

**CARNEGIE ENDOWMENT FOR INTERNATIONAL PEACE**

**HENRY M. PAULSON, JR.:**

**IN ADVANCE OF THE FOURTH CABINET-  
LEVEL MEETING OF THE U.S.-CHINA  
STRATEGIC ECONOMIC DIALOGUE**

**WELCOME:**

**JESSICA T. MATHEWS,  
PRESIDENT,**

**CARNEGIE ENDOWMENT FOR INTERNATIONAL PEACE**

**SPEAKER:**

**HENRY M. PAULSON, JR.,  
SECRETARY OF THE TREASURY**

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JESSICA T. MATHEWS: Good morning, ladies and gentleman. My name is Jessica Mathews, the president of the Carnegie Endowment for International Peace. It's a particular pleasure today to introduce the distinguished secretary of the treasury, Hank Paulson, on the eve of the fourth cabinet-level dialogue of the U.S.-China Strategic Economic Dialogue, which will convene in Annapolis a week from now.

The dialogue, as you know, began in 2006 and covers the gamut of important bilateral issues from food and product safety to financial sector reform, transparency, innovation, and, of course, energy and climate change. The last meeting in December of 2007 launched a 10-year framework on U.S.-China energy cooperation. Mr. Secretary, you are to be congratulated for significantly strengthening the SED and for beginning to address the critical long-term issues of energy and climate, which are, together, surely among the gravest threats to the world.

Our two countries, China and the U.S., account for roughly 40 percent of global greenhouse gas emissions. And working on a bilateral basis to end what we've called the "suicide pact" of each government insisting that the other act first on climate is exactly what we need to be doing.

Here at Carnegie, we too have begun to do our bit. As globalization takes hold of so many aspects of our lives, an international approach is required to tackle the major challenges that confront us. And to do that, we've decided to try to break the traditional mold of Washington think tanks and to create lasting partnerships with leading scholars in and around the rest of the world. And so we've embarked on what we have called "the new vision" of the Carnegie Endowment, to create the world's first global think tank.

Building on 15 years of experience in Moscow, we have recently opened new offices in Beijing, Beirut, and Brussels. In China, we've been honored to have been joined by Zhou Dadi, the former director general of the Energy Research Institute of NDRC. And he will be working with William Chandler here in Washington, who heads our energy and climate work on several important initiatives on how to move forward on both energy and climate policy together. Chandler has – and Dadi – have been invited by the Chinese national – by NDRC to organize a track-two dialogue on U.S.-China cooperation, which will be beginning in the next few weeks.

It's often the case, unfortunately, that politicians take on only those issues that will come to fruition within their term in office and energy and climate and long-term U.S.-China relations are obviously – don't fit in that category. But whoever becomes president next January is going to benefit from a head start, a very substantial head start on cooperation between our two countries because you, Secretary Paulson, have taken on this tough and important issue and have made the Strategic Economic Dialogue into a really important venue for advancing U.S.-China relations, a really substantial diplomatic achievement.

So we are very honored to welcome you here to Carnegie and look forward to hearing from you about the prospects for progress next week.

(Applause.)

SECRETARY HENRY M. PAULSON: Jessica, thank you very much, and thank you to the Carnegie Endowment for International Peace for the opportunity to speak with you this morning.

Today, as has been the case each day since the Sichuan earthquake, our thoughts and prayers are with the Chinese people as they work to meet the challenges resulting from this terrible tragedy. As President Bush has said, the United States stands ready to help in any way possible. Our government, our charities, individuals have already donated or pledged over 100 million in goods and services and money. We are committed to help China rebuild the devastated area.

The U.S.-China economic relationship is complex, broad, and important to both our countries and to the world economy. Through the ongoing, dynamic, and respectful discussions of our Strategic Economic Dialogue, the SED, the relationship is also growing in a positive direction.

