On January 8 and 9, 2019, the participants of this Dialogue gathered in New York for the 18th round of the U.S.-China Track II Economic Dialogue, co-hosted by the National Committee on U.S.-China Relations and the China Center for Economic Research at Peking University.

The meeting occurred at a critical stage in U.S.-China economic relations and amid considerable uncertainty about global economic prospects. In the summer of 2018, the U.S. Administration unilaterally imposed 10 percent tariffs on a wide range of imports from China. Subsequently, China countered with tariffs of its own. In addition, the United States simultaneously tightened rules on foreign investment in sensitive sectors and has also sought to limit the use of Chinese equipment in Western telecommunications.

President Trump and President Xi then met at the G20 Summit in December and agreed to postpone an additional hike in U.S. tariffs (to 25 percent) until March, providing a window to negotiate changes in trade and structural policies and avoid further tariff increases. Because of the potentially far-reaching impact of these negotiations, daily news about progress or setbacks has been associated with sharply heightened financial market volatility.

While in the trade negotiations the U.S. Administration has frequently highlighted the outsized China-U.S. bilateral trade imbalance, economists generally dismiss this metric as inconsequential for a nation that has a multilateral deficit with 102 nations due to its shortfall of domestic savings. Of far greater significance are the Administration’s attempts to protect intellectual property (IP) rights, to thwart cyber-attacks for corporate espionage, to expand access for U.S. firms wishing to operate in China, to boost U.S. exports to China, and to address structural issues, including the impact of state-owned enterprises and of China’s industrial policy (sometimes referred to as “Made in China 2025”) on U.S. firms.

Current Economic Setting
U.S. economic growth peaked around mid-2018, slowing gradually toward a trend of 2 percent growth. Amid tightening financial conditions, surveyed CFOs anticipate a the start of recession in 2019, partly reflecting the elevated leverage of the nonfinancial corporate sector. Nevertheless, economic growth in the 2019 calendar year will likely average about 2.5 percent, reflecting strong job gains and the rise of disposable income and resulting in modest additional tightening by the Federal Reserve. A further slowdown is likely in 2020. According to one recent survey, more than one-half of U.S. economic forecasters anticipate that a recession will begin in 2020.

Importantly, the near-term risks to this baseline scenario are tilted downward. The top threat would be an intensification of the U.S.-China trade dispute — in the form of further tariff hikes — that could trigger an earlier-than-expected economic downturn. The prolonged U.S. government shutdown had also diminished private confidence. Finally, investors are disappointed that significantly more Federal
Reserve tightening lies ahead, which could trigger a new setback in financial conditions. In China, economic growth has been slowing for some time, reflecting diminishing returns on capital investment. Beginning in 2017, Chinese policymakers sought to halt the sharp rise in the leverage of the nonfinancial corporate sector over the past decade. The related squeeze on shadow banking diminished the supply of credit to the private sector, slowing investment. In addition, consumption, which had outpaced the Chinese economy for several years, slowed in 2018 relative to other sources of demand. The deceleration of manufacturing in the second half of 2018 reflects, at least in part, the downward pressures of a global business cycle that are also evident in Europe and other parts of Asia.

In the final quarter of 2018, a variety of short-term indicators in China — including retail sales and surveys of purchasing managers — exhibited a sharper deceleration. Partially in response, China’s policymakers are already implementing expansionary monetary and fiscal policies, aiming to support 2019 GDP growth in the 6 percent to 6.5 percent growth range, while continuing to address legacy issues such as overcapacity in sectors like steel, aluminum, heavy construction equipment and shipbuilding. It remains to be seen whether efforts to support growth will be consistent with the goals of deleveraging and reducing excess capacity.

It is important to underscore that China’s current account surplus as a share of GDP, which approached 10 percent in 2007, is estimated by the International Monetary Fund to have sunk below 1 percent in 2018 on its way toward zero in the coming years. Thus, despite China’s unusually high savings ratio and slowing domestic demand, its overall external imbalance should no longer be a source of international concern.

The Troubled U.S.-China Relationship in Cross-Border Trade and Investment

The U.S-China trade and investment relationship is more troubled today than it has been in decades. Given that China and the United States are now the world’s two largest economies, the maintenance of an open global (and bilateral) trading regime and of large cross-border capital flows depends on the broad perception of evenhanded national treatment and on credible protection of the property rights of foreign participants in both economies.

As the United States and China are the world’s largest economies with a major impact on the global allocation of resources, and the potential to materially harm other economies, the two countries share responsibility to accept an international rules-based regime — not just for trade, but for other aspects of economic policy, such as foreign investment, subsidies, and the relative treatment of state versus private enterprise. One goal of such rules is to limit distortions that artificially alter current or future comparative advantage(s).

In both China and the United States, mutual confidence in reliable, long-term economic collaboration has declined, while policy has become highly confrontational — both reflecting and adding to the loss of trust. Recent policy commentary in both countries points to near-term success in preventing the further escalation of trade disputes, but this will not put the genie back in the bottle. Some forms of economic de-linkage — for example, in sensitive sectors like telecommunications, semiconductors, and batteries— already are under way. It will be a challenge for policymakers in the coming years to keep this de-linkage from extending beyond the areas that are truly related to national security or to the protection of privacy.

