

U.S.-CHINA TRACK II DIALOGUE ON THE DIGITAL ECONOMY

CONSENSUS AGREEMENT

November 17-18, 2021
Zoom meeting

The National Committee on U.S.-China Relations and the **China Institute for Innovation & Development Strategy** convened their fourth Track II Dialogue on the Digital Economy virtually through Zoom on November 17 and 18, 2021 (November 18 and 19, 2021 in China). The Dialogue brought together U.S. and Chinese experts from academia, think tanks, and industry for non-governmental, off-the-record, in-depth discussions on digital economy issues of concern to both countries. (See the name list below.)

The two days of discussion advanced the results of the previous session of the Dialogue held in December 2020, as set out in the Consensus Agreement from that meeting. The November 2021 session focused on two key areas of concern and opportunity in the digital economy for both nations, namely, semiconductors and enterprise software. The participants agreed that China-U.S. relations are at an unprecedented inflection point and both countries need to take concerted action if the digital economy is to develop for the benefit of both nations, their peoples, and, by extension, the world. This document sets forth recommendations that both sides can propose to their respective governments.

The Importance of a Global Digital Economy

The rise of the digital economy has fundamentally transformed the economic and social life of the United States, China and the world. Digital technologies are now critical to the economic growth, job creation, technology leadership, and national security of both countries. Today, business in the global technology and digital services industries is strong and growing. Trade between China and the United States continues to expand, with digital technologies, including software, semiconductors, and intellectual property, entering into China and phones, personal computers, and server products exported globally from China. American digital technology products are also widely available in China.

The participants recognize that a global, interconnected digital economy is in the best interests of both countries. Just as open trade in goods has powered the growth of many nations, including that of China, so globalization of technology, including semiconductors, the Internet, data, and cloud services, have enormous benefits for the Asia-Pacific region and the world. As the two leading countries driving and benefiting from the digital economy, China and the United States have their respective strengths in semiconductors and software. There are thus, to a great extent, intersections of the two countries' long-term goals and areas for cooperation. The next round of innovation and cooperation of both countries in the digital economy will present an opportunity to accelerate global digitization. In addition, both countries play a major role in maintaining the stability of global digital economic value and supply chains and developing an open and standards based digital ecosystem.

Current Risks and Harm of Decoupling of the Digital Economy

However, recent actions and longer-term policy preferences and initiatives of both the Chinese and American governments are threatening to accelerate further “decoupling” of the global digital economy. The compromised foundation for strategic mutual trust and security concerns of both sides have caused obstacles to technology exchanges, increased market constraints, stricter investment reviews, and weaker supply chain cooperation, leading

to market fragmentation of the global digital economy. These phenomena of decoupling have clearly injured both U.S. and Chinese industries in the digital economy, driven up operational costs of companies, and disrupted cooperation within the global digital economy.

Particular policies and concerns raised by each side to the Dialogue include:

Raised by the Chinese team:

- The United States continues to restrict the access of Chinese companies to U.S. technology based on a generalized concept of national security, tying the entire semiconductor industry to issues such as military applications and human rights related to national security, and by introducing exclusionary bills to impose export restrictions on semiconductor products in non-sensitive fields.
- The U.S. is increasing its subsidies to industries to support domestic supply chains and is also accelerating its efforts to work with global allies, seemingly to develop a “non-Chinese” supply chain.
- The U.S. administration continues to expand its export control lists, which brings tremendous uncertainty to supply chains and undermines globalization. Chinese companies are forced to pursue supply diversity.
- Some bills recently passed by the U.S. government appear to consider China as a foreign adversary and forbid Chinese digital companies from accessing sensitive personal data of American citizens. This appears to be inconsistent with the United States’ emphasis on the free flow of data across borders.
- U.S. policies and proposed bills focusing on Chinese companies have had significant reputational costs for Chinese software companies, such as cloud service and AI companies, making it more difficult to operate in the United States.
- The United States should further clarify Committee on Foreign Investment in the United States (CFIUS)’s criteria and rules of national security reviews on Chinese investments. The United States seems to continue tightening its review criteria and rules for Chinese investments, particularly in areas involving personal data.