I look forward to making further progress on shared objectives at the fourth meeting of the SED next week. This meeting will be the first opportunity for my Cabinet colleagues to collectively meet and work with China's newly appointed leadership team. We will welcome our new Chinese colleagues and together we will demonstrate that the SED can effectively manage our economic relationship through a period of leadership transition while laying a course of concrete action to achieve our strategic objectives. In particular, I look forward to welcoming my new counterpart, Vice Premier Wang Qishan, in his new role for his country.

A critical goal for the 21<sup>st</sup> century is to get the U.S.-China economic relationship right. At next week's SED, we will have a robust discussion of our economic relationship, envisioning a future of sustainable economic growth over the next decade.

And so the SED meeting next week will focus on five areas. These are: managing financial and macroeconomic cycles, developing human capital, the benefits of trade and open markets, enhancing investment, and advancing joint opportunities for cooperation in energy and the environment.

The SED has brought progress faster and more broadly on issues important to the U.S. and global economy than would have been possible otherwise. Success has come through ongoing collaboration, candid high-level discussions, understanding each other's priorities and objectives and interests, and surmounting particular bureaucratic interests by working with the Chinese government as a whole.

It is clear that our strategy for robust engagement with China – intensive dialogue but with resort to WTO dispute settlement and WTO-sanctioned trade remedies if needed – is more productive than protectionist policies or legislation.

Managing financial and macroeconomic cycles will be our first discussion topic next week. Both the United States and the Chinese economies face current challenges, including adjusting to higher energy and food prices. The United States is working through a housing market correction and re-pricing of risk in credit markets.

China is grappling with rising inflation and growing internal and external macroeconomic imbalances. China's imbalances stem largely from an economic structure that has become too heavily dependent on industry, investment, and exports. This has led to a growing trade surplus, high energy use, environmental degradation, and rising domestic inequality.

Continued exchange-rate reform is among the macroeconomic and structural measures China should take. Exchange-rate reform will be critical in meeting China's short- and medium-term

challenges. Greater exchange-rate flexibility will make Chinese monetary policy more effective in controlling inflation. It will help bring about the structural economic shifts China needs to reduce its imbalances. Despite the progress that China has made, including almost 20 percent renminbi appreciations against the dollar since July of 2005, continued movement and greater flexibility are still needed. Increasing the pace of reform of China's financial services markets is also important to further support the growth and development of the Chinese economy.

A major contributor to the structural imbalances is a savings-rate challenge in each of our economies. In the United States, our savings rate is too low. In China, it is too high. In order to effectively deal with this issue, we must address how to adequately provide for our aging populations, including the role of private and public insurance and financing for social services such as health care and retirement. Inadequate social safety nets in China lead to high levels of precautionary savings and are a major contributor to low domestic consumption and the large and rising trade surplus.

In the United States, rising healthcare costs and our aging population are creating public policy challenges. Restraining the growth of healthcare costs and reforming our Medicare and Social Security programs are critical to prevent a looming fiscal problem. These steps are necessary and important measures to help us address our low savings rate and the resulting imbalances.

Increased openness to competition and international trade is critical for continued economic growth in both our nations and for the future prosperity of our people. We will discuss steps that we can take to ensure that our countries, and the world economy, remain open to trade.

We will examine how we can promote mutual interests, including enhancing innovation and developing and protecting intellectual-property intensive industries, improving food and product quality and safety, stopping the global trade in fake products, furthering transparency and the rule of law, and supporting green energy and environmental product markets.

We will build on previous progress, such as the civil aviation agreement that resulted in a new nonstop flight between Atlanta and Shanghai this past March, and a new group leisure travel agreement that is estimated to bring up to 100 million Chinese travelers to the United States over the next 15 years, creating jobs and growth here at home.

America's policy of open investment is one of our predominant economic strengths. Foreign direct investment stimulates competitiveness, growth, jobs, and productivity. At the fourth round of the SED, we will discuss the best way to promote and protect bilateral investment and counter protectionist pressures. We will also discuss the concerns of American companies that China's investment regulations are opaque and seem in many ways to be designed to favor China's national champions.

