



Washington REPORT

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

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Asian Imbalances, Currency Misalignments Require New Policy Solutions

USAPC Interview with Dr. C. Fred Bergsten

The Bush Administration has argued that the economic challenges caused by China's burgeoning surplus and undervalued currency are best addressed through engagement—a combination of bilateral dialogue and an “intelligent use of leverage” in the form of WTO suits and U.S. trade remedy actions. A growing number of U.S. lawmakers who regard the massive U.S.-China trade deficit as a threat to America's economic welfare have argued that “engagement” has not produced timely results. Some are advocating using protectionist means to resolve the twin problems.

Dr. C. Fred Bergsten, Director of the Peterson Institute for International Economics, offers new approaches for dealing with economic imbalances and currency misalignments that are not protectionist. Importantly, they would engage all the major Asian nations in a cooperative effort to ensure an orderly adjustment process.

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,¹ would not be enough. Japan, Taiwan, Hong Kong, Singapore, Malaysia, and the other member nations of ASEAN² are piling up surpluses and currency reserves that are at least as big as China's. So Asian nations are important in the

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Congress Considers Impact Of Sovereign Wealth Funds

Since the first of the year, Members of Congress have become increasingly concerned about the extent to which U.S. economic problems have created fertile ground for investment by Sovereign Wealth Funds (SWFs). In a one-month period, the U.S.-China Economic and Security Review Commission (USCC), the Joint Economic Committee, and the House Financial Services Committee held hearings to consider the extent to which SWFs help to strengthen the U.S. economy or pose national security risks.

The U.S. Treasury Department defines SWFs as government investment vehicles funded by foreign exchange assets, which manage those assets separately from official reserves. Nearly 40 funds currently maintain \$1.9–2.9 trillion in assets globally. According to some projections, these assets could grow to \$10–15 trillion by 2015, fueled by increases in revenue from oil and other commodities and large balance of payments surpluses in China and other Asian nations.

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Official Washington

In each issue, *Washington Report* provides the names and contact information for selected executive branch officials with jurisdiction over economic, political, and security issues important to U.S.-Asia Pacific relations. This issue presents pertinent personnel from the **Office of the U.S. Trade Representative**.

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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 because 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 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

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Hearings:

Congress recently devoted two hearings to issues important to Pacific Island nations.

● **“Climate Change and Vulnerable Societies: A Post-Bali Overview”**—The United Nations representatives from the Federated States of Micronesia (FSM), Fiji, the Republic of the Marshall Islands (RMI), the Republic of Nauru, and Samoa called on the United States February 27 to play a leading role in implementing the four-prong plan developed at the United Nations Climate Change Conference held in Bali, Indonesia in December 2007. “It is a scientific fact that sea level rise and soil erosion are threatening the very existence of some of the low-lying atoll countries of island states and cities in the Pacific,” Amb. Mason Smith of Fiji told the House Foreign Affairs Subcommittee on Asia, the Pacific, and the Global Environment.

The so-called Bali Action Plan calls for negotiations during the next two years aimed at (1) enhanced national and international action on mitigation of climate change; (2) enhanced action on adaptation to climate change; (3) enhanced action on technology development and transfer ; and (4) enhanced action on the provision of financial resources and investment to support action in the previous three objectives.

Subcommittee Chairman Eni Faleomavaega (D., American Samoa) criticized the Bush Administration for not signing the Kyoto Protocol. He agreed with the witnesses that Washington must step up to the plate and play a leading role in implementing the Bali Action Plan. However, some Republican members sharply disagreed. Representative Dana Rohrabacher (R., California), for one, questioned the “fear” generated about global warming and “non-sensical arguments” about the impact of carbon dioxide. The witnesses were visibly taken aback by Rohrabacher’s remarks. They

stressed there is undeniable evidence in the Pacific Islands of sea-level changes and climatic differences that must be addressed through global cooperation on climate change. “You don’t have to be a scientist to see these changes,” Amb. Charles Paul of the RMI said.

