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ISSUEBRIEF

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INTERNATIONAL SECURITY PROGRAM

A New Framework for US-China Economic Relations

For nearly four decades, there has been a broad consensus among US policy and opinion leaders that China's success will, ultimately, be good for the United States. But this long-standing consensus is now fraying. We need a new consensus, based on an updated framework that reflects the reality that China is no longer a "developing" economy but an increasingly established one.

Eight US presidents from Richard Nixon to Barack Obama have actively fostered closer economic relations with China. We have welcomed Chinese products into the United States, encouraged American companies to invest in China, shared business practices and technologies, and actively supported China's admission into the World Trade Organization (WTO) and participation in other forums that set international rules and norms.

But the old consensus that underpinned this approach is coming apart for several reasons:

- The United States' fiscal and economic challenges in the wake of the financial crisis have coincided with China's relative continued economic success;

- Chinese industries are moving up the value chain faster than many US competitors expected. Thus, Chinese firms are beginning to compete (or show the potential to compete) globally in areas that touch core American comparative advantages, such as advanced electronics or aircraft manufacture;

International Security Program
Task Ahead Project

The Atlantic Council's *Task Ahead Project* is a series of memos from senior policy practitioners to the winner of the November 2012 US presidential elections on the most pressing items on the international agenda. The original *Task Ahead* report featured memos from a bipartisan list of top-flight experts, including Madeleine K. Albright, Brent Scowcroft, James L. Jones, Jr., Chuck Hagel, Josef Ackermann, and Fran Townsend, offering recommendations for US policy on Iran, China, NATO, counterterrorism, supporting democracy, relaunching economic growth, and other issues. This brief is the final report in the series.

For decades, the Atlantic Council's International Security Program has shaped and influenced the strategic debate by facilitating dialogue through critical analysis and policy-relevant programming concerning the greatest security challenges facing the United States and the transatlantic community. This year, the International Security Program will officially be renamed the Brent Scowcroft Center on International Security and will expand the breadth and depth of its programming and expertise to address the new array of security challenges and opportunities facing the transatlantic community around the globe.

For more information about the International Security Program or the Brent Scowcroft Center, please contact the Center's Director-designate **Barry Pavel** at bpavel@acus.org or Deputy Director **Jeffrey Lightfoot** at jlightfoot@acus.org.

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- And China's military buildup and mercantilist policies are viewed by some as threatening. These have led a growing number of Americans to look at China as a certain strategic competitor, and even a possible adversary.

The good news is that the power to restore US competitiveness and fix our fiscal challenges lies largely in our hands. These problems are of our own making, not China's. And we have by far the world's largest and richest economy. Indeed, although we face significant problems, the challenges we face are less daunting than those confronting China and virtually every other major nation.

But here is the bad news: the long-standing consensus supporting positive US-China relations is fraying at precisely the moment when our two economies have become deeply interdependent. Many Americans look skeptically at China, yet China has cemented its place with the United States and Europe as one of three principal engines of the global economy. As a result, Chinese economic problems will bleed into the United States' economy. China's success at sustaining growth and transitioning from an economic model too dependent on exports and fixed asset investment is closely connected to our own future success.

Bluntly put, the United States will suffer if China fails to get ahead of its growing list of economic challenges, which are now threatening to interrupt its remarkable record of success in recent decades. And we cannot afford to have all three of the world's principal growth engines facing a crisis simultaneously.

It is essential, therefore, that whomever is elected US president in November not only attempt to rebuild the consensus around positive US-China economic relations, but also make policy changes that help put our two economies on a path to greater complementarity.

To assure a more mutually beneficial economic framework, we need some new principles to guide our relations. The fact is, the United States and China are working through an outdated economic framework—one created at a time when China was still an underdeveloped economy. And a combination of technological, economic, industrial, and political change means that we cannot address today's dynamic and considerable economic challenges with our current policies.

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For our part, the United States needs a level playing field in China.

But we would benefit, too, from more investment from China. After all, China is sitting on over $3 trillion in foreign exchange reserves (much of it in US dollars), with billions more in the hands of corporations eager to invest here and become global companies. Where US investment once flowed principally to China, we now need investment to flow from China—and in a way that creates good jobs for American workers, farmers, and ranchers. We should want our dollars back—but to be invested in productive ways that create American jobs and boost the US economy.

For its part, China wants a fair shot at the US market too: the Chinese want policy changes that will allow better access to technology, and a clearer, more predictable process for investing in the United States.

So, I recommend five basic principles as a guiding framework to help put our economies on a sounder—and more complementary—footing.

Principle One: Unlock the Promise of Capital and Cross-investment

For the United States, this means assuring greater openness to Chinese investment, leading to the creation of American jobs.

For China, it means undertaking financial reforms now that Beijing might well prefer to kick down the road.

Here is what you need to press hard for in Beijing: China should pursue a market-determined currency and an accelerated timeline for capital account liberalization. But just as important, it must put the financial tools in place today that will better position China to respond to the current crisis while preventing China's own crisis down the road.