The value of the SED to economic issues is clear. The SED also increases U.S.-China collaboration on security and other key international issues, making our overall relationship stronger and broader.

Finally, next week we will also focus on energy security and environmental sustainability. I will elaborate further on that today.

The U.S. economy faces significant headwinds from a number of factors including rising energy prices. Gasoline, food, and many common household items have become more expensive for American

families. There is an urgent need for U.S. energy policies to significantly evolve to ensure U.S. energy security.

Since the beginning of the Bush administration, the United States has spent nearly \$18 billion to research, develop, promote, and bring clean and efficient technologies to market. We continue to develop new strategies; last December, President Bush signed the Energy Independence and Security Act, which responded to his 20-in-10 challenge to improve vehicle fuel economy and increase alternative fuels. But much more is needed if we are to adequately address our energy security challenges.

As the two largest net importers of oil, China and the United States face similar challenges. We have a strong and a shared interest in avoiding supply disruptions, increasing energy efficiency, promoting the efficiency and transparency of the global energy markets to the benefit of all oil importing nations, and expanding the availability and use of alternative energy sources.

To power its economic growth, China has become the world's largest coal producer and consumer. In 2006, it became the second largest purchaser of new vehicles, which is one of the key reasons why China has now become the world's third largest consumer of oil.

To find solutions to these shared challenges, the U.S. and China have been working together under the SED to address energy security. We already have an agreement to strengthen cooperation on next generation biofuels, to increase industrial energy efficiency, strengthen cooperation on the certification of energy efficient products, increase cooperation on nuclear safety, and a joint five-year commitment to promote large scale deployment of alternative fuel technologies for vehicles. In conjunction with the International Energy Agency, the IEA, we have also strengthened cooperation on strategic oil reserves.

But to comprehensively address its energy security, China must go beyond these joint efforts. China has made a good start by establishing numerous plans and ambitious goals, highlighted by the 11<sup>th</sup> five-year plan, for 2006 to 2010, which established aggressive goals to reduce energy consumption per unit of GDP by 20 percent. China has moved towards meeting some of these goals by reducing energy consumption over 3 percent per unit of GDP output in 2007. While I applaud this continued focus and am encouraged by this progress, further results cannot come fast enough.

As the United States developed, we found that harnessing market forces, combined with strong regulations and enforcement, were powerful tools to support economic growth. For example, the sulfur dioxide tradable credit system established under the 1990 Clean Air Act has demonstrated how market-driven measures can cost-effectively reduce pollution. We also learned a costly lesson in the 1970's when we attempted to defy market forces and imposed oil price restrictions. Rather than achieving our intended result, we experienced winter heating oil shortages, supply problems, rationing, and a reduction in domestic oil and gas investment and exploration. In some cases, we attempted to control output prices without being able to control input prices, forcing operating losses and large cuts in supply.

China, by setting price controls on fuel, is facing similar consequences today – as can be seen by persistent gasoline and diesel shortages throughout the country. The consequences of these policies also extend to the power sector, where price caps on electricity and fuel contributed to nationwide power outages during snowstorms this past January and February. The United States learned that price controls interfere with the natural equilibrium of markets to match supply and demand, and lead to

shortages. And because market forces can never be completely eliminated, price controls often lead to smuggling and corruption.

Indeed, the best way to deal with economic shocks is to allow markets to operate fully and with full information. For oil, information on stocks and reserves is particularly important, and therefore it is critical that China and all oil producing countries provide information on their reserves to the IEA. In the United States, innovation, coupled with market-based policies and regulations that encourage energy efficiency, lead to technological advances that reduce energy consumption. As a result, the consumer benefits and markets evolve and grow. We also achieve a cleaner environment.

The U.S. and China both know that tomorrow's economic opportunity requires conserving natural resources today. To focus more sharply on this goal, at last December's SED meeting, we announced the beginning of 10 years of cooperation on energy and environmental issues. Working together on this framework will challenge all levels of government, industry, academia, and non-governmental organizations to find answers to these and many other questions: How do we reduce dependency on oil and increase energy security? How do we better preserve the natural environment and prevent greenhouse gas release due to deforestation? How do we meet our energy goals? How do we ensure that our water is clean and safe?

