U.S.-CHINA TRACK II ECONOMIC DIALOGUE

CONSENSUS

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The Dialogue participants gathered in Beijing – at the 16th round of the track II dialogue on U.S-China economic relations co-hosted by the National Committee on U.S.-China Relations and the China Center for Economic Research of Peking University – at a key moment in the ongoing evolution of China-U.S. economic relations. The new U.S. Administration under President Trump is seeking rapid progress in opening up markets abroad, especially in China, in order to boost U.S. exports, job creation and economic growth. The government of China is preparing for the 19th Party Congress, which will be a source of major new economic reforms and initiatives to support long-run economic development and growth.

Current Economic Setting

- While China and the United States have been able to maintain sustained economic expansions, both face a fundamental challenge: how to promote long-term economic growth given slowing expansion of the labor force and productivity in each country.

- China's efforts to promote growth are associated with several issues. First, the country's high national savings are generating incrementally fewer output gains. Second, a range of imbalances are lingering and, in some cases, intensifying, including: overcapacity in some sectors, increasing leverage, and rapidly rising housing prices in some top-tier cities.

- Against this background, policy reform could provide substantial benefits for the Chinese economy. Greater reliance on competition and market forces would speed growth, as more productive firms gain market share at the expense of less efficient ones, including state-owned enterprises (SOEs). At the same time, policies that accelerate the ongoing shift from manufacturing to labor-intensive services and deepen the social safety net can help sustain the transition to consumption-led, rather than investment-led, growth. In the short run, the government could also pursue an expansionary fiscal policy, involving lower taxes and increased outlays.

- In the United States, policies that promote long-run growth usually aim to: (1) boost productivity growth, which has been slowing for over a decade, (2) encourage greater international trade and business dynamism, and; (3) facilitate labor mobility, speeding the shift of workers to sectors with unsatisfied demand for skilled labor. Hence, the long-run decline in U.S. manufacturing employment — which has been driven more by technology than trade — seems largely irreversible. Unwarranted optimism about long-run growth risks could result in complacency in the formulation of fiscal policy and in the face of rising government deficits and debt.

Policy Reform and Market Discipline

- A key goal of policy reform in both economies is to impose greater market discipline that leads to a better allocation of resources and clearer assessment of risks. For example, regulatory reform is a useful means for promoting both greater economic efficiency and resilience in the long run. In some cases, existing regulation distorts incentives, imposes high compliance costs, stifles competition and innovation, or fosters the buildup of imbalances — for instance, through (implicit or explicit) government guarantees that lead to soft budget constraints. The latter is most evident in U.S. government-sponsored enterprises (GSEs) and China's SOEs.

- In the United States, the Administration has a broad regulatory reform agenda in sectors like energy, finance and health care. The Administration's agenda emphasizes tax reform, a revitalization of infrastructure, and policy shifts in trade and immigration. In some cases, these proposed changes — such as the efforts to expedite permitting for infrastructure projects or to reduce the compliance burden on small and medium-sized banks — would promote long-run economic growth. In many areas, notably including tax policy, the Administration's reforms remain to be specified. Finally, in a few instances, especially with respect to trade and immigration, the Administration's approach risks impeding economic growth.

- Notably, China and the United States are both currently exploring a wide range of changes in financial regulation. Some of the challenges are similar across the two economies: for example, a few very large banks account for most of each nation's banking assets while shadow banking (that is, bank-like activity outside the usual regulatory perimeter) is a rising and important source of credit.

- In China, regulators are currently acting to contain the risks associated with increased leverage and debt, especially those related to rise of shadow banking. In the United States, regulators and legislators are focused more on reducing the burdens associated with financial regulation, which has expanded substantially since the financial crisis. In both countries, there is room to make regulation more cost-effective and transparent, while also making the financial system more resilient. The latter requires imposing greater market discipline on the largest financial intermediaries, encouraging them to internalize the costs of the risks they pose to the financial system as a whole. While promoting financial resilience, policymakers also need a credible framework to mitigate financial crises. This framework should include means for the orderly resolution of large intermediaries. Otherwise, when a future government in either country faces a financial crisis, it will be tempted to repeat the bailouts of too-big-to-fail institutions. Higher capital requirements, supplemented by careful oversight, are widely viewed as the leading tool to align the interests of the largest intermediaries and the public, as this strategy favors better risk management and protects taxpayers at the same time.

