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UNCERTAINTIES IN CHINA'S ECONOMIC PROSPECTS AND THE BROADER PROBLEM OF GLOBAL IMBALANCES.

A presentation by Ambassador Richard McCormack
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SUMMARY

China's problems and vulnerabilities cannot be understood unless viewed in a broader economic and political context.

Unsustainable economic imbalances, including those involving China, are gradually increasing the dangers to the long-term health of the world economy. Other economic and political problems, including rising oil prices and America's out-of-control 700 billion dollar annual current account deficit, add to these uncertainties. Wise statesmanship and some important policy changes are needed. Above all, the United States needs a strategy to address its economic imbalances that includes a rapid major currency appreciation in Asia.

KEY ISSUES INVOLVING CHINA

Last spring, there was a lot of discussion in Washington about whether China would experience a hard or soft landing of its overheated economy. So to take a deeper look at this question, I visited China in August, with former speaker Newt Gingrich, and again in December to talk with central bankers, members of the Central Committee, key officials and investors.

This was my 9th trip to China since l983. To see the continual improvement in ordinary peoples' lives since those early years is a heartening confirmation of many hopes and the result of much hard work, both in Washington and much more importantly in China itself. The large number of hungry and ill-dressed children that were evident in every city in China in earlier decades, is now largely a thing of the past. All involved need to make sure it stays that way.

After these recent visits to China, I also traveled to Japan, Hong Kong, and Taiwan to meet with senior leaders from the public and private sectors to learn how China's prospects looked from the perspective of these neighboring locations.

Most, but by no means all, of the experts consulted suggested that China would, in fact, engineer a soft landing, with growth falling from its present 9-l3 per cent rate, depending on whose numbers you believe, to somewhere near 7% in 2005.

Even the hopeful experts, however, reported an unusually large number of downside possibilities that could result in a Chinese economic crash landing. Some went so far as to suggest that the breakneck pace of the Chinese economy was like a man surfing a giant wave off Hawaii. There was no possibility of slowing down the tremendous forces driving the surfer, only a desperate need somehow to stay on top of the hurtling board to avoid a bone-crushing wipe out.

In the meantime, the issue of a hard landing or a soft landing for the overheated Chinese economy has been temporarily answered: thus far, no landing whatsoever.

So today, I'm going to list some of these wild cards in the Chinese economic and political deck for your own evaluation.

There are obvious and growing strains in global oil markets. Experts from Goldman Sachs have recently projected that oil prices have the potential to double from the present $50 odd dollar a barrel level. Even a less dramatic oil price increase from current high levels would, of course, cause serious problems for China. China has only l5 days of reserve oil supplies, as opposed to 90 days' reserve in the U.S. strategic stockpile. Any lengthy new spike in global oil prices would obviously savage global equity markets, including those in the U.S., China's principal export market. An economy so massively driven by foreign trade and exports is deeply vulnerable should external factors like oil prices impact the health of China's overseas markets.

There are serious tensions in China between the experts in the central bank and finance ministry and many of the regional political leaders over the pace and direction of the cooling off process. Leaders in the central and western parts of China, where living standards are only about l/l0 those of the richer coastal province, resent the pressure from Beijing to cancel or delay their own investment and growth plans as part of the national campaign to prevent overheating and over capacity problems from spiraling out of control. The result of this tension has been a delay in the full implementation of Beijing's overall economic program to address the overheating problem. Indeed the effort a year ago to slow down overall growth in the money supply was abandoned in June of 2004 due to mounting political and economic strains that disturbed authorities.

China doesn't have the financial instruments of more advanced economies, such as deep bond and other financial markets, to fine-tune economic growth. They have to depend upon reserve requirements in banks and credit allocation by category and by geographical area. They also have to rely on compliance by unruly and sometimes corrupt regional leaders to carry out the edicts from the Center. But forbidden new factories, real estate projects, and golf courses are still emerging in China, according to earlier reports by Morgan Stanley's Andy Xie, which add up to more credit and monetary creation than China's Central Bank would like, generating ever more overheating in some parts of the

Chinese economy and growing excess capacity problems in other parts of that same economy.

