U.S.-CHINA TRACK II ECONOMIC DIALOGUE

CONSENSUS

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The participants gathered in New York for the 17th 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. The meeting occurred both at a key moment in the evolution of U.S.-China economic relations and in a period of unprecedented challenges for global institutions that have supported economic growth and trade since World War II. The U.S. Administration under President Trump has embraced new principles of international economic engagement ("America First") that appear to be targeted at U.S.-China trade relations. The administration has also sought to protect U.S. property rights and to boost U.S. exports, especially to China, with a focus on job creation and economic growth. In China, following the 19th Party Congress, the government remains engaged in efforts to promote both domestic and external expansion, while still addressing the imperatives of structural adjustment.

Current Economic Setting

The short-term economic outlook in China, the United States, and in many other economies is now more favorable than it has been since the global recession that ended in 2009. In the United States, unemployment and inflation are unusually low, while stimulative financial conditions and tax cuts will support the economy's momentum for some time. In China, recent activity continues to shift in favor of consumption and away from investment without a further slowing of economic growth. China also has reduced its dependence on net exports, with the current account surplus likely to be less than 2 percent of GDP this year. In addition, some progress has been made in reducing overcapacity and in slowing the rise of leverage.

At the same time, there are notable risks. First, amid unusually low risk premia, U.S. financial conditions appear fragile. In particular, the prices of risky assets are generally high and—despite improved growth prospects and an outlook for rising federal deficits—the yields on bonds remain surprisingly low. Second, despite recent progress, the challenges in China associated with sectoral overcapacity and high corporate leverage remain significant. Simultaneously, the share of credit intermediation going to privately-owned (and higher-productivity) firms has slumped sharply. Third, geopolitical concerns—especially with respect to North Korea—pose genuine risks for the economies in both countries. Fourth, cyber threats have the potential to disrupt financial and economic activity in many countries. Fifth, as we discuss below, the potential for increasing conflict over bilateral trade relations could undermine confidence and, in the worst case, depress both economies.

Some concern also has been expressed about the prospect for rising policy interest rates in the United States and other major economies. However, in the absence of clearly rising inflation, it is doubtful that the Federal Reserve would tighten policy sufficiently to threaten the U.S. expansion. Moreover, following an easing of the pressure on foreign exchange reserves and in the CNY/USD exchange rate, the Chinese economy is now less vulnerable to rising U.S. interest rates than it was a few years ago.

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

Despite the improved short-term economic outlook, and despite strong growth in U.S. exports to China, the U.S-China trade and financial relationship appears more uneasy today than it has been in decades. With China and the United States 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 increasingly on the broad perception of evenhanded, national treatment and on credible protection of the property rights of foreign participants in both economies.

Yet, in a remarkable change, the December 2017 U.S. National Security Strategy identified China for the first time as a "strategic competitor," signaling: (1) a recognition of China's increased heft in the global economy; (2) a decline of U.S. confidence in China as a long-run economic partner; and (3) an intention for a more confrontational policy approach.

For years, participants in this Track II dialogue have advocated the adoption of enforceable, transparent, 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 to restore mutual confidence over the long term.

At the same time, it is important at this stage to acknowledge the decline of trust and to seek ways to mitigate any damage that could result. The greatest danger would be a series of increasingly confrontational economic disputes that lead to outright trade war. Such a conflict would impose enormous costs on both economies in terms of jobs, investment, and wealth. Indeed, a sufficiently large disruption can lead to recession, higher inflation, and financial disturbances as well. Even a modest conflict can undermine business confidence and slow investment and economic growth.

To put it simply, outright trade conflict is in no one's best interest. Nevertheless, it is easy to imagine how differing perceptions and (mis)calculations can trigger an escalating series of disputes that are difficult to control and would leave both economies substantially worse off. In the current atmosphere, it would take little more than a divergence of expectations on the part of China and U.S. policymakers about the willingness of the other to take the next (more aggressive) step in an escalating quarrel.

It would be far better for policymakers to seize the opportunity for escalating *cooperation*, rather than *conflict*. 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 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, pointing 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.

More realistically, to avoid an escalating conflict, Chinese and American policymakers should engage in frequent and open dialogue to highlight and resolve differences over trade and cross-border finance. In addition, 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 includes ensuring that firms' property rights are respected and enforced. Policymakers in both countries should welcome and rely on multilateral mechanisms for resolving trade disputes, such as those of the World Trade Organization.

We close by noting that the long-term relationship between China and the United States will depend significantly on economic developments in both nations in the next few years. In the United States, there is a major debate whether the government's tax and regulatory changes will add meaningfully to long-term economic growth or whether they will lead primarily to a larger federal debt burden. In China, following interventions in the high-tech sector and expressions of support for state-owned enterprises, there is increased uncertainty about how far the government will go in implementing its commitment to give market forces a decisive role in the allocation of resources, and how that will impact efforts to boost efficiency.

In both countries, the more that longer-term economic prospects improve, the larger the opportunities for, and benefits from, cross-border cooperation.