- Another example where greater market discipline, achieved through regulatory and other changes, would be particularly beneficial is that of American GSEs and Chinese SOEs. In both countries, the reform initiatives in these areas have slowed or stalled. Accelerating a shift to private housing finance in the United States and to diversified ownership of SOEs — along with lowering the entry threshold for newcomers into these business sectors — would improve the allocation of resources and contribute to economic growth in both countries. One long-run positive externality would be an increased resilience of the financial systems of the two countries.

Policy Should Seize the Opportunities for Large Mutual Gains

The current state of the U.S.-China economic relationship brings with it both large risks and opportunities. The risks are varied. In the United States, these include: a propensity to focus excessively on simplistic forms of bilateral reciprocity, without putting enough weight on integrated global supply chains, and a possible reversion to trade protectionism, which could be a serious mistake for a savings-short U.S. economy that is naturally prone toward a large multi-lateral current account and trade deficit. Moreover, some of the current bilateral challenges mirror those of the early 1980s, when the U.S. government obstructed trade through the imposition of "voluntary export restraints" on Japanese auto producers. In China, a key risk would be a lack of effective implementation of its long-standing reform agenda, (especially that adopted in the 13th Plenum of 2013 and the 13th Five-Year Plan of 2016). This would limit the country's growth potential and the welfare gains of China's consumers, while sustaining impediments to foreign firms wishing to do more business in China. Indeed, foreign firms' perceptions of rising business obstacles in China already risks diminishing their focus on opportunities there.

At the same time, the opportunities for mutual gains through more open trade and finance remain enormous, reflecting natural complementarities between the two economies. For example, the United States enjoys a comparative advantage in services at a time when China is lacking that capability and attempting to increase its services sector in the shift to a consumption-led economy. Welcoming U.S. firms to compete in China would speed this transition, promoting China's competitiveness and boosting economic growth. In the world of finance, the households of both countries can be judged to have under-diversified portfolios, if we refer to large gains from cross-border investment flows. China's outward direct investment remains small relative to the size of the economy or even relative to its stage of economic growth. Both countries would gain especially from the increased market discipline that greater cross-border competition naturally brings with it.

Dialogue participants would urge policymakers in both countries to seize the moment and embrace these opportunities wholeheartedly.

- The government of China should speed the opening of the services sector to foreign competition.
- To realize the full benefit of cross-border investment potential, the two countries should work rapidly to reach agreement on a Bilateral Investment Treaty (BIT) that would provide for open and enforceable rules that protect firms' technologies and intellectual properties, ensure nondiscriminatory national treatment in major business activities (including selling, licensing, investing, and majority ownership), and encourage competition driven by market forces. Given the mutual gains available, the two countries should work on a BIT simultaneously with trade-opening measures, rather than sequencing them one behind the other.
- Consistent with the goal of opening the services sector in China, an effective BIT means that the negative list of excluded sectors should be significantly shortened.
- In reviewing foreign direct investment from abroad, the United States should maintain CFIUS's current focus on security matters, rather than expanding its scope of review to include issues of so-called economic competitiveness. It should also conduct CFIUS investigations in a way that provides clarity for foreign firms wishing to invest in the United States as to what is acceptable.
- Both countries should encourage regulators and policymakers to engage in frequent and open dialogue 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.

- When market conditions are ready, China should seek to make progress toward its espoused goal of establishing a flexible exchange rate regime and removing the capital controls that pose obstacles to more sweeping capital market reforms and long-run economic growth.

<u>The Provision of Public Goods</u>

Finally, as the world's largest economies, both China and the United States need to underscore their respective roles as global leaders through their provision of global public goods, including the trading rules and institutions that support more than $40 trillion dollars in annual global trade. As such, both countries should be consistent advocates of broad-based trade liberalization and develop domestic policies that are consistent with that commitment. At the same time, both countries should be encouraged to add to global public goods with the provision of sustainable development support for third world countries through existing (World Bank) and new (China's Belt and Road initiative) institutional arrangements.