

CARNEGIE ENDOWMENT FOR INTERNATIONAL PEACE

**MR. OBAMA GOES TO ASIA:
DEFINING A REGIONAL POLICY**

WELCOME AND MODERATOR:

DOUGLAS PAAL,
VICE PRESIDENT FOR STUDIES,
CARNEGIE ENDOWMENT

SPEAKERS:

MICHAEL PETTIS,
SENIOR ASSOCIATE, CHINA PROGRAM,
CARNEGIE ENDOWMENT

TAIYA SMITH,
SENIOR ASSOCIATE, ENERGY AND CLIMATE PROGRAM AND CHINA PROGRAM,
CARNEGIE ENDOWMENT

MICHAEL SWAINE,
SENIOR ASSOCIATE, CHINA PROGRAM,
CARNEGIE ENDOWMENT

THURSDAY, NOVEMBER 5, 2009

*Transcript by
Federal News Service
Washington, D.C.*

DOUG PAAL: Good afternoon everyone. I hope you've all had enough to eat and have settled in comfortably. Welcome to the Carnegie Endowment for International Peace. My name is Doug Paal. I'm the vice-president for studies here and direct the Asia Program. We've invited all of you to come here because we want to take advantage of President Obama's impending trip through Asia to talk about a number of issues. Obviously, in this tight format and with so much else being said in so many other places in town, we'll pick and choose what we'll talk about today but leave the forum open for your questions and answers after our presentations

We're trying to kill several birds with one stone. One is to talk about the trip, and also to give a chance for all of you to see some of the people we've assembled here at Carnegie who are specializing in the region in various ways. First and foremost – well, let me start by telling you how we're going to proceed. I'm going to spend a few minutes just outlining the trip as I see it and main themes from Mr. Obama's trip. Then I'm going to introduce Michael Pettis, who's joined us this year.

Michael came to my attention because of his extensive writing, at the outset of the financial crisis, on China and the international financial scene. And I thought he seemed to be the most adept at understanding and explaining what's going on. He comes to us – I'll introduce him more fully in a few moments, but he'll be talking primarily about China's economy and its impact globally, which will be, obviously, a very important topic for the president's discussions in all of his stops, especially in Southeast Asia where he will be joined by President Hu Jintao and leaders of 20 other economies.

I'm then going to turn to Taiya Smith, who has joined us this year as well, who was very much involved in the senior economic dialogue with China on climate change and will be able to give a few insights into what can and should be done on the climate side of the president's agenda, especially in China, then turn to Michael Swaine for a look at the security issues that will be presented in the course of this trip.

Let me just begin with a quick thought about what's happening on President Obama's trip. I will have a longer piece setting forth my analysis on the Web site of carnegieendowment.org. If anybody's looking for elucidation or quotations, it'll be available there. My view of the visit – and I think it's not far from the government's own view – is we have a pretty good situation in East Asia, but we've been under-involved.

The United States, in the second Bush – George W. Bush term reduced its activity and involvement in East Asian meetings and didn't really focus on the concerns that matter to Asian populations. President Bush, in his visits to the region, often focused on counterterrorism and not on the issues that were highest on the minds of the Asians. This sense of inattention was accompanied by, of course, the palpable rise of the China that has much greater economic and political influence and military capabilities than was the case a decade or two decades ago.

And so you see one power, sort of, retreating and another power rising and it's created a sense of instability. I think the principal objective of the Obama trip, whether it's conscious or not, will be to rebalance the region, to give the countries that live around the rim of China a sense that while they will profit from their beneficial economic and other relations with China, that they're not going to be solely under China's influence – that there will be a counterbalance provided by others.

Lee Kuan Yew was here a week ago and spoke on this very directly and in the typical Singaporean fashion about Asia looking for a counterbalance to China in the region. And at the same time, the countries of the region are looking for the United States to show it can have a productive and constructive relationship with China.

And the president will have two days of stops in China, in Beijing and Shanghai, where I think a lot will be seen of the new levels of cooperation we're seeking to effectuate with China in the important areas of the financial crisis management, climate change and energy efficiency and nonproliferation, which is the code word for Iran and North Korea.

So I think that it's both a positive sign that the president's getting more involved in the region and the U.S. government is bringing its attention back to the region for those countries that have concerns about the future of China but also want to see China more involved in their lives economically and at the same time, reassuring that the United States will have a constructive relation – and not a confrontational relationship with China in the near term.

The president will stop first in Japan. He'll give a very important Asia policy speech there. This will be his fifth major policy speech since the ones he's given in Prague, Cairo and Ankara, and one other – I've forgotten the fourth one. This will set for the administration's main themes for policy in the region.

He's giving it in Tokyo, in part because in 1998, when President Bill Clinton went to Asia, he went to China and didn't stop in Tokyo. And he wants the Japanese public to understand that we're not bypassing Japan, that we're taking Japan seriously and it will be – remains America's most important ally in the region.

At the same time, the president faces challenges because there's a new government in Japan, which has stood for a lot of things in opposition to the government of the preceding 50-plus years. And there's a lot of the usual shakedown cruise problems of a new cabinet – not fully harmonized, campaign promises that are hard to realize. And so the president's going to have to walk a fine line between providing counseling and giving time to the Japanese side to work its way through its differences and at the same time lay down important markers about things that are too important to be left to political expediency in our alliance relationship.

He then goes to China. I've just discussed that. Excuse me, he goes to Singapore after that for the APEC meeting – the Asia Pacific Economic Cooperation forum. And that meeting will probably be stronger on form than on substance. The APEC movement has lost a lot of its trade liberalization focus in recent years and this is probably not a good time to focus on trade liberalization, given the economic setbacks of the last 2 years and popular concern about markets and jobs.

But there will be an important event at this APEC meeting and that is that the 10 ASEAN leaders from the Association of Southeast Asian Nations will meet with the president in a summit of their own. George Bush tried to do this a couple of times, but they stumbled over the inability to accommodate Burma. We had a strong policy of sanctioning Burma and the United States was not willing to meet in the company of the Burmese leadership.

Mr. Obama, I think, has wisely chosen to review Burma policy because, for 20 years, the policies of sanction and isolation have been unavailing and have been driving Burma into China's arms. And this is an opportunity today to send a signal to the Burmese that the United States is willing to work with them if they're willing to take some significant steps toward liberalizing their internal political situation.

I just read the account of Kurt Campbell, Assistant Secretary of State for East Asia-Pacific Affairs, visit yesterday with Aung San Suu Kyi and with the prime minister of Burma in Myanmar, Burma, however you call it. The U.S. has been laying down markers where we can make progress and break out of this cycle of isolation and sanction down the road. And this is a very important subject I think you'll be reading about as the president meets with this group of leaders in Singapore.

He then will go to China, as I discussed earlier, and finally exit through Korea. Korea and the United States are now enjoying probably the best state of relations in the last dozen years. The Lee Myung-bak government is very much in sync with the Obama government on how to handle North Korea and a host of issues.

Last Friday, the Korean government announced that it would be sending 300 troops and about 200 experts to Afghanistan to help with constituting a provincial reconstruction team – a PRT – in Afghanistan. This is a very positive contribution and it's one of a string of contributions the Koreans have been making outside their own region to security and counterterrorism.

We also have a very important, outstanding bilateral trade agreement with South Korea that really is due to be moved even though the climate here is not good for moving free trade agreements. So that'll be an important topic there. That's just a quick rundown of the stops that I wanted to leave you with and hope that that will provoke some questions after we have our respective presentations.

I now want to introduce Michael Pettis, who comes to us not just fresh off an airplane having got caught in the traffic in New York and, therefore, apologize to him for having to just jump on a stage as soon as he arrived here. Michael is really a Renaissance man. He's done investment banking; he's a professor at the Guanghua School at Beijing University, which truly has China's best students.

He's been teaching them how to think in ways that are not often available in Chinese schools. And he's also very popularly the founder and controlling presence of D-22, which is the hottest underground music scene in China today, and he's here in the United States touring with three of his groups, including Carsick Cars and some really top performers.

He's an active blogger and I recommend you go to – just look up Michael Pettis on Google and you'll find a whole host of thoughtful things to read that he's done. I'm grateful that he's able to come here today and present his views on the upcoming trip and where we are on the economy. Also, you should find available his latest policy brief he's just written for Carnegie. Michael?

MICHAEL PETTIS: Thanks. How long should I do this part?

MR. PAAL: 15, 20?

MR. PETTIS: Okay.

MR. PAAL: (Off mike.)