● **“The Impact of Increased Wages on the Economies of American Samoa and the Commonwealth of the Northern Marianas (CNMI)”**—The Senate Energy and Natural Resources Committee considered the impact of a recently enacted law that will increase the minimum wage in American Samoa and the CNMI by fifty cents per hour effective in July of 2007 and automatically every thereafter until 2014 for American Samoa and 2015 for the CNMI.

Congressman Faleomavaega told the committee that while he was pleased to see the wages of many of his constituents increased by this law, he is worried that further increases—the so-called escalator clauses—could be harmful to American Samoa’s economy. Faleomavaega is concerned that the automatic wage increases will prompt the tuna canneries on which the island’s economy largely depends to move their operations to Thailand and South America where wages are lower. “We must slow down the departure of [the] canneries until the [American Samoan] economy is diversified,” he told the committee. Faleomavaega expressed interest in working with Committee Chairman Jeff Bingaman (D., New Mexico) on a “legislative fix” that would address his concerns.

Concerning the CNMI, Jay Berman, Senior Economist at the Labor Department, told a similar story. He said automatic wage increases would exacerbate problems in the CNMI’s already declining tourism and textile industries. Consequently, CNMI workers increasingly may move into U.S. labor markets, further propelling the island’s downward spiral.

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Sovereign Wealth Funds

China’s SWF—SWFs have existed for decades in places as diverse as the South Pacific and the Persian Gulf. However, China’s creation of a \$200 billion fund in September 2007—the China Investment Corporation (CIC)—appears to have set off alarm bells on Capitol Hill about the potential influence of these entities on U.S. economic and national security interests.

Even prior to its formal incorporation, the CIC invested \$3 billion of its reserves in the Blackstone Group, a leading U.S. private-equity firm, representing 9.9 percent

share. In December 2007, China’s SWF followed this up with a \$5 billion investment in Morgan Stanley, which also represents a 9.9 percent interest.

Suspicious Motives—Chinese authorities have maintained that they have no intention of using CIC investments to harm the U.S. economy. They seek only to maximize the rate of return on CIC’s investments. Indeed, some experts point out that SWFs, in principle, are stable, long-term investors that have an interest in and the potential to promote financial market stability.

Some Members of Congress nevertheless are skeptical that CIC’s investments are commercially driven. “China’s drive for economic advantage, including rampant

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between what Chinese officials say and what they do. In that same period in late 2007 to early 2008, there was 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, also have begun 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 establishing a Substitution Account at the International Monetary Fund (IMF) to help ensure that currency realignments proceed in an orderly manner. Please elaborate.

Bergsten: In the short-term, a Substitution Account at the IMF would help to prevent the dollar from going into a free fall caused by, for example, sudden and substantial movement from 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. 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 economy is about as big as the U.S. 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. We came very close to adopting the IMF Substitution Account.

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 deutsche mark 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?

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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

The outlook is quite bearish for the dollar and recent changes in the economic forecast add to that downward pressure

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 problems in the U.S. economy and financial system undermined our credibility in global economic and financial forums?

Bergsten: 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, 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 to 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. The rest of the world currently does not depend so heavily on the United States. However, the United States now is being held up by the strength of other economies, particularly in emerging markets in Asia. Nevertheless, 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 terri-

Our current economic difficulties, as bad as they are, will not undermine U.S. economic leadership

ble 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.

Bergsten

USAPC: As you mentioned earlier, there has 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 the potential impact of SWF investments on the U.S. economy?

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 interest rates at a moderate level and to prevent the dollar 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. Then, however, much of the 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 States³] 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.

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 you don't think that Congress should develop new regulations governing China's SWF investments in U.S. companies or financial institutions?

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. ♦

Dr. C. Fred Bergsten is Director of the Peterson Institute for International Economics. He also is a member of the U.S. Asia Pacific Council (USAPC). An expanded version of this interview is available at <http://www.eastwestcenter.org/ewc-in-washington/us-asia-pacific-council/>. Click on newsletter link.

Endnotes

1. 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/.
2. The Association of Southeast Asian Nations (ASEAN) is composed of Brunei, Burma, Cambodia, Indonesia, Laos, Malaysia, Philippines, Singapore, Thailand, and Vietnam.
3. 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.