Statistics in China are not always reliable, although they are better than they were ten years ago, thanks to help from the IMF and other experts mobilized by the Central Bank. The problem comes not just from bad news that the government considers a crime to report in the media, but more pervasively, from the distortions that flow from reporting from the provinces and are collected at the center. Naturally, provincial authorities wishing to keep their jobs, like to report to Beijing that edicts and goals are being fully complied with. This, however, is often not true. When you add up the individual inaccuracies and fudging, to produce a national statistic on growth, or even monetary creation, you can get major distortions in your statistical base.

There are l50,000 State owned enterprises in China. If you think Enron's books were not always models of probity, can you imagine the disparities between the published statistics on these companies, and the actual economic health of many of them? Can you also imagine what collective distortions appear when you multiply the fudging in the reports of individual companies by l50,000? This is particularly true of profit and loss statements, asset estimates, company debt and contingent liabilities, pension problems, etc. according to many close observers of the scene. This has important implications for China's banks, which for decades have been providing loans to these state owned enterprises to keep them afloat. These bad loans continue to accumulate inside the Chinese banking system. It is not clear that the published statistics dealing with this problem are totally candid, nor that the problems involving China's overall banking system are going to be improved a year or two from now, notwithstanding Chinese efforts to purge some of the bad loans from certain categories of banks.

Nor are the problems in the Chinese banking sector confined to bad loans to state owned businesses. Recently more and more scandals involving outright embezzlement in banks have covered the pages of the business press. Concerns about questionable loans to already overheated property and real estate markets are a frequent subject of discussion among concerned China watchers.

Last October, the China Bank Regulatory Commission conceded that the default rate on the 22 billion dollars of car loans extended since 2002 exceeded 50%. That is a truly shocking statistic, reported in the Financial Times on April 4, 2005. The possible implications are sobering, indeed, not just for what this says about credit quality in banks, but also about the grand strategies behind these loans. This continuous default rate cannot have been unknown to the authorities, yet they permitted credit to be extended to hundreds of thousands of people who obviously could not afford the upscale cars that were being sold to them. But the artificial demand stimulated by the lax credit standards encouraged automobile manufacturers to continue to build ever more manufacturing capacity in China. A steadily growing percentage of this excess capacity will surely find its sales outlets in the already overcrowded international auto market. This in turn is likely to add to China's trade surpluses, and create new deflationary pressures in this industry world wide, as Chinese car exports are ramped up in the years ahead.

In the meantime, ever more bad loans from all sources continue to mount in the banking system of China.

Top Chinese government officials reporting to the National People's Congress in early March of 2005, noted with concern that troublesome new financial and economic problems keep appearing as soon as they begin to address existing ones. This is characteristic of a state directed economy attempting to avoid the consequences of ignoring basic economic principles and powerful market forces. History tells us that such attempts usually end in tears. Many also believe that China's economic planners are running enormous risks for China and for the global trading system as a whole by attempting to accomplish through excessive credit expansion and ever growing exports the economic progress in one generation that should have been the work of two.

There is often a marked lack of full candor in discussing China's problems in public on the part of foreign business leaders and even some scholars. Those who wish to do well in China, are sometimes advised to speak well of China. Ultimately such silence or flattery does not serve either China or the cause of truth. Critical public pressure can sometimes help avert problems that otherwise could prove highly damaging to China's interest in sustainable growth and political stability and in a healthy global market place.

IMPORTANT CURRENCY ISSUES

The Chinese currency has been pegged to the dollar at a fixed rate since l995. This currency peg is favorable to China as an export platform, and linked as it is to currency regimes elsewhere in Asia, helps undermine the whole purpose of the floating exchange rate system, which was to permit an orderly, gradual and automatic adjustment between surplus and deficit countries. By contrast, China's present highly competitive currency situation and its impact on other currencies is intensifying the global imbalances and creating an ultimately unsustainable situation. In the case of China, a dollar-linked currency, combined with the inexpensive labor, has resulted in a massive annual increase in exports and foreign and domestic investment. Investment and exports at this rate are seen by the Chinese as critical to sustain China's over all economic growth and stability. Additional export-linked investment also increases the already existing dependence of this huge national economy on foreign trade as the primary driver of China's growth.