MR. PETTIS: Okay. The great thing about talking about China is that you can talk for a long time and you can say almost anything and it's plausible because it's so complicated. What I want to talk about a little bit is what it means for China and for the world if President Obama and Larry Summers do one of the things that they say that they want to do, and that is restructure the U.S. economy to put into place systematic, higher savings.

And that may seem like, sort of, irrelevant for China, but it's not because for the past several decades, and especially in the past decade, the U.S. and China have had a very interesting relationship in which Chinese savings have been, probably, the highest in the world, maybe the highest ever recorded. Certainly Chinese consumption has been the lowest ever recorded. And that was balanced by the U.S. with the lowest savings rate – savings rate down to zero – and the highest consumption rate, probably, ever recorded for a major economy. And we needed the two to work together like that.

But one of the things that the financial crisis had done is show the instability in this set of imbalances – both domestic imbalances within China and the United States – resulting in a balance of payments imbalance. I know that sounds like a contradiction but you'll see what I mean by it in a minute. If U.S. savings rise, by very simple balance of payments accounting identities a number of things have to happen. Or rather, I should say, a number of things might happen that accommodate that rise in U.S. savings.

And to go through them very briefly, one possibility is that global savings rise – I'm sorry, global investments rise. In that sense, you continue to have a balance between savings and investment, depending where that increase in investment takes place, that would have some effect on the trade balance and the capital flow balance in the U.S.

I think most of us would agree that with rising unemployment in Europe and the United States, that's probably not a likely outcome. In fact, it's probably safer to say global investment is going to decline, putting even more balance-of-payments pressure on the impact of rising U.S. savings. So some other things could happen. And I want to simplify the world and pretend that it's only the United States and China. Later on, we can relax that simplification; I don't think it changes the model very much.

But if the U.S. savings rate rises, then we're going to have to see one of three possibilities occur. If we assume that global investment doesn't rise in step with it or even declines, one possibility is that U.S. savings itself doesn't go up. That may seem surprising, that if the U.S. savings rate goes up, U.S. savings don't go up, but that just means that we have a contraction in U.S. GDP, as we did for the four quarters until the last quarter.

In that sense, the increase in the U.S. savings rate has a limited balance-of-payments impact on the rest of the world, on China in this model. That would be a very bad outcome for the U.S., of course. A second possibility is that we see a surge in Chinese consumption. Chinese consumption has been growing at about 8 to 9 percent a year in the last 10 years, which is a pretty good growth

rate. But it significantly lags GDP growth rate. And since GDP is equal to consumption plus savings, by definition if consumption is growing slower than GDP, the savings rate is going up.

And I'll explain a little bit why I think the Chinese savings rate is so high and rising. So the second possibility is that Chinese consumption surges from 8 to 9 percent a year, where it is now to maybe 12, 13, 14 percent a year, which allows China to continue growing at double-digit levels as it has in the past. The third possibility is that consumption in China doesn't grow or rather it grows at the continued, at the 8 or 9 percent that it's been growing over the last several years.

If that happens, Chinese GDP growth must come in below that over the medium term. In the short term, we can change that through investment. But over the medium term, as long as U.S. consumption was growing faster than U.S. GDP, that meant, for many years, Chinese GDP could grow faster than Chinese consumption. If we believe that's going to reverse itself in the next several years in the U.S. – that is, we're going to pay down debt and increase our savings rate, another way of saying that our consumption will grow more slowly than GDP – that means China also has the obverse over the medium term.

So consumption growth becomes the upper limit for GDP growth over the next several years and there is a good scenario and a bad scenario. The good scenario, of course, is that we see a surge in Chinese consumption that pulls GDP growth with it. The bad scenario is that we don't see a surge in Chinese consumption and, in fact, GDP growth has to slow significantly once the effects of the investment stimulus are over.

I'm going to argue that the distribution of pain between the United States and China – that is, whether we see a slowdown in U.S. GDP growth or – I'm sorry, let me rephrase that – whether we see a contraction in U.S. GDP growth or a significant slowdown in Chinese GDP growth – is going to be distributed through the trade account.

And it's for that reason that I'm fairly pessimistic about the outlook for trade tensions. I think we're going to see a significant increase in trade tensions. And the reason I say that is because I don't think Chinese consumption is going to grow nearly as quickly as people expect or hope it grows. Why do I say that? In order to say that, it's important to understand, I think, why Chinese savings rates are so high, why consumption rates are so low.

And we've been given many a reasons. Some of them are fairly nonsensical. For example, we often hear that Confucian cultures save a lot. That's not really true – in the 1940s and 1950s, when the problem was very low savings rate and persistent poverty. We also explain it by saying Confucian cultures don't save and they're fairly lazy people. We've switched that around so that Confucianism, sort of, explains everything. Probably not a very good explanation for the high savings rate.

We're also – the consensus has now developed that the reason Chinese save a lot is because of the non-existing social safety net or medical safety net. I think that's partly true, but much less true than we think. And it's part of a bigger phenomena, which I will try to discuss later. And one of the reasons I think it's probably not true is because if you look around the world, there really isn't that much of a correlation between the strength of the safety net and the amount of savings.

After all, countries that followed similar industrial policies as China has in the last decade, even if they had very strong safety nets like Singapore or Japan until quite recently, also had very high savings rates, whereas it's very easy for us to point to countries around the world – in Latin American, Africa, parts of Asia – that have no social safety net and very, very low savings.

So I'm a little bit uncomfortable with that answer as the explanation to why Chinese save so much. I would argue that it's very different. As we know, savings is simply the difference between production growth and consumption. Whatever you don't consume, you save. And in China, by definition, if the savings rate is going up, that's because production has been growing more quickly than consumption. Do the Chinese not like to consume? Not true.

Anyone who's spent time in China knows that the Chinese, like everybody else, love to consume. But if you look at Chinese household income, it has grown much more slowly than national income. Yasheng Huang estimates that over the past decade to have grown around 9 percent a year. I would argue that when you include other factors, it's been growing more slowly than that.

In which case, consumption growth of 8 to 9 percent a year is not bad. It's quite good. It suggests that Chinese are consuming as quickly as their household income growth allows them to consume. So the real question is, why hasn't household income grown so quickly? Why has it grown so much more slowly than production, which by the way is typical of many of the so-called Asian development model countries?

And the reason that has happened, in my opinion, is because the development model followed by China has involved a whole series of subsidies for the manufacturing in the state-owned sector. There are many, many ways they can subsidize it. And someone has to pay for subsidies and, of course, it's the household sector that pays for subsidies. What are the subsidies?

The one we like to talk about the most, of course, is the undervalued exchange rate. Undervalued exchange rates, as you know, reduce real household income by increasing the cost of imports and they act as a tremendous subsidy to the tradable goods sector. I think that's the easiest one to argue about and the easiest one to understand but I'm not sure it's the most important. I would argue that, probably, the most important subsidy is the interest rate subsidy.

Interest rates in China are not set by the market, they're set by the PBOC – People's Bank of China – the central bank. And they're set at very low rates. In fact, over the last four or 5 years, lending rates have been negative in real terms as often as they've been positive. And there is a lot of theories as to what is an appropriate interest rate in a country like China, but nobody that I know of would argue that the appropriate interest rate is anywhere near the lending rate set by the PBOC.

Why does that matter? It matters because, in part, it explains one of the paradoxes of Chinese growth, which is why is one of the poorest countries in the world so dependent on very capital-intensive growth? I would argue that's not a surprise; that's not a paradox. It's because capital is basically free in China. And when you reduce the cost of an input, not surprisingly, producers use more than an optimal amount of that input. So Chinese companies are very capital-intensive, especially the state-owned sector, and they're very capital-intensive because capital is basically free.

Well, no, it's not free; it's never free. It's free to them. But who pays for that? Of course, the household sector through extremely low deposit rates. How big is the subsidy? It's very hard to explain the amount of the subsidy without developing a theory of interest rates, but there was an interesting study done by a think tank in Hong Kong in which the question they asked was not, "what is the right interest rate for Chinese companies to pay?" It was a little bit different.

Chinese state-owned enterprises pay a lower interest rate because of the perception of the social – blah – credit risk is gone – easier to say – than large Chinese corporations. And so what they did is, they said, what would happen to SOE profitability – SOE is state-owned enterprises – if SOEs paid the same interest rate, adjusted for leverage and size, as large Chinese corporations.