Raised by the American team:

- Domestic companies have a dominant position in China’s Internet and cloud markets, with American companies a clear minority, while the opposite situation prevails in the rest of the world. China is pursuing a set of policies that increasingly emphasizes and incentivizes greater “self-reliance” and “secure and controllable” supply chains, as well as assuring the government’s ability to regulate and potentially restrict some types of cross-border data flows.
- China has adopted a national level policy of technology self-reliance, which appears to be implemented via pursuing a self-sufficient industrial ecosystem. Given the complexity of the sector supply chains, this would be a very difficult and long-term effort with uncertain outcomes. If left unchecked, this dynamic has the potential to lead to two separate semiconductor supply chains, and result in a wholesale “decoupling” of the global semiconductor market, with huge unknown consequences for the industry.
- The Chinese government, through methods such as government subsidies, encouraged venture capital investment and local procurement, seeks to reduce Chinese companies’ dependence on American technology. Left unchecked, this dynamic of increasing government subsidies as well as growing restrictions on Chinese company access to U.S. technology will distort the market driven nature of the semiconductor ecosystem and will worsen the strategic mutual trust in the digital economy.
- U.S. cloud service companies can only obtain licenses to operate in China through a Chinese partner. They are also required to buy connectivity via optical fiber services locally only from Chinese telecoms carriers and cannot operate under their U.S. brand name. This makes it significantly more difficult for such U.S. companies to compete with domestic companies.
- New laws, such as the Data Security Law and Personal Information Protection Law, which were recently enacted and are in the implementation stage, create uncertainty regarding how they will be implemented and enforced, thus imposing additional burdens on American digital companies doing business in China.
- The Chinese government uses a variety of tools, from local procurement requirements, to licensing requirements, to subsidies, and other forms of pressure, to create an uneven playing field in China for American and other global companies. These tools may also encourage technology transfer and data localization by U.S. companies driven by regulation and political pressure.

The Dialogue participants recognize that a bifurcation of the digital economy – in which Chinese companies, headed only by domestic leaders, using only China-developed technology, manufactured solely in China, and sold only to consumers in China and countries having close relations with China; and in which U.S. companies guided only by U.S. leaders, using only U.S.-developed technology, manufactured solely in the United States and sold only to U.S. and allied country consumers – would have an extremely negative effect on the economies of both nations, as well as countries around the world that rely on an integrated global supply chain. This would not only deny Chinese and U.S. companies access to the other country’s as well as other growth opportunities, but also prevent the sharing of personnel and mutually beneficial R&D processes. These benefits could potentially be worth tens of billions of dollars over the next decade.

If left unchecked, the current trends could lead to a disastrous divide in the global digital economy, resulting in massive duplication of systems, investment, and human capital. It could also result in the serious fracturing of the global Internet, supply chains, market, and technology standards and force nations to select amongst different, and conflicting, standards and products.

The Way Forward: Need for Dialogue

The current state of bilateral relations leaves a challenging environment for progress in this area. As more confrontation emerges between the two countries, hostile arguments, security accusations, and policy barriers are more frequently seen. In the digital economy, China and the United States both stand to gain from cooperation and lose from decoupling. The failure to form a unified market in the digital economy would be a step backwards relative to the steady movement towards interoperability and open markets, and reducing barriers to the free flow of data, technology, and labor. During our Track II Dialogue, both sides recognized that the current government policy approach – recommending that Beijing begin dismantling barriers to market access in China for key U.S. technology companies and recommending that Washington consider a narrower approach to national security-related restrictions on critical supply chains – will be politically difficult in the current low trust environment. These concerns would inevitably be obstacles to the bilateral relationship and breaking the deadlock will require creative navigation of the policy, legislative, and administrative measures in each political system.

Making real progress should involve adding China-U.S. digital economy cooperation to the agenda of the next high-level governmental bilateral meeting, restarting Track I discussions at the cabinet/ministerial level, including digital economy issues of concern in these discussions, and constructively formulating a China-U.S. digital economy cooperation framework. The current approach, consisting of the occasional Cabinet meeting, empty talk of collaboration, and heavy criticism of the other side in each other’s domestic media, has become a dead end, with little to no chance of producing forward momentum, let alone success.

These Track I discussions and the study of a China-U.S. digital economy cooperation framework should include the key actors on both sides who are in charge of digital economy policy and decision-making. For example, on licenses for cloud services market access, there are several key Chinese governmental departments that would need to be involved: the Ministry of Industry and Information Technology (MIIT), the National Development and Reform Commission (NDRC), and the Cyberspace Administration of China (CAC), as well as the Ministry of Public Security (MPS), and the Ministry of State Security (MSS). On the American side, discussion of export control policies would require involvement of the Departments of Commerce, State, Energy, and Defense, at a minimum. Such discussions should build on prior longstanding bi-lateral engagement activities.

