U.S.-CHINA ECONOMIC DIALOGUE
CONSENSUS
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BEIJING

- The 14th meeting of the U.S.-China Economic Dialogue took place in a period of slow growth in both economies and amid heightened political uncertainties related to the U.S. elections in November 2016 and to China's 19th National Party Congress scheduled for autumn 2017.

- The growth outlook in both countries has dimmed. In China, growth continues to be restrained by the ongoing decline in the efficiency of resource use by the state sector and a sluggish global environment. This has been only partly offset by a temporary burst of new credit. Investment supported by this credit expansion has provided declining growth benefits. Moreover, the economy remains unbalanced; relative to China's per capita income level, the consumption share of GDP remains relatively low by international standards. Nevertheless, most meeting participants believe that the country continues to gradually transition away from export-led expansion of manufacturing and construction toward services and domestic consumption.

- An important issue for China is the high and rapidly increasing leverage of the corporate sector, particularly among state-owned enterprises (SOEs). As a result, policymakers face the challenge of reducing corporate leverage while simultaneously sustaining economic growth. There remains the potential for increased leverage in some sectors—namely, the central government and the household sectors—but the continued increase incorporate leverage poses clear sustainability risks. In addition, reliance on credit expansion feeds volatility in asset prices, including the equity and real estate markets. Sustaining growth while limiting corporate leverage will require more efficient use of capital and other resources. This implies the need for greater market discipline in the allocation of resources, including, most importantly, the development of a stronger credit culture in the banking system.

- Related to the worrisome build-up of corporate leverage are clear signs of excess capacity in a range of sectors, including mining, metals and certain industrial products. In a world of slow economic growth, there is little prospect for absorbing this overhang of capacity through stronger demand at home or abroad. Consequently, policymakers face the additional challenge of rationalizing key segments of industry.

- In the United States, economic growth has averaged only two percent since the mid-2009 business cycle trough and potential future growth is likely to be even weaker. In the absence of a surprising rebound in this long and sluggish productivity growth, the U.S. economy is unlikely to serve as the engine to drive the global economy. Together with low growth in Europe and Japan, this creates a weak external environment for China, the world's largest exporter. While the U.S. Federal Reserve began to tighten monetary policy in 2015 for the first time in nearly a decade, dialogue participants expect only a modest further adjustment this year amid slower U.S. job growth, sensitive financial conditions and international concerns. Some dialogue participants highlighted the impact of Fed decisions on China and urged policy caution or coordination. Over the long run, Congress and the executive branch need to focus on measures that will increase productivity to boost potential growth. Those efforts should include upgrading infrastructure, investing in human capital, and encouraging research and development.

- Political uncertainties featured prominently in the discussion. U.S. participants believe that the 2016 elections represent a potential branching point for U.S. foreign policy, including trade and cross-border investment policies. One presidential candidate has called for the imposition of tariffs on major trading partners and the repudiation of treaties on international trade. If enacted, these policy changes would disrupt U.S. economic relations with other countries, including China. The other candidate favors policies that are consistent with greater continuity.

Nonetheless, prevailing attitudes toward trade have become less supportive. With the elections looming, there is limited prospect for enacting new U.S. cross-border economic policies.

- Participants from China noted that its own political calendar would also have an impact on the content and pace of reform, especially with leadership changes looming in the 19th Party Congress scheduled for next year. There was a mix of views about China's implementation thus far of reforms from the Third Plenum of 2013, with some suggesting that the process has recently stalled. In connection with this, there was particular concern about the pace of SOE reform. It was also noted, however, that policymakers have made progress in enacting several structural changes, such as family planning policy, *hukou* reform, and proposed safety net initiatives in healthcare and retirement plans. There was general agreement that, if enacted, the reforms identified in the Third Plenum and underscored in the recently enacted 13th Five-Year Plan, would provide solid support to long-run economic growth in China.

- The problem of high and rising corporate leverage is mirrored on the balance sheets of banks in China. These have deteriorated amid slowing economic growth and rising excess capacity. Estimates of bad loans range widely. Official statistics report that nonperforming loans (NPLs) reached 1.75 percent of total loans in the first quarter of 2016. Adding "special mention" loans boosts that ratio to more than five percent. Including unrecognized losses embedded in the shadow banking system and other off-balance sheet instruments could boost the aggregation of bad and shaky debts into the 15-20 percent range. There is a wide range of views among participants about potential recovery rates, adding to uncertainty about the quality of bank balance sheets.

- The mix of high NPLs and uncertain recovery ratios raises doubts about the capitalization of China's banks. Historically, weak banks, if they increase lending at all, usually lend to weak businesses by rolling over maturing loans rather than acknowledging losses and directing credit to new innovative sectors. The resulting misallocation of resources slows economic growth. Timely recapitalization of banks is the most effective means of preventing this outcome.

- Dialogue participants found it helpful to distinguish between the existing "stock" of bad bank debt and the ongoing "flow" of new NPLs. Participants generally agreed that China has the savings cushion and fiscal space to absorb the current losses on the balance sheets of banks. It is important, however, for Chinese regulators to focus on reducing the future flow of NPLs. Conversely, bankers expecting a recurrence of government support will have little incentive to allocate resources more effectively in the future. Thus, any solution to the bad debt problem must also focus on disciplining future credit supply to avoid repeated waves of credit expansions followed by NPLs. This is critical not only to promote economic efficiency but also to avoid repeated bailouts.

- Participants agreed that reforming SOEs is the most effective way today to address both high corporate leverage and excess capacity in China. While not limited to SOEs, both of these problems are concentrated in the state-owned sector. Imposing market discipline on credit supply to SOEs is an effective way to ensure that capital is allocated more efficiently and to minimize the risks both to banks and to government coffers.

- Separately, dialogue participants agreed that the United States should uphold its earlier commitment to support Article 15 of China's protocol of accession to the World Trade Organization. This Article automatically designates China as a market economy as of December 2016. U.S. participants agreed that politicization of this issue would damage U.S. credibility in future negotiations and should be avoided.

- Finally, in light of the increasingly complex and vital role that China and the United States play in today's challenging bilateral and global environment, participants believe that priority should be given to building on the existing Strategic and Economic Dialogue (S&ED) to institutionalize ongoing collaborative efforts at data exchange, policy assessment, and dispute resolution in both economic and security matters. The precise structure deserves further study with the objective of taking the pressure off the annual S&ED cycle and providing a deeper and more continuous focus to bilateral U.S.-China engagement. One approach would be to establish a Secretariat appointed by the leadership of each country to focus on strategic, economic, financial and trade issues. An alternative or perhaps complementary approach would be to establish a "wise persons advisory council," consisting of a few leading members appointed by each country to come up with innovative solutions to difficult bilateral policy issues. Further institutionalization of the U.S.- China bilateral relationship along these lines should be a priority for both countries when a new U.S. president takes office.

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