And their finding was that 100 percent of the profitability of the SOE sector is explained just by that subsidy. So if you include other forms of subsidy – the fact that interest rates, in general, should be higher; the fact that energy prices are controlled; that land prices are often controlled for the SOE sector – and throw in the undervalued currency, it seems that there are fairly large subsidies provided to the manufacturing sector from the household sector.

So to me, this is at the root of the high savings and low consumption of China. Households are forced to pay to make viable otherwise nonviable investment – very low-returning investment; perhaps even negative-returning investment. And that constrains household income growth while it boosts growth in national income and total production. And as the gap between the two grows, that's the savings rate that's growing. And not surprisingly, that also requires a high and rising trade surplus.

So why can't we change that? As we all know, the government has engaged in major policies this year to boost the economy fiscally, monetarily and most importantly, by a massive credit expansion. I would argue that that increase in investment has exacerbated the underlying imbalance in China and is likely to result in further constraints on consumption growth. Why? It's often said that China, as an underdeveloped country, has lot of room for improving infrastructure investment. I'm not sure I agree with that. I think China probably has the best infrastructure investment in the world for its level of development. And that's a very important point.

Poor countries don't have the same optimal amount of infrastructure as rich countries. The easiest way to think of why is simply the value of infrastructure to the extent that it increases worker productivity or reduces the amount of time worked is very, very dependent on the levels of productivity. So if you compare, for example, Japan with China – a comparison that's often made when speaking about the scope for infrastructure investment, Japanese workers are much more highly paid and much more productive than Chinese workers. So you can think about, in one sense, saving an hour's worth of Japanese time is economically more profitable than saving an hour's worth of Chinese time.

So that to spend the same amount of money in infrastructure in the two countries, in my opinion, is pretty meaningless. Nonetheless, there has been a massive increase in infrastructure investment. Not as much as people think. A lot of the expansion went into the stock market, into real estate speculation, into commodity stockpiling and into the productive sector, into increasingly capacity in a whole variety of industries.

And my concern is this – that if that investment is not viable – and remember, China began the crisis with the highest investment rate in recorded history and already, many of us believed that a significant amount of that investment was misallocated and not viable economically. But from that very high level, it significantly increased investment levels. So the question is, how much of that increase in investment has been profitable, has been economically justified? I don't know. We don't know.

In four or 5 years, we may know. But my instinct tells me that much of it, and certainly the gossip and the rumors that we hear, is that much of it is not economically justified, that a lot of it is going to result in rising nonperforming loans in the future and, unfortunately, that means that Chinese households are going to be forced to subsidize this significant increase in investment.

And if that happens, if we're going to be asking Chinese households to pay massive amounts of money for infrastructure that they don't fully need, for rising inventories which we're seeing, for increasing capacity in a world of contracting demand, then it's going to be also very difficult for them to significantly increase their consumption spending.

So I think I've gone, probably, beyond the 10 or 15 minutes but that's how I wanted to lay out the framework. If U.S. savings rise – an important “if,” you may agree or disagree with me – something else must happen. There are some good scenarios and some bad scenarios. I believe the good scenarios are improbable – an increase in global investment or a significant increase in Chinese consumption. And that leaves us the bad scenarios, which are contraction in the U.S. or much slower GDP growth in China. And it's through trade that we're going to fight over the share of the distribution. Thank you.

MR. PAAL: Thank you, Mike. I think this is going to be an interesting basis for us to analyze the statements that emerged from Beijing between our leaders on the question of how to handle the respective growth packages to stimulate our economies and the anticipated trade problems down the road. I hope everybody has a chance to make that contrast thanks to Michael's presentation.

I'd like now to turn to Taiya Smith, who is double-hatted here at Carnegie in our Climate program and our China program, to look at the – what we understand to be – a prominent part of the upcoming stop in China.

TAIYA SMITH: Great, thank you very much Doug. We're looking at climate change and everyone's talking about climate change with China, and especially in relation to this trip, for two specific reasons. One is because Copenhagen is coming up in December and the second is because we're worried about where does, sort of, long-term U.S.-China strategic cooperation go?

So to talk first about Copenhagen, about six months ago everybody was talking U.S.-China and the U.S. and China have to get together and come up with some agreement and then Copenhagen will be successful. That type of discussion has really changed a lot since President Hu made his announcements of what is China's climate change policy in September. The Chinese have done a very effective job of shifting blame away from them.

And that really leaves one country left to blame for Copenhagen not producing the result. And we're probably sitting right at the nexus of that blame here – maybe a little bit south of Mass.

Ave., but not very far. When Hu came out in September, he said that China was now incorporating climate change into the social and economic planning for China. And that was a big statement.

It's actually more important than the things he was saying about having the energy intensity for a GDP of dollar changing because it means that China has really taken this fully on at the highest levels of the government and is putting it into every aspect of their planning going forward. And what we've seen is an incredible amount of activity on a very pragmatic level.

So keeping in mind, in the Copenhagen negotiations, China's position is still that they're not going to have carbon caps; they want to focus on some kind of a carbon-intensity figure, and that China is a developing country and, thereby, in essence, leading the G-77 in the Copenhagen discussions, China actually looks pretty good as you go into the negotiations. They recognize that they have a problem; they're actively doing things about it.

And if we take a moment and just imagine the discussion between President Obama and President Hu at the Great Hall of the People, you can imagine that President Hu will be listing a long, long list of targets and commitments that China has made domestically to deal with climate change. And President Obama, I'm sure, will come back with the policies that his administration has put into place as well.

And the end conclusion of that discussion, we can hypothesize, is that they both will agree that Congress needs to take action. And we know already from Todd Stern – and many had suggested this before – that there will be no grand bargain between the U.S. and China announced during this summit; that the discussions are really going to have to take place on a much more pragmatic level.

So that leaves Copenhagen up in the air, and I'm sure there will be a lot of discussions with the climate change experts who are going along for this discussion about some more of the details of Copenhagen and how do we work on specific parts of it, and you know, is the Africa bloc pulling out of the discussions in Barcelona going to be that big of a deal or not. But you know for sure that there will be a good exchange of all of the different things that China's doing.

So that leads us to the second part of why we're discussing it so much. And this is a very active topic of conversation amongst the business communities in the U.S. and China. It's this idea that U.S.-Chinese cooperation in clean technology and mitigating and both adapting to climate change is a real area of cooperation.

So when we look across the scope of different issues that the U.S. and China are engaged in, you immediately come into the issues that Michael was just talking about: Trade tensions are likely going to rise. We've seen the tire case; we've seen some suggestions that things are more relaxed; we've seen the JCCT says, yes, American pork will be allowed back in China.

But there's no time for it; there's no timeframe for how these things are going to get worked out. And the potential, instead, is that we'll have increasingly complicated trade relations between the two countries. We already have complicated relations around issues of Iran; the other direction Michael will be talking about, the defense side.

There's one area that's really, really positive, and that's on how do we cooperate on energy and environmental issues. Both countries have enormous markets for this – the largest producers of greenhouse gases; there's lots of work to do. The Chinese side is able to do a lot of the production and manufacturing of these products. The U.S. side is providing a lot of the innovation.

Both sides – we've got lots of scientists and lots of engineers. And we know when you get scientists and engineers together in a room, they don't particularly care what country they come from. They do a great job of working together and finding pragmatic solutions. It's really when politics get involved that we have more complications and difficulties.

And so one of the real outcomes from this summit, hopefully, is going to be how are we going to get around the politics and get focused on the work at hand? Because you can talk for as long as you want in Copenhagen, but if the U.S. and China are actually doing pragmatic things to reduce carbon emissions, then we're making progress on climate change.

So look for some good agreements. In the pragmatic level, there's been discussion about electric vehicles and CCS technology. But also look for how are these governments saying they're going to get this done? Because what we've seen is the U.S. has been actively engaged with China, and China with the U.S., at the highest levels of the governments now for almost 2 years, and the question is, have we really produced and changed things in a way that's going to make differences in everyone's life? Is it easier for the private sector to work in both countries? Are we seeing new technologies developed and disseminated that we haven't been before?

So the real question that's coming out of this is, are the things the governments are engaging in things that were not normally done by the private sector? Is there money behind it? Are the governments actually committing more money? And are they setting up a bureaucratic structure that will help move this forward, and provide avenues for NGOs and academics and the private sector to be engaged in this area?

Because if this is really one of the few strategic areas that we can make progress on and that we have a real shared interest, then we need to see that our governments are working together in a way that's going to make that happen and produce the relationships and the growing trust between both countries in the short term.

