



CONSENSUS VIEW OF THE SIXTH U.S.-CHINA TRACK II ECONOMIC DIALOGUE

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This year, a leadership transition in China and the reelection of Obama in the United States present both new opportunities and challenges in improving the economic relationship and building trust between the two countries. Chinese economic growth stabilized in late 2012 and will likely improve modestly in 2013. However, three favorable economic factors that drove growth in the past – unlimited labor supply, low production costs and rapid export expansion – are diminishing rapidly. Future growth in China will depend more on reforms, innovation and industrial upgrading. The U.S. economy narrowly escaped the fiscal cliff at the start of 2013, but near-term legislative deadlines on key fiscal issues still pose significant risks that could disrupt markets. Despite progress by households in deleveraging their balance sheets, a recovery in housing and a modest resumption in job creation, the U.S. unemployment rate remains high and economic growth is well below its long-term potential.

Both China and the United States require important structural reforms to sustain growth and support stability. As new teams take over economic leadership in both governments, they should move expeditiously to implement needed reforms, rather than await a crisis to act. Reforms in China and the United States, combined with collaboration between the two largest economies, can underpin prosperity for both countries and support the global economy.

The new leaders in China have made firm commitments to re-accelerate economic reforms, with the central theme of urbanization. They will likely introduce or deepen reforms in several areas, such as the household registration (*hukou*) system, extension of experiments on service VAT, property tax and resource tax, and income distribution policy. In coming months, the Obama administration will have to work with Congress to raise the debt ceiling, avoid sequestration by agreeing on a plan to cut spending and pass a continuing resolution to keep the U.S. government operating. Over time, the United States will also need to, revitalize its tradables sector, rebuild its infrastructure and educational system, reduce projected increases in health care spending and put its entitlement outlays on a sustainable path as it seeks to reduce unemployment. These will help to create robust growth on a sustainable basis.

The dialogue discussed the respective concerns China and the United States have for the other country in the economic arena, the needed reforms to address these concerns and recommendations for collaborative efforts to improve the trust between the two countries.

American Concerns About and Suggested Reforms for China

From a U.S. perspective, China appears to have slowed the pace of reform in recent years. The critical shift toward reliance on market forces has gradually lost steam. That is seen in the continued state control of interest rates, energy prices, and the exchange rate as well as the continuing presence of state-controlled monopolies, the lack of transparency and lack of intellectual property protection. Increasing disclosure and transparency will be critical to make the market for private securities function effectively as a capital allocation mechanism. Thus required reforms include liberalization of factor markets (for capital and labor) as well as liberalization of entry into sectors where state-owned firms have extensive market power. In addition, to make the system robust, China needs a deposit insurance scheme that can sustain confidence in a liberalized banking system.

- **Expedite Interest Rate Liberalization:** Interest rate liberalization in China, which began in the late 1990s but slowed substantially after 2004, should resume and accelerate. The next round of reform should focus on liberalization of medium and long-term bank deposit rates and later short-term deposit rates as well. Likely this will lead to higher rates, which would increase household income and thus contribute to increase consumption expenditure, a key objective of the government's rebalancing policy.

Banks undoubtedly would pass on in part their higher cost of funds and this would tend to reduce China's extraordinarily high rate of investment. Liberalization of interest rates should also include the corporate bond market, which would lead to the development of a yield curve that would improve the allocation of capital.

- **Market-Determined Value of Currency:** In order for the value of its currency to become even more market determined, China should further reduce its intervention in the foreign currency market and allow greater flexibility of the exchange rate.
- **Hukou Reform:** China should consider accelerating the reform of its household registration (*hukou*) system. This liberalization of the labor market would lead to a more efficient allocation of labor and help reduce income inequality, a major concern not only of China's citizens but its leadership as well.
- **State Sector Reform:** China's private businesses have become an important source of China's economic growth but their contribution would be further enhanced by reducing barriers to entry in sectors where state-owned firms exercise monopoly power and by improving private firm access to capital. These reforms will allow private firms to compete on a level playing field with state companies and drive innovation in China's next wave of growth.
- **One-Child Policy Reform:** China also needs to reform its one-child policy given the potentially grave population aging issue and the related health care and welfare problems.

Chinese Concerns About and Suggested Reforms for the United States

There are four key areas of policy concern: fiscal, monetary, trade, and bilateral relations with China.