What are the problems with this arrangement?

Because of the central role of China as the hub and assembly point for much of the East Asian economy, neighboring countries like Thailand have been forced to intervene massively in the currency markets to maintain their own de facto dollar pegs. In Thailand's case, this is generating excess monetary creation, and growing inflationary pressures. Thailand is not an isolated example.

Many of the countries of East Asia are thus being pushed into a de facto currency bloc, regardless of the local economic circumstances in each of the different countries. Price

competition in China's inter and intra regional trade is incredibly fierce, and profit margins very narrow. Those countries now part of the growing hub and spokes economic system built around China are forced to toe the currency line imposed by China's standard to keep their products competitive. Even Japan is not immune from this pressure and will be more so in the future as China produces more and more high technology products for the global market. China will also inevitably gradually increase its share of value added of the products now assembled in China from regional imports for export market destinations. China has organized a huge national effort to accomplish this latter objective.

The bottom line here is that any currency adjustments in Asia will have to begin with one involving China. Until that happens, mounting pressures may continue to build at a different rate in different parts of this China centered system and more broadly in the global trading system as a whole. The great value of a floating exchange rate is that it allows pressures to be released at a gradual pace. Otherwise you have, in effect, a pressure cooker with the safety valve stuck, and this is a dangerous utensil, as history has repeatedly demonstrated.

Distortions and monetary policy problems from the current dollar peg also impact China directly. During part of 2003-2004, over one l2 month period, intervention by the Bank of China to sustain the dollar peg in the face of market pressures exceeded 200 billion dollars. This eventually triggered complaints by the U.S. Treasury, which became uncomfortable with the vulnerabilities of direct Central Bank intervention on this scale. The Japanese Central Bank and other central banks in Asia adopted similar tactics on a similar scale. Sustaining the dollar peg and the export advantages that flow from it appears to involve quiet but extensive consultations among a number of governments in Asia.

In China this massive Central Bank intervention in currency markets, which was not sterilized by contractions elsewhere, had the result of generating excessive monetary creation, with M2 growth exceeding 25% for a period of time. This was a recipe for overheating and potential future inflation. The Central Bank eventually found other market related means to help sustain the dollar peg, namely encouraging local insurance companies and others with surplus cash or credit to invest abroad, or purchase such assets as commodities and commodity producers to soak up excess dollars, in one of recent histories greatest buying binges.

This favorable exchange rate has helped China to expand her exports by 46%, year on year from June of 2004. This massive compound annual increase in exports has continued at an ever-expanding pace for years. This explosive increase in exports contributes to both economic and political problems for China's main export destination country, namely the U.S. In 2004, China's trade surplus with the United States was $l62 billion. Early trends in 2005 show an even higher rate.

During the past Presidential election, disaffected, unemployed, and worried manufacturing workers and their families in places like Ohio and Pennsylvania nearly

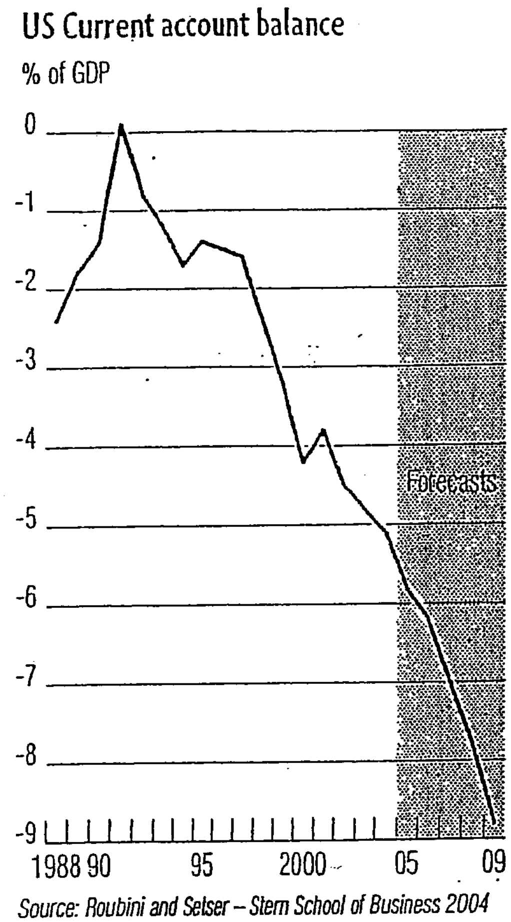
caused President Bush's defeat. If present relative currency and competitiveness conditions continue, these economic and political pressures are unlikely to ease in the years ahead. That means future problems in Congressional and Presidential elections, and steady increases in the political pressure on Washington to find new policies to deal with this situation.