MR. PAAL: Thanks very much, Taiya. Now, our next – in all of the four stops the president is undertaking, there will be explicit or implicit security agendas that we ask Michael Swaine, our senior associate who is in the final throes of finishing a book on U.S.-China relations and has written extensively on crisis management and grand strategy, to take a look at this aspect of the upcoming trip. Michael?

MICHAEL SWAINE: Thank you, Doug. Well, I just want to lay out some points about what I see as the major security-related issues that confront the U.S. in Asia and that relate to this trip that President Obama is about to make. And certainly, I don't have time to go through all of these in any detail; I just want to really touch on some points that I think relate to each of them and give my guess as to what, if anything, will occur through the Obama trip that affects them.

As I see it, there are six issues that really affect Asian security that are in the mind of the U.S. administration as this trip is about to be taken. The first, and probably the most important, is the

U.S.-Japan alliance relationship and the basing arrangements associated with that relationship in light of the new DPJ government that's come to power in Tokyo.

The second is the views and concerns/desires of the countries of Southeast Asia regarding the U.S. economic and political involvement in that region. And, related to that, the discussions that have begun about trying to move towards some kind of regional security arrangement. This is not really – I shouldn't say security – a regional arrangement; a regional community – it's not really directly related to security, per se, but it has implications.

The third issue is more bilateral in nature between the U.S. and China, and that's the military-to-military relationship, or defense issues writ large between the two countries. And then the fourth is also a bilateral, but relating to other countries that will not be visited during Obama's trip. But that is Chinese relations with Pakistan and indirectly with Afghanistan, or also directly, in some cases.

Fifth is the handling of the North Korea and Iran problems – nuclear issues. And that obviously has resonance and is important to the countries being visited on this trip, particularly Japan and China. And then finally, last but not least, building stability in the Taiwan Strait. I think these six issues really are the most important ones on the security agenda that face the U.S. administration and are related to this trip.

Now, the bad news on this is that I think it's unlikely that we are going to see anything that anybody would call a significant breakthrough or major development in any of these areas during the Obama trip. I don't think there's going to be some kind of new resolution of a particular point on an issue.

What we could see are statements that are designed, basically, to dampen down concerns, to reassure the countries involved and the region more largely that the countries are on the same wavelength in terms of their objectives or in terms of many of their approaches to dealing with some of these issues, but nothing that I would regard as what you would call, in the parlance, a deliverable – a concrete agreement that moves the ball much further down the field. So having said that, let me just speak briefly on each of these issues in turn.

The first, the U.S.-Japan alliance: In my view, on the basing question, the Hatoyama government is still working out its bottom line on this issue. We have seen various comments coming out of the Japanese government by senior officials on this question of the relocation of the Futenma Air Facility, the Marine facility in Japan, in Okinawa. And it indicates that they are still in the process of dealing with this.

It is not going to be resolved before Obama sets foot in Japan, in my opinion. And part of it is because it is very much related and bound up in Japanese domestic politics now. It's not just a bilateral question. It's very much bound up in coalition politics within the Japanese government, and the position that the DPJ took before it came to power and the reconciliation of some of those positions, and the need that the DPJ government has stated to have some degree of reassessment or re-examination of the agreements that had been reached between the U.S. and Japan in 2006 on this issue.

That doesn't mean rejection, but that does mean there needs to be some interval of time to get their ducks in line and within the Japanese government and to get some kind of understanding with the U.S. government on this. So I don't see a resolution of this issue during the Obama trip; it's not impossible but I think it's not very likely.

On the alliance issue, here we've also seen some indications of views within the new Japanese government that you could say are somewhat all over the map in terms of the future of the alliance and the reliance on the U.S. nuclear umbrella and the role that Japan should take within the alliance. There certainly has not been an overall rejection of the idea of the alliance – far from it. Hatoyama has stated that this remains a lynchpin in Japanese foreign policy but nonetheless, he is also committed to wanting some kind of more independent posture on the part of Japan in its foreign relations.

He wants, it seems, a greater focus on intra-Asian interactions in terms of Japan's foreign policy, particularly in the economic arena. I'll get to this in a minute because it relates to the architecture question. He wants, I guess, what you could call less reflexive support on the part of Tokyo for U.S. preferences involving the dispatch of Japanese military assets overseas, in one way or another, that are not associated with a U.N. imprimatur or sort of U.N. authorization of one sort or another. And he wants, certainly, to deepen contacts with other major powers, particularly China, and an emphasis on political, diplomatic and economic contacts over ones that are led by or focused primarily on military counterbalancing of one sort of another.

Now, what does this all mean? Well, we don't know what it means. I mean, these are various themes that have come out, various statements that have been made. And I think that there is certainly much that needs to be done both within the Japanese government and in relations with the United States in clarifying some of these positions. And it will take some time to do this.

And I should say, as well, that the Japanese public is not in favor, it seems, of any kind of major restructuring of the alliance between the United States and Japan. There has been a consistent high level of support that has been indicated for the alliance, so I doubt very much that we're going to see some major changes here. I think probably a lot less than most people fear, at least most people in the United States might fear, in terms of changes in the Japanese position.

And so I think what you'll have in this trip, actually, is you'll probably have some very reassuring statements that will come out. Obama is due to make his major Asia speech while in Tokyo. I'm pretty confident that that speech is going to strike some very strong notes about the alliance, how important the alliance is, how much it's a centerpiece of U.S. policy in the region, to try to emphasize as much as possible the continued U.S. commitment and desire to have the alliance move forward.

And you're not going to get any pushback on that in any fundamental way from Hatoyama with Obama present in Tokyo. So a lot of positive statements, I think – some reassuring statements – but a lot of issues will remain hanging.

Secondly, now, on the issue of Southeast Asia and ASEAN and the security architecture in the region, I think Obama's presence in Singapore will be designed, as Doug suggested, to reinforce the message that's already been sent by Clinton during her trip in July – that the U.S. is strongly committed to Southeast Asia; that the kind of perception that the U.S. was not as actively engaged,

particularly on the political and economic side as on the security side in the context of counterterrorism, is going to be rectified – to have some reassurance there, in part, most likely to try and counteract some concerns about the increasing influence of China, although there'll be no explicit, deliberate, public statement of any kind by any U.S. official to that effect.

U.S. policy on that issue is fundamentally that China's involvement in Southeast Asia is very welcome and should continue. And I think that is the view within the U.S. government and they don't want to encourage the idea that what they're doing here is trying to counterbalance the Chinese; it's much more than that.

Now, Obama might make some comments, although I think it's unlikely, about all the discussions that have been occurring in recent weeks about an East Asian community. There has been, in two different contexts, discussion about this. One has been by Japan that's followed on statements that have been made by Hatoyama both in New York and most recently in Thailand, which have really raised the idea of some kind of larger, intra-Asian, EU-style arrangement that really needs to be developed within the region that includes all the countries in the region, that is very economics-oriented, that will take some time to build but is something that Japan really should take a leadership role in.

The Chinese government has responded to this and spoken alongside with Foreign Minister Okada recently in endorsing this notion of a larger community for the region. Indeed, China likes to think of itself as being a major force behind this effort, and has been in the past. ASEAN, however, also sees itself as having played a major role in this whole approach to building some kind of larger regional community.

And then you had, most recently, Kevin Rudd in Australia has come out and made a statement saying we need to move in this direction as well, but we need to make sure it includes the United States, and it probably should also have a strong focus on dealing with future economic problems.

So as you can see, there are differences here. And there's a desire to move in this direction. There are no details on this issue. I'm not sure how strongly it might resonate in meetings that the president might have on Southeast Asia. He may speak about it; he may not. Doug may have his own view on this; I simply don't know.

But it is an issue that's worth keeping an eye on because I think there are definitely many countries in the region that want to move in this direction. And the major players in the region see themselves as taking a leadership role on this. And the U.S. really, itself, needs to position itself and decide where it wants to be in the way of supporting this development.

Now, on the third point, mil-mil relations between China and the United States, issues that involve mil-mil relations in the defense area, in general, involving the operation of the two militaries in Asia, in particular, especially in the area of surveillance and reconnaissance and space-based capabilities: the issue of the growing reach and weapons capability of the Chinese military and, of course, U.S. arms sales to Taiwan.

All these defense issues are at the center of what could be tensions emerging between the U.S. and China in the future, in addition to the economic problems that Michael referred to, which,

I would believe, in general, are ones that could be dealt with through a negotiation, through structures that have been well-established by now – or fairly well-established – either bilaterally or multilaterally.