- **Fiscal Sustainability:** The fiscal situation in the United States continues to deteriorate with no agreement on spending cuts. The U.S. Administration and the Congress need to compromise on a long-term plan for expenditures and outlays that restores the sustainability of the federal debt path and ends the periodic crises that result from policy stalemate.
- **Federal Reserve's Quantitative Easing (QE):** The Fed has conducted three rounds of QE. While there is considerable doubt that QE has done much to spur output growth or job creation, repeated rounds of QE introduce distortions into the U.S. and global economies by injecting excessive liquidity that places upward pressures on commodity prices and, as a result, price levels in emerging economies. The Fed's QE policies also risk the creation of new asset bubbles that will lead to future disruptions.
- **Protectionism:** Rising protectionism in the United States is evidenced by the number of anti-dumping cases against Chinese companies. Some of the punitive actions adopted by the U.S. government have triggered retaliatory actions by the Chinese government. Although the volume of trade involved has been relatively small, this exchange of punitive actions influences public opinion in both countries and is detrimental to building mutual trust. Free trade has been one of the key elements of American success and one of the cornerstones of American foreign policy. The U.S. government should put up a strong firewall between its trade policy and populist demands, so that trade continues to serve the country's long-term interests.
- **Hedging on China:** Before the financial crisis, the U.S. foreign policy toward China was one of engagement. Since 2010, however, this policy has been increasingly replaced by one of caution and hedging. China and the United States have different political systems; but history shows that this need not – and should not – be an obstacle for the two countries to improve their relations. While the U.S. caution is most evident in the political and security arena, the shift also affects the U.S. economic policy toward China. One example is the “Trans-Pacific Partnership” (TPP) proposal. This proposal for free trade sets standards for membership that China will not be able to meet over the medium term, but its impact on the economies of the Pacific region will be severely limited if China is excluded. Another example is the U.S. government's tighter security check on Chinese acquisitions and greenfield investment in the United States. The earlier U.S. engagement policy brought positive changes in China that are in the U.S. interest. The U.S. government needs a policy toward China that is based on coexistence and cooperation.
- **Reform of the Financial Sector:** The United States should strive to further enhance real reform of the financial sector, expand/revive its tradable sector and reduce external imbalance in order for its economic recovery to continue.

Building Mutual Trust through Collaborative Efforts

Trust between the United States and China has been faltering in the strategic and economic arenas. This dialogue has identified the following areas of possible collaborative efforts between the two countries that are not only mutually beneficial economically, but would also help rebuild trust.

- **Open Trade Environment:** Both countries benefit from open trade environment and therefore both governments should institute an open trade regime that allows for natural resources to move back and forth with fewer restrictions. The promotion of bilateral energy trade can be a fruitful foundation for cooperative policy making.
- **Bilateral Investment Treaty:** Chinese investment in the United States is increasing rapidly while U.S. investment in China should increase as China implements its 12th Five Year plan and moves to a consumption-driven economy. Increased investment creates jobs, helps both economies and strengthens US-China relations. Both the process of negotiating and the actual establishment of a Bilateral Investment Treaty (BIT) would facilitate investment, so joint efforts to move towards a BIT should be given a high priority in both countries. In the interim, each country should appoint a public ombudsman to help resolve investment problems that the other country's investors encounter.
- **Free Trade Agreement:** A free trade agreement (FTA) between the United States and China will require many years to negotiate and build political support to ensure approval. Nonetheless, commencement of negotiations on an FTA would symbolize both countries' desire to build an even more mutually beneficial economic relationship. In addition, the discussions would help China anticipate what domestic economic reforms it would need to undertake to conclude an FTA. The same discussions would allow the United States to understand Chinese concerns about impediments for deepening entry into the American markets.
- **Restructure the Strategic and Economic Dialogue:** The two governments need to revitalize the structure of bilateral economic dialogues away from the large-scale media event that the Strategic and Economic Dialogue has become and return to smaller, more frequent (at least twice a year) gatherings where top leaders from both countries devote at least two days to the economic issues at each meeting. Groups of 10-12 persons on each side will accomplish more than the 200 participants on each side that have met in the past. In addition to leading discussions on the important issues, this more focused process will foster strong working relationships that build trust over time.
- **Protection of Intellectual Property Rights (IPR):** China needs to enhance its protection of intellectual property, both to foster continued foreign investment and to promote domestic innovation. Foreigners will invest in and export more advanced technologies when they have confidence that those technologies will be protected. A stronger IPR regime also is important for China because domestic entrepreneurs will need the same protections as the economy shifts toward services and away from manufacturing. China can build on its progress in IPR protection that has encouraged domestic companies to use IPR lawsuits to secure their interests. There is ample room for improvement. For example, both sides of this dialogue acknowledge that the Chinese government should implement more vigorous enforcement of the intellectual property laws. One way to expedite this process is for the two governments to set up a working group comprised of scholars and industrial experts to study the issue and come up with some model IPR arrangements to recommend to both Chinese and American companies.



National Committee on
United States - China Relations



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