There are safeguard provisions in China's WTO access agreement which could allow countries like the U.S. to limit the future pace of export expansion in some situations. Even the articles of the IMF have a balance of payments provision allowing countries with dangerous payments problems to take special measures to correct the situation. If the currency situation in Asia remains unchanged, and the U.S. current account problems persist, there will be inevitable Congressional voices urging the Administration to adopt such unilateral measures. The debt build up in the United States caused by the current accounts problem threatens the country's long-term economic health.

Earlier in the decade, China's overall trade was roughly in balance. The problem is that neither China's nor the Asian regional trade nor the rest of the world's trade with America is balanced. This comes partly from the Chinese currency linkage to the dollar that prevents China's competitors and component suppliers from allowing their own currencies to float. Recent pressure on the yen from Japan's large trade surplus has triggered hints by various government officials of renewed massive Central Bank intervention. Other Japanese officials have talked about diversifying some of their dollar reserve holdings to Euros, which would, of course, weaken the dollar and by strengthening the Euro, weaken Europe's competitiveness in dollar markets for such things as automobiles and aircraft. All this is suggestive of the dilemmas facing not just the United States, but many of our trading partners.

It is clear that the short-term trends are positive for those benefiting from the status quo, but it is equally clear that these trends, if sustained, will eventually kill or gravely weaken the American goose that lays the golden eggs, and from which much of the world's economic growth and stability depends.

SOARING AMERICAN TRADE AND CURRENT ACCOUNTS DEFICITS



(*Financial Times,* Wednesday October 13, 2004)

The U.S. current account deficit is now approaching 700 billion dollars per year, nearly 6 % of our GNP (See above). That means the U.S. must attract each and every day two billion dollars in loans and investments to fill the gap in its current accounts. Concern over how much longer a current account deficit of this magnitude is sustainable is rapidly rising around the world. What will happen to China's growth and highly leveraged new export oriented factories if a future Secretary of Treasury repeats what Secretary Baker did in l985 when President Reagan deemed the then 90 billion dollar U.S. current accounts problem dangerous for the long term economic and political health of the United States.

President Reagan was concerned that out of control current accounts deficits would eventually undermine the U.S. dollar, and that massive sales of U.S. assets to finance imports carried long term costs for the American economy. President Reagan also understood the key lesson of the l956 Suez debacle. This was an abortive effort by the British and French to prevent Egyptian President Nasser's seizure of the Suez canal,

Europe's trade life line to Asia. Notwithstanding the military success of the initial attack, when the modern armies of Britain, France, and Israel cut through Egyptian defenses like a hot knife through butter, it only took one phone call from President Eisenhower threatening to end all support for the vulnerable British pound to terminate the whole military campaign and force the resignation of Britain's prime minister, Anthony Eden.

President Reagan believed that the American dollar must remain an element of national strength, not the weak link in our armor.

Sustained, massive, current accounts deficits create long term debt to foreigners that must be serviced, ultimately by exports of goods and services. President Reagan and Secretary Baker moved vigorously to implement a program to address this problem. They began by talking down the dollar and gradually added a number of important but controversial macro and micro economic measures aimed strengthening U.S. competitiveness and its current accounts position. These measures and others, for a time, brought U.S. current accounts into balance. There were also unintended consequences from part of this major shift in policies, which included a linkage between G-7 monetary policies and relative currency rates that may have contributed to the l987 stock market crash. During the decade that followed, a far worse long term deterioration resumed. After years of neglecting this problem, America's net external debt now amounts to 3 trillion dollars. New trade agreements provided little help, notwithstanding all the hopeful speeches and op ed pieces to the contrary.