In the defense area, it's not so clear a picture. There are some very fundamental differences between the U.S. and China on the issues that I just mentioned. Of course, Major General Xu Caihou, the number two man in the Chinese military, has just visited Washington and toured various places and military installations in the United States. That reflects a significant improvement in the mil-mil relationship – the direct military-to-military relationship between the U.S. and China.

And I think it reflects the desire that exists on the part of both countries to deepen that relationship and to improve the level of contact between the two militaries. And Secretary Gates has most recently said – and Deputy Secretary Steinberg reiterated this – that there is a need for the mil-mil relationship to be, in some way, insulated or better separated from the ups and downs of the relationship.

So you've got that kind of desire but distrust remains very strong in this area. The EEZ intrusions that we saw earlier this year and, of course, the Chinese strong resistance to any further sale of significant arms to Taiwan have become major issues in the agenda for the Chinese military, at the very least.

And they are by no means resolved. The EEZ issue is nowhere near being resolved between the U.S. and China. And the issue of arms sales is, I think, continually being kicked down the road by the U.S. administration because it does not want to face the question of making a basic decision on this issue at this particular time for a whole host of reasons, and we can talk about that.

And then, in the context of all this you have the statement of what's called "strategic reassurance," that has now been coined by the Obama administration, which may or may not be restated by President Obama during his trip to Asia. I wouldn't be surprised if it is; it's regarded as the fairly significant, I think, concept here that has been unveiled by the U.S. government.

But we don't really know exactly what it means. It's another one of these terms where the implication is what it means is we need to be more candid with each other about what we intend to do strategically over the longer term so that we don't get into a security competition. Fine – we still don't know what that means. And that's not that surprising that it will have to be worked out through, I think, some level of dialogues.

Now let me just jump through the last few points here because I've already taken a fair amount of time. While I just should simply say that what Obama will say in this area of defense, the military will, again, seek to emphasize the positive on this trip. I don't think he's going to be raising issues in the areas I just mentioned that are designed to confront the Chinese on these questions.

The question of Pakistan: This is an issue where I think that there are sectors of the United States government, particularly the Pentagon, who want to see China, in particular, do more with Pakistan to deal with this question of the increasing level of terrorist activity that is going on in the tribal areas in Pakistan beyond what Pakistan is doing now as a way of trying to stabilize the situation in Afghanistan, as well as Pakistan, itself.

My view is that the Chinese are unlikely to comply with this in the sense in which the U.S. government would like to have them comply, or at least people in the Pentagon would, for a variety of reasons that have to do with Pakistan's longstanding relations with China, the interest that the Chinese have in Pakistan, in not being simply signing onto a U.S. agenda on this issue. There's a whole host of different questions. We can discuss that in the Q&A.

So bottom line is, I don't see this as playing a major role in anything that's going to happen on the Obama trip at this point. You're not going to see any kind of meeting of the minds in terms of greater Chinese involvement on this issue in Pakistan beyond joint statements about counterterrorism and the need to control or oppose terrorist activities in the Middle East, which the Chinese have made numerous statements about over many years.

Now, North Korea and Iran are somewhat different. And I'll try and be very brief here. China's view on this, I think, is that Beijing believes that it has brought the North Koreans, now, back to the point where they're willing to go back to the negotiating table, and that this was a significant accomplishment. They've, in effect, stepped back from their more extreme positions – the North Koreans – that they took in the spring and summer of this year, and are willing to re-engage on negotiations.

So the Chinese attitude is, basically, we brought the North Koreans back; now it's up to the United States to come in and close the deal by having a direct contact here that will lead, at some point, to multilateral talks and, hopefully, a resumption of the Six-Party Talks and a revival, from the U.S. side, of the original agreement of September of 2005 for North Korea to commit to denuclearization.

Of course, there's a lot of bumps along the road to getting to that point and the North Koreans have by no means altered, fundamentally, their position that they took in the spring and the summer. They've basically said we're willing to discuss the denuclearization of the peninsula. And they combined that up with a lot of larger issues that are not game-starters for the U.S. side. These are not basic starting points for talking with the North Koreans.

And the U.S. has thus far held tough on this position. It's not going to get drawn back into negotiations so the North Koreans to renegotiate yet again a set of agreements for a new set of incentives to give the North Koreans to get back to where we were six months or a year ago. And so because of that, I don't think you're going to see anything happening between now and the Obama trip or doing the Obama trip. I mean, Bosworth may go to North Korea and have a meeting, but I don't think it will result in much other than the fact that he goes to North Korea, although that's not by any means clear at this point, either.

So I think you also – on the Iran issue, you're not going to see much in the way of any statements because even less than in the case of North Korea is China regarded as a critical player in dealing with Iran. I mean, in the North Korean case, you could make an argument that it has played a very important role. In the Iranian case, the Chinese, even more so today I think, are able to take a more hands-off position against any further pressure on Tehran, against any further sanctions, in part because the Russians are not going to go in that direction at all.

And the Chinese have much more running room, given the Russian position on this issue. And so they will try to continue to keep this balancing game of not wanting to seem like an outlier

against what the U.N. has wanted to achieve vis-à-vis Iran while, at the same time, preserving its equities with the Tehran government, which are very substantial. And this situation is not going to be changed between now and the completion of the Obama trip, so you won't get much going there.

Last couple of comments, on the Taiwan situation: Here, even more so, I think you will get what you would regard as pro forma statements about the Taiwan situation. The U.S. stating, again, it's very happy with the improvement in cross-strait ties that has occurred since the Ma Ying-jeou government came into power. I don't think you're going to get a strong repetition of support for things like confidence-building measures, which had, in fact, been stated by a U.S. official in the past, but has been very carefully qualified because it is viewed by some in Taiwan as pressure on the Taipei government.

And the United States government does not want to convey that message at all. It was seeking to convey simply that the idea of more contacts and discussions that will reduce tensions and, therefore, in confidence-building areas would be useful. I don't think you'll see anything beyond very sort of anodyne statements in that regard during this trip.

You might see some kind of a statement by the U.S. or by President Obama urging Beijing to take greater initiatives to start the ball rolling in this area, again, on the question of missile deployments and such. But I wouldn't necessarily bet money that he will say even that. And I'll stop here. Thank you very much.

MR. PAAL: Thank you, Michael. As you can see from the presentations, when the president of the United States goes to four consequential destinations, there's a hell of a lot to talk about and a lot to do. And it's going to be, in many ways, chopped up and segmented by the media to get the story to ourselves and to the public out there. And you're going to have to read between the lines and kind of work hard yourself to understand a lot of what's going on.

On each of these topics today, we could have had an all-day seminar. We obviously can't do that. And we have a very diverse audience here today – people with all kinds of particular interests. Both in this room and in the room behind us, there are people. Here, we'll be able to call on you for your questions and observations. We ask, when we call on you, that you identify yourself.

We also have people in the back room – they will have cards to write their questions on because I won't be able to see their hands back there. And they'll be brought forward. And thirdly, we have people who are online with us today who will also be able to submit their questions, and they're very much welcome as we go forward. Now, let me open the floor here in this room. Please, sir?

Q: George Condon with Congress Daily. Let me ask you to talk a little bit more about the role that trade is going to play in this trip. Is there frustration by the leaders in the region that President Obama's failure to really outline his trade agenda? And is there a danger of these countries just giving up on waiting on the United States and going on their own trade agreements?

MR. PETTIS: It seems to me that for the next few years, there's not going to be a lot of progress on trade issues. U.S.-China issues get all of the headlines. But the fact is that trade relationships have been probably worse between a number of Asian countries, including China and

India, China and Indonesia, China and Korea, et cetera. We're probably going to be hearing more in Europe. So I don't really think we're going to get much progress in that direction.

I think the key issue for the Obama team is to understand a couple of things. First of all, it's going to be very, very difficult for China to change the structure of the economy quickly enough to satisfy American concerns about trade. It's going to be brutally difficult. And to the extent that we see a contraction in trade and a significant increase in trade tensions, that will make the process much more difficult.

I would argue that this can very easily lead to trade war and the historical precedents aren't good; we've seen it over and over again. I would argue because it is so important for China to be a committed member of whatever the institutional framework that evolves out of the global crisis, that the U.S. would need to bend over backwards – without giving everything away, but to get a commitment from China that it puts into place over the next five or 6 years, the steps that are necessary towards the steps that are necessary towards the rebalancing, and in exchange, it would be able to commit to leaving markets open and giving China as much room as possible to make the adjustment.