Sovereign Wealth Funds

intellectual property theft, currency manipulation, and subsidies for manufacturers and exporters raise serious concerns about how [its] sovereign wealth funds might be used," Senator Evan Bayh (D., Indiana) told the USCC on February 7.

Senator Jim Webb (D., Virginia) agreed with Bayh, saying the "political element"—referring to CIC's ownership by China's State Council—is the key difference between SWF and private foreign direct investment. "Undoubtedly some funds are interested solely in their financial return and will invest like a commercial investor, but we should not presume that all funds will act in this manner," Webb asserted.

Webb is not alone in suggesting that the unclear motive behind SWF investments may raise national security concerns. House Financial Services Committee Chairman Barney Frank (D., Massachusetts) said March 5 that Congress might want to develop new procedures that would subject foreign government purchases of U.S. financial assets to a higher level of scrutiny than foreign private investments. Other lawmakers have proposed regulations that would limit SWFs to strictly passive investments or set lower thresholds for SWF investments in U.S. companies or financial institutions.

Opacity—What causes U.S. lawmakers to assume the worst about the motives of CIC and other SWFs is their lack of transparency. The CIC, for example, is not publicly accountable, so little is known about its governing structure or fiduciary controls. "It is clear we need to find out more about [SWFs]—how they are run, what drives their investment decisions," Joint Economic Committee Chairman Charles Schumer (D., New York) said on February 13.

Schumer called upon SWFs to provide such information voluntarily and agree to guidelines that promote good governance and accountability. Bayh, in contrast, advocated "incentives for compliance and meaningful consequences for a lack thereof."

Avoid Protectionism—U.S. Treasury officials, who have been actively studying SWF activity in the United States for at least the past two years, have acknowledged that these investment funds raise potential economic and national security concerns. But they have urged Members of Congress not to address suspicions about SWF motives by closing the doors to foreign direct investment. Such a response, they have argued, likely will precipitate reciprocal foreign action, which will end up hurting U.S. companies at home that benefit from foreign investment as well as U.S. companies that have established overseas operations.

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EWC/USAPC Special Events

"The New Geography of Innovation—Asia's Role in Global Innovation Networks"

Dr. Dieter Ernst, Senior Fellow at the East-West Center, discussed the implications of what he has termed the "new geography of innovation" in a seminar at the East-West Center in Washington on February 14 organized by the U.S.-Asia Pacific Council. Asian governments are playing an increasingly active role as promoters and new sources of innovation, Dr. Ernst said. Perhaps not surprisingly, Asia's role in global innovation networks—driven by the resurgence of China and India—is increasing, although the United States, Europe, and Japan retain their dominance.

If Asian nations are to catch up to these leaders, they must bear in mind that the new geography of innovation is not a flat, rather it is hierarchical, he said. Concentrated network dispersion will give rise to a handful of new, but very diverse innovation hubs in Asia. But to fully realize this potential, Dr. Ernst emphasized that Asian policymakers must dismantle potential barriers to innovation by developing policies that will increase network integration both within and beyond borders. Dr. Ernst's special report, *Innovation Offshoring: Asia's Emerging Role in Global Innovation Networks*, is available at—www.eastwestcenter.org/.

"Asia's New Regionalism"

Asian governments are forging closer links and building new regional architectures, while globalization is fueling the spontaneous (re)integration of Asia's maritime regions, according to Dr. Ellen Frost, Visiting Fellow at the Peterson Institute for International Economics and Adjunct Research Fellow at the National Defense University. On February 25, Dr. Frost discussed the conclusions of her new book, *Asia's New Regionalism*, at a special program at the East-West Center in Washington.

Dr. Frost argued that Asia is witnessing a return to a pre-colonial maritime configuration that includes India to the West and stretches as far east as New Zealand. She said this regional "re-mapping," spurred initially by the emergence of regional entities such as the Association of Southeast Asian Nations (ASEAN), has as much to do with the search for national autonomy and stability as it does with economic expedience. Asian regionalism also reflects a growing awareness of transnational threats and the need to accommodate and hedge against China, according to Dr. Frost.