Looking at this problem today, officials from the Treasury Department and those from the White House Trade Office (STR) sometimes privately point to each other as being mainly responsible for America's out of control trade deficits. The one side cites inappropriate macro economic and currency policies. The other points to weakly enforced and, in some instances, poorly crafted trade deals. Many neutral observers believe that America needs both macro and micro economic remedial measures

At least on currency ratios, the status quo seems to many observers, including the Financial Times, very unlikely to continue much longer. Should a future dollar crisis develop, China is unlikely to be allowed to retain its current dollar peg, forcing the full brunt of the adjustment onto the Euro and other currencies which freely float. Otherwise, the European auto export industry's head would only be the first on the chopping block.

If existing relative competitive conditions continue, including currency ratios and inadequate enforcement of WTO rules, additional investment decisions relocating U.S. manufacturing plants and creating new export facilities in China and elsewhere will undoubtedly occur. This means even more pressure on U.S. current accounts and more long-term U.S. external debt. When any eventual dollar crisis does come, perhaps triggered by loss of faith in future U.S. macro economic policies, or by a sudden economic shock of some kind, the sudden adjustment difficulties for all involved could be very great indeed.

FACING THE PROBLEMS

No one should underestimate for a moment the complications and difficulties that could accompany an effort by officials to deal with global economic imbalances, including possibly some highly negative unintended consequences. At the very least, adjustment pain and transitional impact on financial markets could be highly unsettling. It is, however, unlikely to be any less painful if we wait until the U.S. accumulates another trillion or two dollars of net debt through continuation of the status quo. It just means that the U.S. will have a deeper hole to dig out of, and more newly constructed export facilities abroad will have to find other markets, or close. Additional production facilities to serve an unsustainable export market also makes more likely a final burst of deflation in products with excess capacity. These and other adjustment problems that could flow from an effort to deal with global imbalances and excess debt building up in the United States, may not fully unfold, but officials need to be mindful that they easily could.

If policy measures addressing the U.S. relative competitive situation are implemented, there will undoubtedly be a new burst of investment in manufacturing in the U.S. itself. After the Reagan/Baker reforms, for example, more and more foreign auto makers built cars and car parts in America, rather than importing them. The same presumably would happen again. America has an absolute requirement either to cut our overseas purchases dramatically, step up our exports of goods and services, or some combination of the two.

Other deep seated U.S. deficiencies may also need to be addressed if the longer term problems are to be corrected. For example, after the shock of Sputnik in the Eisenhower and Kennedy years, the United States undertook a number of measures to make its young people more competitive in science and technology, including revamping the entire educational system. The influence of this effort was felt in one degree or another in nearly every school in America. The intellectual capital which grew from those early government funded and encouraged efforts not only put a man on the moon in ten years, but America's entire economy profited from the technological breakthroughs and spin offs that resulted. This historical experience should not be altogether forgotten as we address our current problems. Indeed, Bill Gates of Microsoft has recently urged the American Government to provide leadership in this critical area.

If we mobilize ourselves again to become more competitive internationally, and devote additional billions of dollars in public and private funds to education, research and development, and science and technology, we will need to intensify our efforts to capitalize commercially on this national effort. Part of this must involve more effective curbing of out of control theft of intellectual property in many parts of the world where potential markets exist, including China. No matter how much money you spend on research, and how innovative your scientists, if the product of your money and work is simply stolen and marketed by others, gradually the incentive for this activity will be drained away. Some in Congress believe that greater unilateral punitive measures against intellectual property theft are needed so that the theft becomes utterly counter productive for the individual pirating companies, and the countries which tacitly or actively support them.

The solution to the problem of global economic imbalances preferred by some academic economists is an explosion of new economic growth world-wide. In theory, this new growth could absorb additional production and imports from the U.S. and elsewhere.

Looking, however, at the all the political and economic obstacles likely to delay this wonderful day, causes others to conclude that a new dollar crisis is far more likely to come long before the rest of the world restructures itself to permit new growth on the scale needed. Moreover, today economic growth in many parts of the world is largely export driven, and largely at the expense of long term U.S. trade deficits and debt. More of this kind of growth will only make America's long-term adjustment difficulties even greater.