To mention one other historical precedent, remember that in the 1920s, the U.S. was very distrustful of European motives. It assumed that European institutions were aimed primarily at limiting U.S. rise. There were fights over debt payments and the linking of debt payments and reparations, and one of the consequences is the United States didn't play its committed role as a stakeholder.

It didn't join the League of Nations, it didn't participate in any of the multilateral currency-stabilization agreements, et cetera. And I think most historians would now say that U.S. failure to participate fully was much worse for the world and led to a lot of the imbalances and tensions in the 1930s. And I would argue that that's something that we need to understand in the U.S., that it's really important to make sure China is committed in whatever comes out of this. But my fear is that trade disputes are going to dominate and are going to derail the possibility of a serious engagement.

Should I address this now?

MR. PAAL: We have a question from Joshua Luna (ph).

Q: I'm not sure that either question was addressed, though. I mean, is there frustration by the other leaders that President Obama has not outlined or strategized it yet, and might they go unilaterally without waiting for the United States?

MR. PAAL: In my own contacts with regional leaders, I don't find frustration with the lack of a policy outline. There seems to be an acknowledgement that he campaigned in a climate of concern about free-trade agreements, and there will have to be a period of digestion, and that's been compounded by the economic downturn, which does not improve the atmosphere for trade agreements bilaterally or multilaterally in the region.

Now, this is a source of impatience, particularly in Korea, which is now two-and-a-half years after reaching the Korea-U.S. Free Trade Agreement, and it's going to be hard to sustain support in the Korean public – when there are quite strong divisions – for this agreement if it has to go another

year-and-a-half, wait for another election cycle in the U.S. before we're ready to deal with it. So I think, yes, the answer is both there's understanding and there's some frustration.

And I don't think the world's standing still. Michael's right, there's going to be tension, he's looking ahead. But right now, in the last couple of years, China has worked hard and we will see on January 1st the beginning of this new Chinese-ASEAN Free Trade Agreement, which is putting pressure on Taiwan to catch up through something they're calling the Economic Cooperation Framework Agreement, the negotiations for which have been delayed. So there's a lot going on in the world, and when we come out of our period of introspection on trade policy, we're going to find that a lot of people have different arrangements that we're now disadvantaged by.

Q: Thanks. My name is Steve Hirsch (ph), I'm a journalist. I cover the region periodically. Mr. Paal, you mentioned the ASEAN meeting, and you also referred to the administration's evolving Burma policy.

It's probably not questionable that for what seems to be the administration's new Burma policy to work, there would have to be some sort of cooperation from ASEAN members. Can you tell me if – what you expect – what do you expect ASEAN members to say about this to Obama, and do you expect that we'll hear anything about any of this? I could kind of phrase that better, but –

MR. PAAL: No, I understand your point, though, which is, is ASEAN going to cooperate with the U.S. in trying to bring Burma out of its shell in its domestic-political repression of the opposition?

Q: That's what I meant to say.

MR. PAAL: Yeah. (Laughter.) And I think ASEAN is going to try to cooperate. ASEAN has a new charter which is just being implemented which allows, to a degree that's unprecedented but to a degree we would find quite small, interference in each other's affairs. And as a preliminary step to sort of ASEAN telling Burma it needs to do more, and there's a lot of frustration among capitals with Burma because it has not done more. It has restrained ASEAN as a corporate body's improvement of relations with the United States, because they always have Burma there causing this problem.

So we've gotten in all kind of a push-me, pull-you where they went to Burma recently and they met Aung San Suu Kyi as well as the leadership and they said, we need some progress here so that then the Burmese can take part and ASEAN as a whole can meet with President Obama. And then you start an iterative process where you give a little more in Burma to the opposition party, allow Aung San Suu Kyi to meet with her party leaders, do some organization for the impending elections, slowly – presumably slowly – moving toward a freer atmosphere there, in exchange for which there will be benefits in terms of recognition and involvement in the broader international community.

And, and very significant, I think, a loosening of the stranglehold which China now has on Burma. Historically, Burma has never been comfortable with the tough, strong, hot dragon's breath on its neck, and – but they're not in much of a position now, having isolated themselves, to resist. One detects in their recent behavior a desire to balance that out somewhat, but they have their own

internal requirements to move slowly and cautiously, and the question is, which will motivate them more?

Q: Do you think –do you see ASEAN countries taking any action to exert pressure, either cooperation with American sanctions or other, harder action?

MR. PAAL: I think ASEAN will express itself in a variety of ways. We probably will have – be hard-pressed to detect it. Things will be said. I don't think the Thai are going to stop buying Burmese gas if they don't move quickly. A lot of things are not going to happen that will force Burma to move, but there'll be the subtle ASEAN diplomacy, again, at an unprecedented but rather small level more intense than before. Bronson?

Q: Hi, I'm Bronson Percival from CNA. I'm not a journalist. First of all, I just wanted to make a comment. We did some work recently on China and Af-Pak, and I think you're on the mark. I don't see why China should make major efforts where they don't have that much influence in FATA or in Afghanistan, and part of what we're going to be doing is trying to provide strategic reassurance for China about what we're doing ourselves in Pakistan.

But my question is this: For Doug and for Michael, do you see any possibility during the president's visit to Singapore that the South China Sea might come up as an issue, not as an issue in terms of the differences over the EEZ between the United States and China, but there are rising differences between South East Asian countries and China about how to handle an issue that had been put aside for a long time, and I'd just like your comments on that.

MR. SWAINE: My guess is that I don't think you're going to see much, if anything, in the way of any kind of comments about this. The president has, if I got this right, Tokyo first, Singapore second, Beijing third, South Korea last, right? I don't think he's going to make statements in South East Asia that will set up a bad trip to China.

So even if countries in the region were to express their greater concerns about what China's doing or the impact of military whatever, issues to do with the Chinese, I don't think you're going to have this reflected in any public level in what's said. But I could be wrong. What's your view on it, Doug?

MR. PAAL: I think it's a little early, Bronson, to take this on, not only because of what Michael just said but because we have to sort through ourselves what it is we stand for on this subject. Obviously, we believe in freedom of navigation; we would never have signed the Law of the Sea Treaty if we didn't. The Law of the Sea Treaty would never have come into effect if the major maritime powers would agree to what China says is its special rights in their economic zones. China, India, Peru and a couple of other countries take exception to the general agreement.

We need to establish a principled position on that. I think there's overlap with the six claimants to South China Sea-territory among the ASEAN 10. Finding a diplomatic way of harnessing their energies and ours together to achieve a better outcome on this subject is going to take some time. We need the preliminary thinking about it, take the thinking to the action phase, action to diplomacy and then see what kind of iteration we can get going with the Chinese.

I'm hoping, here at Carnegie, to begin a series on the subject of the two really tough issue areas that lie before us where there's a lot of uncharted territory: the maritime frictions, because China's a new maritime power, and space. Space is another area where the rules are not clear. The Bush administration took a position that's led to certain consequences that are now becoming quite concerning, and these are areas – again, we're not going to get a quick policy adjustment on, but it will be – I think a responsible administration will attend to them in due course.

MR. SWAINE: Just a note on that, that – I mean, I think it's – and this is sort of implied by what Doug just said. There's also the issue that within the U.S. government itself there isn't clear recognition that this is issue is something where the United States needs to sit down and really reflect on its position more and work out a position that is going to be more congruent with that of other countries and thereby deal with any kind of outliers, whether it be the Chinese or anybody else. I mean, there is a viewpoint, I think, in parts of the U.S. government that basically says, our position is exactly what it should be.

And our interests in this regard are exactly supported by our position, so opening up this can of worms could lead us into situations that we don't want to go – to places we don't want to go, or at least people in the U.S. Navy certainly don't want to go. And that's an issue that has to be resolved within the U.S. government, I think, even – first, even though there are those people, as Doug says, who recognize that you need to have this larger coordination with other powers, there has to be this understanding within the U.S. government and somebody to take the lead to say, this is an issue that has to be reassessed, and that hasn't happened.

MR. PAAL: A question back here, and then we have a written question that Michael will take in a moment.

Q: Bob Tanzy (ph) from the Nature Conservancy. I've got a question for Michael Pettis or Taiya Smith or both. And I think we would agree with Taiya Smith that it makes sense to be optimistic on greater cooperation on climate and energy, and we'd even be hopeful that just like President Hu took the occasion to show what China's doing in these areas, that China might be more open to working with others in terms of its global ecological footprint. And my question is, how do you see possibilities for a shift in China's domestic spending to invest more in basic needs, in terms of health, education and particularly the environment? Thank you.