The key areas that should be considered for discussion in the Track I dialogue include the following:

- Create a favorable atmosphere for cooperation between the two countries by encouraging bilateral engagement between cabinet-level officials from both countries on a range of key issues.
- **Define how both nations can agree on clear and transparent definitions of national security** so as to limit the types of industries and applications that are classified as “national security risks” and, as a result of such classification, are subject to certain restrictions on their activities. Successfully navigating this issue and achieving binding agreements would enable the vast majority of the market to be free from restrictions and reduce new restrictions stemming from changes in administration on both sides. We see two parallel and concrete implementations of such an approach in critical digital economy spheres:

- Export restrictions on semiconductors to be used by Chinese companies solely in non-national security consumer electronics, such as mobile phones (including 5G phones), tablets, and televisions, should be reduced or eliminated without discrimination. Any verification measures taken to ensure compliance with export control requirements must be developed and implemented according to an agreement negotiated by the commerce departments of the two countries. Moreover, where national security concerns are more clearly present, both governments should consider providing mechanisms for companies involved to address and/or mitigate those concerns.
- Joint venture requirements, excess licensing regulation, and localization requirements that global cloud providers operating in China must now comply with should be reduced or removed. National security requirements related to the sharing and protection of data should be handled via compliance mechanisms developed in joint discussions between the relevant authorities in each market.
- **Develop mechanisms to limit the arbitrary unilateral imposition of trade restrictions, such as tariffs,** so as to create favorable conditions for mutually beneficial trade and collaboration.
- With a new generation of open-source software and cloud services reshaping the software market, **determine how both countries can pursue an equally open market, jointly maintain the autonomy and rules of open-source communities consistent with agreed national security approaches of both countries, promote cooperation and knowledge flow between both countries' enterprises, universities, and research institutions, and make targeted institutional arrangements for the growing market over the next decade.**
- Given the increasing importance of cross-border data flows for maintaining and optimizing global business operations, **create mechanisms that avoid restricting the free flow of data,** particularly data critical to business operations and with lower privacy and national security concerns, to the maximum extent possible. This could include developing a study on cross-border data flows, setting out a definition of data each country considers sensitive and important and therefore subject to government control, with the objective to allow the free flow of data that do not fall within these categories as soon as possible. China may consider piloting in free trade zones/ports (e.g., Beijing Digital Trade Port) to explore a cross-border data flow model between the two nations.
- **Bring both countries' laws and regulations regarding the digital economy in line with the high standards and best practices around data issues as developed within international agreements,** such as the Digital Economic Partnership Agreement (DEPA), and the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP).
- **Restrict or minimize domestic provisions that hinder companies from the other country from doing business in their respective domestic markets.** Areas that should be included for discussion are: data localization rules, local partner requirements, limitations on listing in the domestic securities markets, and removal of non-national security related “buy local” requirements for technology systems.

To be effective over the long term, such a Track I dialogue will require leaders from both countries to approach discussions and a workable roadmap going forward with an open mind, a respect for each other's needs and concerns, a willingness to make concessions where appropriate, and a desire to establish mutual trust.

Parallel Efforts at the Track II Level

Both teams realize that this Track I process can and should be supported through a sustained Track II effort that assists in establishing a realistic and viable roadmap and assists policymakers in both countries, **helping them understand the tradeoffs and benefits of certain policy actions, and how they can contribute to producing a more stable U.S.-China relationship within the digital economy.** These discussions can provide clarity about key issues and avoid, as much as possible, the constraints of ideological pressures that have mounted unchecked over the past two years in particular.

Conclusion

The current stalemate between China and the United States runs the risk of permanently hindering the ability of multi-national companies to compete on a level playing field in the United States, China, and globally. This outcome would have its own serious national security and economic security and commercial consequences for both nations, and these would extend more broadly to other countries around the world. Despite the potentially dire

consequences, both governments continue to emphasize posturing rather than looking for realistic and implementable ways to reduce tensions and identify new channels for dialogue that can lead to long-term appropriate compromises with verifiable outcomes.

The global digital economy is too important for this state of affairs to continue indefinitely. Both nations must move towards dialogue at the highest level to address the current situation and establish rules of the road to guide and build technology for the benefit of all peoples. Numerous groups, including this Track II dialogue, are available to help in this endeavor.

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