for their eventual graduation from such support, she said.

**China's Role**—Committee members discussed the critical importance of securing China's cooperation in global efforts to reduce carbon emissions. Senator Debbie Stabenow (D., Michigan), an erstwhile critic of China's trading practices, argued that the bill needs some sort of enforcement mechanism to ensure that China makes good on commitments to reduce carbon emissions. Senator Jim Bunning (R., Kentucky) concurred, arguing that no matter what Congress passes, “this will be pointless unless China acts.” Senator Bill Nelson (D., Florida) inquired

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*A punitive tariff on Chinese imports, in reality, would have very little effect reducing China's overall carbon footprint*

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about the utility of a punitive carbon tax on Chinese imports as a means of pressuring Beijing to sign on to and uphold its commitments under a global climate change agreement.

Horlick highlighted the potential WTO illegality of Nelson's proposal. But he also noted that a punitive tariff, in reality, would have very little effect reducing China's overall carbon footprint. This is because clothing is China's largest export to the United States, the manufacture of which is not very energy intensive. He urged committee members to consider that “incentives work better than threats” in the broader campaign to reduce global emissions.

Recapping his recent trip to China, Senator Kerry sought to assure committee members that Chinese officials, indeed, expressed willingness to commit to mutually verifiable reductions in emissions—but they made clear that this pledge is contingent on U.S. leadership by example. While this puts pressure on Congress to enact a regime, Kerry acknowledged that the controversial free allowances and border adjustment provisions—if retained in a Senate bill—create a conundrum in that they likely would undermine timely conclusion of an interna-

tional climate change accord.

**Energy Market Potential**—Senator Maria Cantwell (D., Washington) suggested that collaboration and energy-related trade provide a less contentious way forward for the United States and China. In the years ahead, Cantwell declared, “energy [will be] the mother of all markets.”

China wants and needs U.S.-developed energy efficiency tools for its commercial and residential construction needs, she said. Such trade would be a boon to the U.S. economy while also help to reduce energy consumption in China. Picking up on this point, Kerry noted that China is moving aggressively to become the world's leading producer of electric cars. This potentially could be a collaborative endeavor benefiting both countries, he suggested. ♦

### PECC General Meeting Features Session on Climate Change and the Asia Pacific

The 18th General Meeting of the Pacific Economic Cooperation Council (PECC), which was held in Washington, D.C. on May 12–13, included a session entitled, “Economic Recovery and Post-Kyoto Cooperation: Challenges and Opportunities.” The session was chaired by Ms. Joan MacNaughton, Senior Vice President for Power and Environmental Policies, Alstom Power Systems, and featured commentary by:

- **Prof. Kenneth Lieberthal**, Professor, University of Michigan and Senior Fellow, The Brookings Institution, who discussed the prospects for the pending U.S.-China Clean Energy Partnership and its potential as an open platform for multi-lateral participation;
- **Dr. Hu Tao**, Coordinator, China Climate Change Partnership Framework, UNDP, Beijing, who detailed China's efforts to promote green trade and the need for intellectual property rights protections for green technologies;
- **Mr. Hajime Ito**, President, Japan External Trade Organization (JETRO) New York, who considered how APEC could boost the prospects for the global climate change meeting in Copenhagen later this year; and
- **Dr. Hadi Soesastro**, Chief Economist, CSIS, Jakarta, and Member, Terrestrial Carbon Group, who explored appropriate policy responses to “green protectionism,” among other issues.

See <http://www.pecc18.org> later in July for the speakers' remarks.



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