MR. PETTIS: We've been talking about this for a long time. I don't think as much has been done as has been promised, which is perhaps not a surprising thing. But my concern is that many of the solutions that we're going to need for the rebalancing of the Chinese economy, including spending more on health and education, basically amount to a reversal of that transfer of income from the household sector to the corporate sector.

And there's – I won't mention his name because perhaps he doesn't want it to be so public, but there's a well-known Chinese academic who once told me that the biggest problem with my analysis is that I'm insanely optimistic. (Laughter.) And I asked him what he meant by that, and he said, you know, the financial crisis is the best thing that could have happened to us. And I said, why? It's going to be really bad for you. And he said, yeah, but at least it's going to force us to do what we should have done five, six, 7 years ago, when conditions were really good and when we didn't.

I think he's partly right. I think it's more difficult than ever now to make those systematic transfers. There are attempts at doing so; there are attempts at rebuilding the health system or repairing the health system, spending more money on education, but the numbers really aren't huge. And I think that – here's my guess – my guess is that we're going to continue to see contraction in trade, which will act as a drag on growth, but next year and the year after, what we're going to be worrying about is not so much the contraction in trade but the impact of very high inventory levels, which I suspect are going to be very high.

And as we start bringing down inventory levels, that itself begins to have an impact on economic growth, and given all of these concerns, measures to reduce the competitiveness (sic) of the tradable-goods sector and the SOEs in order to transfer a significant amount of income back to the household sector I think are going to be politically quite difficult. The best time to do that of course is when the economy is booming, and that's exactly when you don't bother doing it, but I think it could be quite difficult to do that in the next few years.

MS. SMITH: I think I would agree with that and fall to what you are more likely to see is Premier Wen traveling through China and going to the places where you've got unrest. So we've seen that there are a large number of demonstrations average out across a daily rate of more than 50 a day dealing with environmental issues, and what we've started to see is that there's more engagement with the leaders saying, yes, we're paying attention to these issues. So while you might not actually see the money change, you are seeing a political tension to it and a significant political tension also the blogs and what's going on in the Internet and what people are talking about. So maybe no money, but political high-level attention.

MR. PAAL: We had a question from the back room for Michael.

MR. SWAINE: These are actually two questions, but they both relate to the alliance, the U.S.-Japan alliance. The first one is, if Japan fails to find a solution for the Futenma Military Base, the Marine base issue, what would be the worst scenario for the alliance?

MR. PAAL: Well, I think the worst scenario would be that you would have continued dragging on of this situation. There would be a lot of unhappy people in the U.S. government, particularly in the Pentagon, and in the Japanese Ministry of Defense in the self-defense forces. And you would have a lot of unhappy people in Okinawa.

Because this issue has been dragging on for so many years, it has served as a real irritant among many quarters, and I think if the Hatoyama government were to be seen as clearly obstructing some kind of resolution of this, either the '06 agreement or some modification of that that would be a sort of mutual compromise that could be arrived at, if – and that's a worst-case scenario from the U.S. point of view is to at all go down that road again.

But if the Hatoyama government were not to agree to either of those two things, I think it would become an increasing irritant that would be a cost for the Hatoyama government, and it would become a political liability for that government over time that would, I think, lead it to probably change its position, if it indeed were seeking to sort of – if it were seen as dragging this on for quite some period of time. Beyond that, I don't see it as fundamentally derailing the alliance or creating really disastrous consequences beyond what I've just said.

And the second question was, if Hatoyama's willing to pursue the East-Asian community without the U.S. presence, how will the U.S. react to that challenge? Well, I guess the first question is, would the U.S. see that as a challenge? The Japanese position has not been unambiguously to state that it is not in favor of the United States being involved in a future East-Asian community. Hatoyama has made a statement about it that is really trying to compare it to the EU, to say, you know, we have mutual interests within the region here that we might want to address economically, and they may or may not include the United States.

That's not a deal-breaker for the U.S. as far as I'm concerned. Much of it would depend on exactly what you're talking about – what kind of authority, what kind of influence would this organization actually have? And would it really have an impact on the United States' ability to conduct its affairs or to defend its interests in the region?

And all of those things remain quite unclear, and if it were evolving in the direction where it seemed as if this is something that the United States really needs to be involved in directly, then I think it would be very hard put – the Hatoyama government or any Japanese government would be very hard put to keep standing on a position or define a position of exclusion vis-à-vis the United States.

MR. PAAL: I'm going to take a couple of swipes at the second and first question as well. The second question about the gap between the U.S. and Japan on regional architecture – we're going to go through a tough period as this transition occurs in Japan, but I fundamentally have confidence in the Japanese people, the rationality of their government to reach a sensible compromise with us on any path they choose as they go forward, and I don't really worry about that.

And on the first question of what would be the worst scenario, I can't tell you the whole scenario, but I can tell you how the worst scenario would start, and that is, we stay at Futenmna, which used to be in the open fields but now is surrounded by a city with schools and housing and the like, and we have an accident that takes lives on a schoolyard or in a – in one of the apartment buildings because we haven't been able to move out of that airbase. Then the finger-pointing will start and the blame assessing, and I think that that would be my candidate for a worst scenario. The floor is open for more questions.

Q: Thanks. I'm Margaret Tawlib (ph) with McClatchy, and many of us who are going on the trip don't know very much yet about his public-speaking schedule, so I was hoping you could flesh out a little bit more about what you think will be a major policy speech on Asia in Tokyo.

MR. PAAL: Well, the first – that will be the major policy speech at the Keidanren Hall in Tokyo, and I have no inside information. I've been watching assistant – Deputy Secretary Steinberg, who spoke a couple of weeks ago and is going to speak again tomorrow. I would look closely at those speeches for trial balloons for the upcoming speech by the president. I think that he's going to also make an important address to the Asia-Pacific business community, which is a subordinate businessman's representation under APEC. And he's got one speaking opportunity set up for that.

He's not going to do the usual speech of a president in China going off to a university, but he will have an opportunity to go down to Shanghai and make remarks there. I don't know of any speaking – I think it's just bilateral meetings in Korea; there's not going to be a speaking opportunity there, other than the joint press conference.

And of course, there's work being done, as yet incomplete, on a joint statement between the Chinese and American leaders to summarize the benefits and concerns of the two sides after the meeting. In the back, yeah.

Q: Hi, Joshua Wu from the Department of Commerce.

MR. PAAL: Welcome back.

Q: Thank you. This question is going back to trade and linking sort of linking macroeconomic policy with specific upcoming trade tensions. What would be your suggestions as far as a persuasive message to the Chinese leadership? They tend to de-link some of the policies they're taking – industrial policies – with exports. And so what would be some suggestions as far as a macro message linking to future trade tensions? Thank you.

MR. PETTIS: Obviously, there's a lot of resistance to including a number of these policies in the context of trade – issues about interest rates, issues about wage growth, the ability of workers to organize – those are all treated as if they were non-trade issues, but ultimately, they are. Anything that affects the gap between production and consumption ultimately is a trade issue.

I'm not very optimistic that there really – both sides see eye-to-eye. For China, their issues of trade are limited largely to issues of tariffs, and maybe the currency. And I think for the U.S., it's a little bit broader, but it's very hard to bridge that gap. I mean, I'm sort of floundering here. Honestly, I don't really know, beyond a much more thorough discussion of exactly why the imbalances have occurred – and in China, it's very difficult to discuss that.

You know, any suggestion – you're not even really supposed to use the phrase “global imbalances” because that implies that it was not a U.S. problem; it was a global problem. And when you start from that position, it then becomes very difficult to discuss why savings rates are extremely high, what policies caused those very high savings rates, what are the trade impacts of those policies, et cetera.

So I'm concerned that we're probably going to see things get worse, in terms of trade, before both sides are able, very openly, to discuss what the issues are. But ultimately, I think it's going to be a multi-year agreement. It's going to take several years, and it will be quite difficult, I think, for China to do the rebalancing.

And I think the best way that, that would occur is if the U.S. slow down the process of the rebalancing as much as possible and, working with Europe, maintains markets as open as possible, which may be politically unpopular here. But I think it's in the best interests of the U.S. in the long term that we do make this transition as painless as possible for China. I just don't think both sides realize what the position is.

MR. PAAL: In fairness, Joshua, to the administration, which you serve, I think the president is not going to be engaged heavily in this kind of issue on this trip. We do have the strategic and economic dialogue, which meets on an annual basis. And they will have this on their agenda. And we also have the JCCT, of which you're a part and others, to address some of these issues.