Increasing oil prices will also serve to push any automatic adjustment in global markets even farther into the future. More and more countries will be desperately seeking additional export markets to cover their increased oil import costs. They will be looking first and foremost at the U.S. market to accomplish this.

As one reflects upon China's economy, it is important also to remember that while China's nominal per capita income is $l000, the internal purchasing power parity of this $l000 is estimated by IMF economists to be five times as great, namely equal to $ 5000 per person. This disparity is caused by many factors, including uneven conditions in the vast Chinese economy, the low price of services and wages, and some administered prices. Some of this results in distorted market pricing signals. China imports less and exports more than otherwise would be the case. By internal purchasing power calculations, China is already the world's second largest economy.

It is also important to remember that China has accumulated a war chest of more than 600 billion dollars in foreign exchange, a policy legacy of the fear that was unleashed when the Indonesian banking and political system melted down after the l997 Asian crisis. The Chinese now tell us that they can not afford to allow their currency to appreciate, because, they say, it will make their banking problems more severe and they need more time to put their banking system in order. Yet much evidence suggests that bad loans continue to accumulate in their banking system. Thus, the bad loan problem may well be more severe a year or two from now than it is today, particularly if the softness in the economies of many of China's trading partners intensifies under the strains now developing from tight oil markets and troublesome macroeconomic problems. Thus, the Chinese are likely to raise the same non performing loan problem to avoid a currency shift in 2006 and beyond.

If the Chinese cannot cope with a currency adjustment while possessing a 600 billion dollar war chest, this may mean one of two things. Either the problem of the bad loans in the banking system could be spectacularly higher than any published estimate, or the Chinese could be using the non performing loan problem as an excuse to justify a policy on currency that they wish to preserve for other important reasons, including maintaining the current pace of export growth. Possibly some combination of these two factors may

be involved. Whatever the case, there is a divergence here of Chinese and American interests on the currency issue which is unlikely to be resolved until meaningful leverage is organized.

Europe and the United States have a common interest in finding a solution to the Asian currency issues that does not involve a melt down of the transatlantic economy. Asia's long term growth also depends critically on preserving the economic health of their major American and European trading partners. Foreign debt accumulating in the American economy via trade deficits will increasingly act as a drag on growth. It will also increasingly weaken confidence in the dollar as a reserve currency, and encourage the shifting of dollar reserves to the Euro. This will strengthen the Euro and further weaken the underlying economy of Europe, part of which is already in borderline recession, with unemployment rates at post war records.

This problem deserves more effective attention by policy makers on all three continents than it now appears to be receiving. It is far better to organize a solution now, than have one imposed on the world by a future financial crisis. History tells us that these occur several times each decade.

ENFORCING THE WTO AGREEMENTS: THE PLEASURES AND PERILS

There are other neuralgic elements involving China and her trading partners that are likely to put additional political pressure on China's current economic situation. Secretary of Treasury Snow told 500 members of the Economic Club of New York last fall that China had passed the required laws to enter the WTO, but was not enforcing many of them, including the intellectual property related items. There are, of course, periodic seizures of pirated CD disks that are crushed on the streets of some provincial city for the benefit of the assembled cameras. This is only the tip of the iceberg of a vast problem. Enforcement problems worsen the farther you travel in China from Beijing. In some provincial cities, Beijing's writ on WTO related matters barely exists. You can therefore expect increasing pressure from the WTO on China in the years ahead to carry out obligations. Failure to succeed in this effort could fatally discredit the WTO itself, and send global trade officials back to the drawing boards for other solutions. The other problem is that there are thousands of individual violations, ranging from Zippo lighter's trademark piracy to far more complex issues. The entire WTO dispute settlement machinery and the tiny Chinese legal structure assigned to handle such cases could be consumed for decades without making much of a dent in this massive pattern of violations

Faced with these problems, officials confront a dilemma. If they complain too much about intellectual property violations and other evasions of the WTO agreement, it will add strength to the arguments of those in Congress who never really believed that the rule of law as we know it will apply equally to places such as China with very different legal traditions. The other side of the dilemma faced by officials is that unless they do press vigorously to remedy existing lapses, violations will continue, and this will have both political and economic consequences.