EWC/USAPC Annual Washington Conference

The U.S. Asia Pacific Council (USAPC), a project of the East-West Center (EWC), will hold its 5th Annual Washington Conference on April 11, 2008.

The day-long program—“**The United States and the Asia Pacific: New Challenges in a Changing Environment**”—will feature the commentary of distinguished experts from business, government, and policy institutions about salient topics in U.S. economic, diplomatic, and security relations with the nations of the Asia Pacific.

Keynote Speaker—John D. Negroponte, Deputy Secretary of State

Luncheon Speaker—James Shinn, Assistant Secretary of Defense for Asian and Pacific Security Affairs

Confirmed Speakers and Panelists include:

- Dr. Muthian Alagappa, Distinguished Senior Research Fellow, East-West Center.
- Dr. C. Fred Bergsten, Director, Peterson Institute for International Economics
- Amb. Stephen W. Bosworth, Dean, Fletcher School of Law and Diplomacy
- Mr. Marshall Bouton, President, Chicago Council on Global Affairs
- Ms. Angela Ellard, Chief Minority Trade Counsel, House Ways and Means Trade Subcommittee
- Dr. Michael Green, Senior Advisor & Japan

Chair, CSIS, and Associate Professor, Georgetown University

● Dr. Harry Harding, Professor of International Affairs, George Washington University

● Amb. Carla Hills, Chairman, Hills and Company

● Mr. Frank Jannuzi, Professional Staff Member, Senate Foreign Relations Committee

● Hon. J. Bennett Johnston, Chairman, Johnston & Associates

● Hon. Jim Kolbe, Senior Transatlantic Fellow, German Marshall Fund of the United States

● Dr. Satu Limaye, Director, East-West Center in Washington

● Dr. Charles E. Morrison, President, East-West Center

● Mr. William A. Reinsch, President, National Foreign Trade Council

● Dr. Stephen S. Roach, Chairman, Morgan Stanley Asia

● Amb. J. Stapleton Roy, Chairman, U.S. Asia Pacific Council

● Mr. Bruce Stokes, International Economics Columnist, *National Journal*

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Sovereign Wealth Funds

In addition, as some economists have underscored, foreign investments by SWFs and private entities largely have financed the U.S. current account deficit. “The likelihood of a gradual, orderly evolution of the U.S. current-account deficit—and the value of the dollar—will be higher the wider is the range of U.S. assets the rest of the world can reasonably purchase and the wider is the range of foreign investors, including SWFs,” Prof. Matthew Slaughter of Dartmouth University said on March 5. Thus, shutting the SWF spigot through new, more restrictive regulations would be highly damaging to the U.S. economy and, in turn, likely destabilize the global system, Slaughter and others have argued.

Balancing Open Investment/National Security—Treasury officials have proposed a multi-prong approach aimed at balancing the need for open investment with the need to protect U.S. national security. First, they have advocated continued reliance on the Committee on Foreign Investment in the United States (CFIUS), an inter-agency body that reviews all foreign investment transactions that relate to national security.

Second, to promote greater SWF transparency, Treasury has proposed that the global community collaborate on the development of SWF best practices under the auspices of the International Monetary Fund (IMF). Third, Treasury has urged that the Organization for Economic Cooperation and Development (OECD) to identify best practices for countries that receive foreign government-controlled investments. These best practices “should have a focus on avoid protectionism,” David McCormick, Under Secretary of the Treasury for International Affairs, said on March 5.

Finally, Treasury has taken a number of steps internally and within the U.S. government to enhance understanding of SWFs. The department also has engaged SWFs directly on numerous occasion in various forums, according to McCormick.