I think down the road, that Michael is right: we're going to have an increasing pattern of trade problems, and I wouldn't be surprised if the second or third summit has the leaders directly engaged in these kinds of issues. It's just not the moment, today, for that. Yes, microphone, please?

Q: Hi, my name is Zhaojin Ji from SAIS China studies. I have a question for Mr. Paal. Do you know any culture and education or exchange between the U.S. and China well beyond the places on the visiting agenda?

MR. PAAL: You know, I haven't – thank you for the question – I haven't asked anybody about that. I don't go around asking all the details; I sort of look at the big picture. Maybe someone in the room knows and they can offer an answer.

I do know the president's going to Shanghai and he's going to be, I assume, trying to promote American – business support for the construction of the American pavilion for Shanghai expo. And in that context, there are plenty of opportunities to discuss the cultural and educational exchanges. And that's where I would expect those comments to be made. Thanks. Front row over here.

Q: I'm Tricia Zengerly (sp). I'm from Reuters. I have a two-part question. One is, on a broad sense, looking at the trip, what do you think it would take for it to be deemed a success? And I mean, more in a realistic way as opposed to, "of course it will be a success." And then the other issue is, how do you – how, if at all, do you see the domestic political situation affecting the outcome of the trip?

MR. PAAL: The domestic political situation where?

Q: In the United States.

MR. PAAL: Okay. No one else is jumping in here. (Laughter.) The flip answer to your question would be, once you read my paper on the trip, and if they do all the things I recommend they do, then that would be a success. (Laughter.) I think we've got a situation where a very welcome president – a new face, a new kind of American president – has just won the Nobel Prize, of all things. (Laughter.) He's got roots in Asia and Indonesia, of his own. He's got a half-brother in China. I think by definition, this is going to be a public relations trip.

My own feeling – and this goes back to my opening remarks – if Asians feel that the U.S. has re-engaged, following on Mrs. Clinton's first trip around the world as secretary in February, her follow-up visit this summer – the kind of visit that Condi Rice had missed a few times – I think the Asians will say, the U.S. is indeed back.

Longer term, we're going to have to answer the question, are we really back? Are we a wounded giant? Is China the tiger in the woods that's getting fatter and stronger and the U.S. is getting leaner and older, or is the U.S. reviving itself? And so I think that's a very interesting question and that won't be answered on this trip.

Domestic politics here – obviously, everybody would like to see the U.S. get back into the trade liberalization game in Asia because they all need markets to boost their economies and they know that the domestic political constraints on that are in place and are going to affect the outcome

of the trip. I don't think the three elections that were announced yesterday is going to play in anybody's thinking on the subject, certainly not among the hosts for President Obama and his team. Follow-up?

Q: I'm sorry, what I also meant was, in terms of anything that the president might want to try to do that might be a little less popular with the domestic audience – and I guess a lot of that does have to do with trade. I mean, when he's trying to push through health care, when he's trying to push through financial regulation, is that going to constrain him at all on the international stage?

MR. PAAL: Well, to answer your question in the most general way, he obviously doesn't want to lose constituencies in this country when he needs their votes for the upcoming health-care debate, and so things like – he'll voice strong support for the 421 that was brought against Chinese tire imports, because there's a constituency there. And I think that, that's – it would be a general admonition to avoid topics that might lose support. He'll probably push for American farm exports because 50 states produce farm exports. But those are so general as not to be very helpful to you. I'm sorry. Over here?

Q: Hi, I'm Ben Carliner from the Economic Strategy Institute. Mr. Pettis, I appreciate your points about the potential for rising trade frictions, but I was wondering if you could expand your analysis to talk about the international monetary regime and in particular, what the prospects are for any future internationalization of the renminbi and lifting of capital controls, but also the role of the Chinese in Obama's plans for fiscal and monetary stimulus.

Is there going to be discussions about that, do you think? Do you think the Chinese have a coherent position on whether or not they support it, whether there are any limits to the dollar purchases that they will continue to make?

MR. PETTIS: Thanks, that's a very good question and a very complicated question and a topic about which much has been written. And unfortunately, I think much of what has been written about it is almost nonsense. (Laughter.) The question about whether China will continue funding the U.S. fiscal program – well, first of all, let's step back a bit.

I remember reading an article by Niall Ferguson – one of his “Chimerica” articles – in which he suggested that the United States is, what, the spendthrift husband and China is the frugal wife and, for a long time, they were very happy because the husband spent what the wife saved and now the wife is very unhappy and wants the husband to stop spending.

I find that a little bit bizarre, because actually, what the wife wants is for the husband to spend even more, right? Because it is U.S. consumption that has driven export growth in China. And if the problem that China is facing is not that the U.S. is consuming too much; the problem that China is facing is that U.S. consumption, until the last quarter, was contracting fairly quickly.

That leads to another thing: One of the big myths, which we often hear about, is, is Beijing Washington's banker? No, not at all. Bankers have discretionary power to decide whether they're going to lend to you or not. If I'm your banker, I can decide not to lend to you. Beijing can't make that decision at the same time that it decides it wants to run a trade surplus. Beijing is very eager – China is very eager – to continue expanding its exports and to continue expanding its trade surplus.

What that means is that they have to recycle the currency. They have no choice. If you want a current-account surplus, you must recycle it. And if you don't recycle it through the capital account, you recycle it through the PBOC. There's a related question – the famous SDR question – should China be accumulating fewer dollars and more SDRs or more euros or whatever?

I found that whole essay a little bit bizarre, frankly, because – the March essay by Governor Zhou – because the SDR is an accounting unit. Any one of us in this room can create SDRs, right? We just have to accumulate our savings in a certain ratio of currencies. So if China really wanted SDRs, why didn't they invest their reserves 44 percent dollars and 56 percent euros and swissies and sterling and yen?

The reason they didn't is because the direction in which they recycled would have required either a contraction in their trade surplus or an increase in the trade deficits of those other countries. So for example, had they bought euros, they would have caused the euro to strengthen against the dollar, the U.S. trade deficit would have contracted, and the European trade deficit would have expanded. And I think people who are much smarter than I am about European politics say that that's impossible – that couldn't happen. Europe has very low political willingness or economic ability to run very large trade deficits, and I think that's widely understood.

So if you want to produce a lot more than you consume, if you want to run a trade surplus, there's really only one country big enough, if you're a big country like China, to be able to absorb it, in which case you're going to run a capital-account deficit with the U.S. in line with that current-account surplus. There really isn't a choice. Countries don't fund fiscal deficits; foreigners don't fund American fiscal deficits. They fund American current-account deficits and they have no choice. If there is a current-account deficit, they will fund it. If they don't fund it, there's no current-account deficit.

So China will continue buying as many Treasuries as it has a current-account surplus – roughly 60 to 70 percent of its current-account surplus will be converted into either Treasuries or equivalent dollar assets. That will go on for as long as China is running a current-account surplus, which may not be very long because it may be contracting quickly as the U.S. current-account deficit contracts.

By the way, this is a little bit of an aside, but it's related, and that is that this is not the first time we've had these big discussions about dollar hegemony and is it over. We've had it two times before – once in the 1960s and once in the 1980s. And I would submit that both times, like the current time, the reason we had all this discussion about the end of dollar hegemony was because there was a dollar glut caused, in some cases, by financing wars – Vietnam, Iraq – other cases, by the Marshall Plan and mostly by current-account deficits.

My guess is that if the U.S. current-account deficit comes down to within 1 percent of GDP, which I think is a reasonable number that it can sustain, over the next three to 4 years, the whole discussion about dollar hegemony will probably disappear, just as it disappeared after the U.S. current-account deficit in the late '80s and early '90s, and just as it contracted in the 1970s.

So I think there's a lot of heat about this reserve currency status, I think, we're probably going to find a little bit quaint in a few years. And certainly, the things that China will need to do in order to make the renminbi truly an international reserve currency, I think, would require significant

reform, including significant liberalization of the domestic financial markets. And I would submit that, that kind of reform is not technical; it is political before it's technical. And I don't believe we are ready for that kind of political reform yet.

MR. PAAL: Thank you, Michael, for really, an excellent and terse response to the nagging question of the summer – or the spring and the summer – that we've had to deal with over and over again. I think everyone will benefit from that answer. I'm afraid we've come to the end of our time and that's going to conclude today's proceedings.

However, we are going to keep our Q&A line open on the Carnegie Web site, so if there are questions that linger with you and you'd like to get answers from us, we will be glad to post those answers after you send the questions in. Thank you all for joining us today; welcome to Carnegie. (Applause.)

(END)