Access and IP protection. Although China’s overt regulatory and entry barriers are more restrictive than those in other countries, Chinese authorities appear inclined to resolve some long-standing “structural issues” to promote greater cross-border investment. For example, caps on foreign ownership already have been removed in key sectors like automobiles and agriculture, while imminent progress appears likely in finance. Removing ownership caps seems the most effective way to address frequent disputes about “forced” technology transfers: foreign firms that wish to sell their products or services in China without transferring technology would be able to do so without being required to operate through a joint venture.
China has also recently created a new legal apparatus that includes specialized courts designed to improve the enforcement of IP rights. While these legal developments are at an early stage and require close monitoring, they reflect changing attitudes in China, partly driven by the growing interests of domestic firms engaged in innovation and the creation of IP.

Other Structural Issues. The most sensitive and difficult structural issues include: (1) the role of state-owned enterprises (SOEs) in China, and; (2) China’s industrial policy. The latter includes enormous subsidies for frontier research in general-purpose technologies with an eye towards dominating the global industries of the future (i.e., “Made in China 2025”).

State-Owned Enterprises. The significant role of SOEs in China affects not only foreign, but all private firms, which traditionally have less access to funding both on average and especially in periods of cyclical policy restraint. With a declining return on assets and rising losses as a share of GDP, SOEs on average depress productivity growth in China. Moreover, numerous mergers of weak SOEs generally have not improved the performance of the sector as a whole. Nevertheless, in recent years, the flow of loans to SOEs has surged relative to that of private firms, and the SOE share of investment is rising again.

Against this backdrop, promoting long-term economic growth and productivity enhancement likely entails a rebalancing of activity toward the private sector. Consistent with the Third Plenum reforms enacted in November 2013, rebalancing would provide a greater role for market forces in allocating resources. It also would help address the similar challenges that foreign firms active in China face from SOEs.

International standards point to “competitive neutrality” as a useful principle for promoting a more efficient allocation of resources and limiting the economic distortions created by SOEs. According to the principle, the state should not discriminate between SOEs and private firms, seeking to ensure that the input costs (including the cost of finance) of an enterprise are not influenced by its ownership. To make the commitment to competitive neutrality credible, monitoring the cost of inputs will require thorough transparency by firms, while limiting implicit guarantees will require the imposition of effective budget discipline on SOEs to prevent reliance on government bailouts.

The Need for a More Multilateral Approach
For years, participants in this track II Dialogue have advocated the adoption of enforceable, transparent, and rules-based mechanisms to promote bilateral trade and cross-border financial flows, while securing property rights in ways that are in the interest of both countries. Examples of this approach include past proposals endorsing a Bilateral Investment Treaty (BIT) (with “ownership neutrality” and a short “negative list”) and prompt enactment of a Trade in Services Agreement (TISA). Dialogue participants continue to believe that such measures are in the long-term economic interests of both countries and would help restore mutual confidence over the long term.

Realistically, however, the broadening of the areas in dispute — including not just trade, but cross-border investment and cyber-intrusions — argues against over-reliance on bilateral negotiations as a means of dispute settlement. The overt failure of bilateral negotiations could possibly trigger further declines of confidence and trust that may be difficult to reverse. Moreover, whereas bilateral negotiations fuel perceptions of a zero-sum game that limit political flexibility, multilateral arrangements allow policymakers to offer concessions where each participant can enjoy a “win” — namely, the benefits of sustained global cross-border trade and investment. Considering the interest of many countries in limiting cyberintrusions for the purpose of corporate espionage, seeking credible and enforceable resolution through multilateral arrangements may be particularly appropriate in this area.

Greater reliance on multilateral approaches to dispute settlement should be supplemented by frequent bilateral exchanges of views. Chinese and American policymakers should continue to engage in open dialogue to highlight differences over trade and cross-border finance. Additionally, the leadership in each country should encourage regulators and policymakers to work closely with foreign businesses
operating or seeking to operate in their economies and to respond to their areas of concern about the obstacles to doing business. This would include measures ensuring that firms’ property rights are respected and enforced.

**The Clear Risks and Opportunities**
The dialogue participants generally remain hopeful that a near-term agreement between the United States and China will forestall a further sharp rise of U.S. tariffs on Chinese imports in March or thereafter. However, the risk of failure is far from trivial. In the judgment of participants, a further escalation of the trade conflict would impose enormous costs on both economies in terms of jobs, investment, and wealth. Indeed, a sufficiently large disruption could lead to recession, higher inflation, and major financial disturbances.

Simply stated, further intensifying the trade conflict is not in either country’s best interest. Rather, policymakers should seize this opportunity for cooperation, not conflict. The opportunities for mutual gains through more open trade and finance remain enormous, reflecting natural complementarities between the two economies. Welcoming U.S. firms to compete in China would speed its transition to a services economy, promoting China’s competitiveness and boosting economic growth in both countries. Financially, the households of both countries have under-diversified portfolios, pointing to potentially substantial gains from cross-border investment flows. China’s outward direct investment remains small relative to the size of the economy or even relative to China’s stage of economic growth. Both countries would gain especially from the increased market discipline concomitant to greater cross-border competition.