These questions may be answered differently in the United States than in China. Yet, our approaches to finding answers may be similar – to implement proven policies, to educate individuals to make environmentally sound decisions, and to ensure that companies follow regulations designed to protect human health. Solutions will also require technological breakthroughs and making existing and new technology affordable by reducing market access barriers. I often hear from U.S. companies that they do not sell their technology to willing Chinese borrowers for fear that their designs and technology will be stolen. The U.S. exporters' concerns are a significant reason for limited sales of technology-based products. I hear from Chinese government officials that the U.S. technology they need for pollution control is expensive in part due to tariffs and non-tariff barriers. We have a shared interest in resolving these dilemmas, and we can solve them.

Since December, we have been adding details to this framework and we will announce the results of our initial efforts at next week's SED meeting. This cooperation will likely bring innovations that we cannot yet imagine and expand our relationship in many new ways. We are selecting shared goals, such as reducing dependency on oil. We are defining specific energy targets, such as increasing vehicle fleet fuel efficiency and creating incentives for the development and use of alternative fuels. We are developing action plans for joint projects that will accelerate existing efforts. These action plans will help each country identify policy solutions to improve implementation of existing regulations and incentives, and challenge us to develop even more innovative approaches and answers.

China's leaders go about this in the face of daunting environmental challenges. According to the World Bank, 16 of the world's 20 most polluted cities are in China. Water quality is deteriorating – 90 percent of all rivers show signs of significant pollution and 62 percent of water is unsuitable for fish. And although the Chinese government has established laudable environmental protection goals, monitoring and enforcement of environmental regulations remains very weak.

Conservation is one area where both the United States and China have made significant progress in safeguarding the environment. In the United States, through a variety of federal, state, and local

agencies we conserve, protect, and manage natural resources. Private industry and a vibrant non-profit sector further support these efforts.

I applaud China's recent steps and would encourage further progress to develop legislation that would more effectively protect natural habitat. I am also encouraged to know that China is adding 2 million hectares of forest per year to increase forest coverage by 6 percent to combat deforestation. According to official Chinese projections, by 2010, 16 percent of China's total territory will be natural reserve areas, and 90 percent of the remaining typical forest and wetland ecosystems, and key national wildlife will effectively be protected.

The environmental aspects of the 10-year framework build upon a solid foundation. We have a memorandum of understanding to combat illegal logging and promote sustainable forest management. And we have launched efforts to help China develop a nationwide program on sulfur dioxide emissions trading. U.S. and Chinese private-sector companies are also helping to create the green economy. Whether it is the public sector or the private sector, this work is aspirational.

Recent meetings between U.S. and Chinese leaders have shown great promise for collaboration on green buildings, energy efficiency in infrastructure projects, and creating "Eco-cities." China adds 2 billion square meters of new construction every year and has 40 billion square meters of existing buildings that need retrofitting. Chinese leaders know that the development of green buildings is a critical need.

As we establish this cooperative framework, my friends in China often ask what can be done about China's immediate energy and environmental challenges. My answer is that China, given its current economic growth and prosperity, can leapfrog the United States and the rest of the world in deploying and using advanced energy and environmental technology.

Adopting advanced technology will increase China's energy efficiency and reduce the emissions of greenhouse gases and harmful pollutants. But bringing this technology to China is hindered by the tariff and non-tariff barriers that China places on environmental goods and services. A high priority should be eliminating barriers on products, goods and services that can improve the health and welfare of the Chinese people.

For example, there is a water membrane technology available right now. If installed properly, it could help local communities take significant steps towards reducing the pollution entering rivers from power plants. That means that, within months, some Chinese citizens could have cleaner water. Yet, a tariff of 22 percent on water membranes makes this technology too expensive for many communities.