It is clear that the Chinese government is having difficulty in carrying out some of their WTO commitments. Some of these obligations, if rigorously implemented, would constitute an obstacle to current Chinese economic strategy. Other future WTO obligations, for example, provisions allowing much greater future access of cheap foreign agricultural imports to China, will generate more pressure on the rural economy in China, as happened with Mexico's corn farmers after NAFTA. This is likely to accelerate an already serious demographic shift in China of surplus workers moving from the farms to the cities looking for jobs.

Providing jobs for tens of millions of displaced former agricultural workers has been and will continue to be one of the regime's main preoccupations. Political stability in China hinges in part upon their success. But there may be both economic and political limits abroad to the degree to which these tens of millions of new workers can be deployed in ever more export producing industries. This constitutes a serious policy dilemma for China and her trading partners.

Coping with regional political opposition to other unpopular or inconvenient WTO commitments will also not be easy for Beijing.

OTHER POTENTIAL TIME BOMBS

The Communist Party has lost a great deal of its reputation in recent years in part because of corruption problems, despite tens of thousands of punitive actions against corrupt party leaders at all levels. In some ways, the current Chinese system combines the worst evils of both socialism and capitalism: namely, the inherent corruption problems of a vast powerful, but low paid bureaucratic establishment, plus exploitation of workers in some places on a scale that has not been seen since the darkest days of the industrial revolution in England. One has only to think of the rash of recent articles about conditions in many Chinese coal mines, and about the difficulty the more exploitive sweat shop managers are facing in other parts of China. This too is potentially explosive.

The over heated Chinese economy has also generated shortages of energy, water, port and transportation facilities and environmental systems that already act as a brake on healthy future growth. Supply has to catch up with demand. This will take time and investment.

China's leaders have also painted themselves into a political corner, whereby if the Taiwanese ever declare full independence, Chinese leaders may have to go to war to avoid massive loss of face, and even their positions. Chinese leaders expressed to Gingrich and myself their great concern that Taiwan's president would eventually attempt to move toward independence.

Any military or economic conflict between Taiwan and China would be massively destabilizing to the economies of both places, and a meltdown of China's already strained financial system could easily be one consequence. Since much of the production is

concentrated in China and Taiwan, shortage of computer chips could also impose real dislocations in the broader global economy, should any conflict over Taiwan get out of hand. There are already discussions in the U.S. about the need for more diversification of sources of supply of critical industrial and defense components, because of potential instabilities across the Straits of Taiwan. The just in time procurement policies of many global companies, make this potential disruption even more worrisome to many thoughtful policy makers in Washington.

Based on what I heard from subsequent visits to Taiwan, and from the results of the December 2004 legislative election which denied the government the 2/3 majority needed to pass controversial constitutional reforms, I doubt that present Taiwanese leaders will, in fact, go far enough in the year or two ahead with their independence aspirations to provoke Beijing into a military response. Today, however, Taiwan is a democracy and 85% of the people are native Taiwanese, as opposed to only l5% from the mainland. Many will not willingly allow absorption of Taiwan by China. Still, Taiwanese investors, directly and indirectly, have placed perhaps as much as $l40 billion dollars of investment in China. This investment, like similar investment by the Japanese, is potentially hostage to Beijing's good will.

Aware of these and other vulnerabilities, Taiwan is no longer the confident little island of ten years ago. There is a lot of nervousness among investors, those facing competition from China, and the ordinary native Taiwanese who like their present liberty. These conflicting economic and political pressures will have to work their way out in Taiwan's robust new democracy. No one can really predict how this tension will eventually end. Much depends upon Hong Kong's subsequent experience with the one state two systems situation, and the conclusions drawn by the people of Taiwan.