CIC Push-Back—Recent remarks by CIC officials may have undermined the case for open investment. On March 6, CIC Executive Vice President Jesse Wang told the *Wall Street Journal* that there is no need for a set of best practices because SWF investments do not threaten national security. “We don’t need outsiders [telling] us how we should act,” he was quoted as saying. Wang’s remark may fan protectionist fires in Congress. ♦

China's Military Buildup Still Lacks Transparency

The overall U.S.-China defense relationship continues to improve, but the continued lack of clarity about China's military buildup may affect stability in Asia and elsewhere by increasing the potential for misunderstanding and miscalculation, according to the U.S. Defense Department. *2008 China Military Power Report*, the Pentagon's congressionally mandated annual report issued on March 3, notes that in reality, Beijing spent as much as \$139 billion in 2007 to modernize its forces—more than three times its announced military budget.

"As China continues to grow and expand and influence the course of world events, it is important for us to have a clear understanding [of the intentions] of its military buildup," David Sedney, deputy assistant secretary of defense for East Asia, said in unveiling the report.

The report says that to date, Beijing has invested in

new generations of survivable nuclear missiles (capable of targeting the United and Asian powers), advanced short- and medium-range ballistic missiles, advanced attack and ballistic missile submarines, Russian aircraft and precision weaponry, multimission F-10 fighter aircraft, Russian guided missile destroyers, and long-range mobile air defense systems.

It says that China's military is developing capabilities for different military options against Taiwan, including an air and missile campaign as well as an amphibious invasion. But long-term trends suggest China is building a force for operations beyond Taiwan.

The Pentagon is particularly concerned about China's ability to use cyberspace to attack computer networks. "While we are not able to definitively label [recent network] 'intrusions' as the work of the Chinese military . . . the techniques that were used . . . certainly are very consistent with what you would need if you were going to carry out cyber warfare," Sedney said. The report is available at <http://www.defenselink.mil/pubs/china.html>. ♦

Regulatory Update

● **WTO Rules Against China On Auto Parts**—

On February 13, the World Trade Organization (WTO) ruled in favor of Canada, the European Union (EU), and the United States in a case about China's treatment of imported auto parts. The three-member dispute settlement panel issued an interim ruling which found that Chinese surcharges on imported auto parts "accord imported auto parts less favorable treatment than like domestic auto parts" and "subject imported auto parts to an internal charge in excess of that applied to like domestic auto parts." The panel called upon Beijing to "bring these inconsistent measures . . . into conformity with its [WTO] obligations." The WTO will issue a final ruling later this year, which likely will not deviate from the interim decision. If China does not eliminate the duties on auto parts imports, Canada, the EU, and the United States would have the right to impose sanctions on Chinese imports. The three nations formally requested WTO dispute settlement panel action on this case in September 2006.

● **3Com Bid Derailed By National Security**

Concerns—On February 20, Bain Capital LLC and China's Huawei Co. withdrew their application from the Committee on Foreign Investment in the United States (CFIUS) for approval of their planned \$2.2 billion buyout of 3Com Corp. CFIUS, a 12-agency government panel charged with examining the national security implications of foreign direct investment, appeared disinclined to approve the transaction. The committee evidently was concerned that the buyout would afford

Huawei—which allegedly has ties to the Chinese military—access to sophisticated antihacking software that 3Com sells to the Pentagon and other U.S. government agencies. In October 2007, key House and Senate lawmakers had threatened to block the 3Com buyout for the same reason. Bain and Huawei withdrew their application rather than have CFIUS outright reject the deal.

● **The United States And The EU File A WTO Case Against China Over The Treatment Of Foreign Suppliers Of Financial Information**—On March 3, the United States and the EU requested dispute settlement consultations with China at the WTO regarding China's treatment of foreign financial news organizations. In September 2006, Beijing issued new rules that required financial information suppliers, such as Reuters Group PLC, Bloomberg LP, and Dow Jones & Co., to operate through the China Economic Information Service, a distributor controlled by state news agency Xinhua, which is also their competitor. "China's restrictive treatment of outside suppliers of financial information services places the United States and other foreign suppliers at a serious competitive disadvantage," U.S. Trade Representative Susan Schwab charged. Washington further has argued that Beijing's new rules on foreign financial news organizations are even more restrictive than those in place when China acceded to the WTO. If the three parties cannot resolve the dispute via consultations, the WTO dispute settlement panel will then consider the case.



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