Significant opportunities exist for the United States and China to achieve immediate progress and make long-term strides towards energy security and environmental sustainability. Through a 10-year framework of cooperation, I believe that we have the foundation to meet these challenges in a sustained, collaborative manner.

Next week's fourth Strategic Economic Dialogue meeting will move the United States and China even further forward to a stronger economic future. We have kept our economic relationship on an even keel, even during times of stress. We are building upon a shared vision that is possible because of our cooperation and feasible because of our commitment to the prosperity of our people. Thank you all. I will now take some questions.

(Applause.)

Yes.

Q: Thanks, Mr. Secretary. I'm Steve Charnovitz from George Washington University Law School. You indicated that Chinese – China's currency had appreciated 20 percent but then indicated that that wasn't enough. If next week the Bush administration were to get what it wishes for and China were to appreciate its currency, what would be the impact on the dollar and the price of oil?

SEC. PAULSON: First of all, the – in terms of China's currency, we have not put out a specific target. And just so you'll understand what we're saying, we're saying that China is not ready yet to have a market-determined currency; that's pretty clear. Secondly, they are not going to be able to get where they want to get in terms of reform until they do have a market-determined currency. And so what we believe is that they need to move more quickly to accelerate the appreciation so it reflects underlying economic values.

Now, to get to your question, every other currency of a major nation that is as integrated as China and to the world economy trades in the marketplace and is set by underlying market fundamentals. I don't believe that China's currency is a primary reason for these imbalances, but I believe that it is a contributor to the imbalances we see and I think that having made a step toward reducing global imbalances will be a contributor to the global economic system and make every economy in the world healthier.

Now, in terms of the price of oil, I think people are thinking about the wrong thing when they look at currency. And, you know, the dollar, for instance, over the period from 2002 to the present has depreciated about 24 percent and the price of oil has gone up well over 500 percent during that period. And the price of oil has gone up in every currency around the world quite dramatically. And the keys are the things I mentioned in my speech: it's supply-demand; it's investing in the production capacity of oil around the world; and aggressively investing in new sources of fuel.

Yes.

Q: Nancy Mofung (ph), Phoenix Satellite Television. Thank you, Secretary. My question is – the recent earthquake in China or the U.S. current elections or the U.S. economy slowdown affect the momentum of SED including the SED deliverable at all? Thank you.

SEC. PAULSON: I would say it – in terms of the earthquake, I see no signs that it has slowed down the momentum of the SED. But I've had several conversations with my counterpart Wang Qishan about the earthquake and when we talked this morning before coming here, we also talked about that. And, you know, it's hard to see any good news when you see a tragedy of that proportion. When you talk to people who have been at the disaster site, they say it's hard to put it in words and there's 15 million people that are homeless beyond all of the deaths.

But if there is any good to come out of that, I believe it is people of the U.S., the compassion they feel and the support they want to give to their brothers and sisters in China and the work. And so we've – there's a big effort underway in terms of a private-public partnership and U.S. companies and NGOs and so on.

Now, in terms of what's going on in the financial markets and the economy, this is made to order for the SED because, as we talk about – we need to talk about long-term issues and short-term issues and, obviously, we'll spend a fair amount of time on that. And there's no doubt that when we began this a couple of years ago that we knew that we were going to be facing headwinds in terms of the political calendar in our country and in terms of leadership transition and looking at the 17<sup>th</sup> People's Congress in China.

But I think it's been remarkable that we've been able to work through those things and that I was able to meet with Wong Shishong in April and the new cabinet ministers, and it looked to me like we haven't – they haven't skipped a beat and they've continued focusing and driving this agenda forward.

Yes.

Q: Thank you. There is a common concern among many Chinese people that the appreciation of renminbi and devaluation of U.S. dollar will bring more and more hot money into China that will do harm to Chinese economy. What's your comment on that?