By the same token, China too faces its own political tensions and governance problems. For example, in December 2004 President Hu published in the front page of the China Daily a long demand that the military of China obey the party. Presumably such a prominent demand would not have appeared if there were not problems of insubordination. Earlier there were reports of strong disagreement between military and party leaders about the role of the military in business, the budget share to be allocated to the military, and issues such as how firmly to oppose the Taiwanese aspirations. Some of the local party/military disputes overlap regional issues. Military involvement and interests may also be complicating the ability of the government of China to address some of the economic problems facing the country. Issues of who ultimately controls promotion in the army may also be involved in some of these disputes. Finally, whenever there are governing institutions that face serious popular dissatisfaction, particularly in societies without a long democratic tradition, the military can become a wild card in the political deck. No one now seriously expects an open military challenge to civilian party rule under present circumstances. Should, however, there be a hard landing to the Chinese economy, with banking failures, unemployment, and public disorder, no one can say what might happen in China.

Finally there are growing strains in the relationship between Japan and China. Part of this, of course, has to do with the legacy of the Second World War and the textbook treatment of these historical issues in each country. Part of it has to do with sheer economic and political rivalry over who will be top dog in Asia. Some of it involves political decisions by leaders in both countries with weak domestic bases. A foreign rival makes a convenient diversion from domestic problems. There are also conflicting territorial claims over fisheries and potentially rich resource deposits under the sea bed.

Unless contained, this rivalry has the potential to generate a new arms race in Asia, and all the dangers that could accompany such a development. Part of China's economic growth is financing a military build up that is alarming to many in Japan and elsewhere. These disturbing trends are one more potential uncertainty in the economic and political outlook for the region. One has only to think of the parallels to the rise of l9th century Germany's power and ambitions, and of the tragic consequences for all.

THE UNPREDICTABLE FUTURE

A few weeks before he died in l996, former President Nixon assembled a couple dozen of Washington's top foreign policy experts at Jackson Place near the White House to hear his views on Russia. He had just completed a trip there. He spoke for more than an hour without notes, which was his custom. Later during the question period, he was asked about his medium and long-term assessment of the direction China would take. He paused for a few seconds, and then said: "I am generally hopeful about long term trends in China, but I have only visited China seven or eight times, and I don't consider myself an expert on China." This was Nixon's way of telling us that there were huge complexities in China that made predicting the future difficult.

I can only agree with the former President's assessment.

China's economy seems likely to continue its upward long term trend, producing higher living standards for the people of the country in the decades ahead. Presumably also the Taiwan/China issue will ultimately find a peaceful solution, since neither party has an interest in economic chaos.

There are, however, a lot of downside local, regional, and global risks at play just now, some political, some economic. Governments are notoriously slow in dealing with even obviously dangerous financial problems. This is partly because any major change in the status quo inevitably inflicts pain on powerful domestic constituencies. For that reason, any major change usually requires sufficient deterioration to generate a crisis of some kind to provide policy makers with the needed political cover.

Current global imbalances, including the U.S. current account problems, and the Asian regional ones involving China, pose trends that seem unsustainable to more and more informed people. Before they are corrected, however, we may see once again the truth of that old Wall Street saying:" The bigger the boom, the bigger the bust"

Ambassador Richard McCormack

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Amb. Richard McCormack, former under secretary of state for economic affairs, joined CSIS in May 2004 as a senior advisor. A long-term high-level advisor to political leaders and senior government officials, McCormack's primary focus is geopolitics and the global economy. Among his principle interests is the role of the international financial institutions in preventing and containing financial crises, and policy reforms in selected economies. During the administration of President George H. W. Bush, McCormack also served as the principal coordinator for the president's involvement in the G-7 economic summits. He was awarded the State Department's highest award by then-Secretary of States James A. Baker. McCormack received the superior honor award for outstanding sustained performance as the U.S. Ambassador to the Organization of American States during the Reagan administration. Prior to that, he was assistant secretary of states for economics and business. Earlier in his career, McCormack served as a policy analyst in both the House of Representatives and the U.S. Senate. He was deputy to the assistant secretary of treasury and a senior staff member of the President's Advisory Council on Executive Organization at the White House, where he had lead responsibilities for developing the rationale and structure for the Council on International Economic Policy.

Prior to joining CSIS, McCormack was ac counselor at the Center for the Study of the Presidency, a member of the State Department's advisory commission on Africa, and a consultant/advisor to the managing director of the International Monetary Fund. He received his Ph.D. magna cum laude from the University of Fribourg in Switzerland and his BA from Georgetown University.