SEC. PAULSON: Well, I would think that the – just the opposite, that as China is struggling with reigning in inflation, they're missing a very important tool; they could be more effective in terms of monetary policy and I think they understand that. So I think the appreciation of the renminbi is net-net positive. I don't disagree that, in terms of the investment flows, that has been – there is – with the expectation that – with the knowledge that the renminbi is undervalued and the expectation that it needs to increase that increases investment flows.

But, to the extent that China restrains the renminbi for that reason, I think it even will add further to this because I think most people recognize that there's an economic law of gravity and that China's not going to be able to accomplish what they want to accomplish if they don't have a currency that's more reflective of underlying fundamentals.

Okay, let me go to – why don't I go to the guy way over there on the aisle because you're near a microphone? (Laughter.)

Q: My name is Nick Consonary from the Eurasia Group. I wanted to ask about your expectations for the future of the SED, what your particular perspective is on the future of the talks and if you plan on addressing that in the next week.

SEC. PAULSON: Well, obviously, the future – the next administration will make a decision on that, but my view has always been that the way to ensure that the SED continues and grows and becomes even more successful in the future is to have a record of accomplishments and tangible results. And I believe it does that. And as I travel around the world and I see every other country wants to start one up, I've always said imitation is the most sincere form of flattery. So I think what we're going to do is we're going to just keep moving forward. This relationship is a very important relationship and I think it should be judged by its results.

Yes, the gentleman way back there.

Q: Thank you, Mr. Secretary. Raghbir Goyal from India Globe and Asia Today. Mr. Secretary, when the U.S. economy goes down, the world of – economy affects everywhere on the globe. You are going to meet with the energy minister of India, Mr. Komanlas (ph), who is in town and also the economy and the food rises and the oil prices are on the rise around the globe. And so is the economy of India and China is growing. Do you think and do you blame that greedy investors in oil-producing countries and also on the New York Stock Exchange are the ones that you can blame for the high rise of oil and food prices? And what advice do you think you have for India and China as far as their growth and how you can control all of these. People are dying around the globe because of hunger.

SEC. PAULSON: Okay, yeah, let me deal with both of those questions. First of all, I don't take the rise in the price of oil at all lightly. When I look here at our country, we have been working through a situation where we have an economy that is dealing with a major housing correction. We've got a considerable stress on our capital markets. The economy has done better because it's quite resilient than many had predicted and some had feared, but this – now, with this rise in energy costs, it's a – I'll tell you – a big burden on Americans and on our economy. And I think it brings with it the risk of a prolonging our economic slowdown. So I take that seriously.

But in terms of looking at what's going on in the energy markets, I don't attribute that to speculators, financial investors – I just – I continue to study it. We've looked at it very carefully and the CFTC has looked at it carefully and the fact is that many commodities and some going up more than oil. You look at iron ore or steel and so on where there are no financial markets – have gone up. This is supply-demand that we haven't seen production capacity increase significantly in the oil area. You have to go back, you know, since the Asian financial crisis. You see nationalization in many countries where you don't have the investment coming in that you need. And so we need an increased investment in production and in alternative fuels.

And financial investors are usually on both sides – they're long and they're short. They don't set trends; they follow them. And we haven't seen the kinds of inventories – you know, inventories are tight and there's a concern it'll be tighter. When you look at food, again, I find very little evidence that this is financial speculators or investors. This is supply-demand and the reason I think it's important to say that is, you know, often, people don't want to treat a disease until the symptoms become quite severe and then it's a mistake if you want to – if you look for things to blame and people to blame, it may keep you from dealing with the root cause. And the root cause to both of these problems needs to be addressed through long-term policies.

And in agriculture, it has to do with productivity. It also, I think, has to do with trade. And I've been discouraged that I thought that if there was anything positive – and it's hard to come up with anything positive that would come out of what's going on with the global food crisis – but at least I thought that that would be an impetus to have breakthroughs on Doha. And so, again, these are serious, important economic issues. We will talk about them and I will be going to Osaka for the upcoming G7 meeting. We will be talking about those issues and we'll be talking about energy.

I thank you all very much. I've got to run to the next meeting. Thanks.

(Applause.)

(END)