You can tell Chinese leaders that there is a self interested case for this: What is happening in Europe is China's second warning bell in as many years.

China is just too big an economy—and still too dependent on exports—to ignore what is happening in the very markets whose demand has powered China's growth for so long. And frankly, the present crisis should make financial reforms more, not less, urgent for China. China has been able to wall off its financial system in the past—during the Asian financial crisis, for example, and again, more recently. But a $6 trillion Chinese economy, deeply integrated into the global system, cannot remain forever immune to what is happening in the $30 trillion economies of Europe and the United States.

Similarly, in our own self-interest, we should be prepared to be much more welcoming of Chinese investment.

Many Americans react negatively to foreign direct investment (FDI)—even though it is the ultimate vote of confidence in our system. FDI creates good jobs in the United States: 5.6 million, including over two million in manufacturing. And the average salary of these jobs is thirty-three percent higher than the national average. But the US government estimates that affiliates of Chinese firms in the US employed little more than four thousand Americans in 2009.

So there is plenty of room to grow—not least because Chinese companies have been reluctant to invest, judging that they will not be welcomed here or because they do not understand the investment process.

We should:

- publish more and clearer illustrative examples of investments that have passed or failed the review process, helping to demystify the process of our Committee on Foreign Investment in the United States (CFIUS), for example, and further clarify how it works;

- and since China's state-owned enterprises also want to invest here, we need a process to define principles for their outbound investment—like the "Santiago Principles" developed for sovereign wealth funds. The United States should lead such a process.

Principle Two: Assure Financial Markets that are Transparent and Have Strong Oversight

For the United States, this means clarifying new regulations and implementing sensible regulatory practices. It also means correcting flawed policies that led to massive consumer debt, a housing bubble, and unsustainable household leverage ratios.

For China, it means speeding up financial reforms and strengthening oversight and transparency of nonbank lending. It also means correcting flawed practices that have led to massive producer debt and the misallocation of capital.

Well-functioning markets get money to where it is needed. But they also prevent financial systems from creating hidden excesses or bubbles, which are counterproductive and can be destabilizing. Both our countries need financial innovation and liberalization. But we both need stronger financial oversight and more transparency too.

Principle Three: Work to Strengthen Market Confidence in our Economies

Markets are built on trust: transparency fosters it. A lack of transparency erodes it.

For the United States, this means overcoming the markets' lack of confidence in our government's ability to take the necessary steps to protect our economy and keep it competitive. In the crisis of 2007 and 2008, the markets lost confidence in mortgage securitizations—and perhaps all securitizations—because they were so complex.

Risks were impossible to understand. Credit ratings lost their meaning. Credit ratings agencies lost their credibility, particularly with regard to securitized products. And one institution after another said they were healthy, right up until they failed.

For China, it means overcoming a lack of transparency—not least a dearth of trust in government data and questions about corporate accounting and disclosure. Recently, outright fraud in a number of Chinese companies that were backdoor listed in the United States has morphed into concerns about the transparency of Chinese banks. So to restore trust, we need to urge Beijing to rectify problems with government and corporate accounting and disclosure.

And there is another ingredient of bolstering market confidence: we need a stronger government commitment to addressing our respective economic challenges. For China, that means deepening its commitment not just to growth but also to rebalancing—and thus to sustainable growth. So we must work with Beijing on an affirmative agenda to help them do precisely that. For our part, we need to forge a political consensus to tackle our fiscal deficit. And we need fundamental reforms to restore our competitiveness, including, but not limited to, entitlements, taxes, immigration, housing, energy, education and training, and our tort system.

Principle Four: Free Up Bilateral Trade

For the United States, this argues for moving toward bilateral trade negotiations with China. The global trade round is going nowhere fast. And it also means granting China market economy status on a sector by sector basis.

For China, this means getting more serious about three things:

- boosting domestic consumption, so that its market becomes a much bigger export destination for US goods and services;
- expanding market access, including by completing residual WTO commitments;
- and ending an array of discriminatory and anti-competitive practices.

Principle Five: Help Technology Flow More Efficiently and Promote Innovation

For the United States, this means reforming our outdated export control system while assuring our national security. Too often, we restrict trade that would create US jobs and is in our national interest.

Separately, the clean energy policy challenge is now so great that we should have a US-China pilot project, relying on scientific input and evidence, to make it easier for the world's two largest economies, energy consumers, and carbon emitters to use the best technologies available.

For China, this means respecting and enforcing intellectual property commitments. But ultimately, it means making the shift from a consumer to a producer of intellectual property by legitimate means—not using access to its market as a backdoor to obtain the intellectual property developed by others. Only when China innovates—not just assimilates—technology will it have enduring incentives to protect intellectual property.

With this framework of five principles in place, we should be able to set our two economies onto a more complementary path. We do not always need to work jointly with China. But we do need to take steps—mostly individually, sometimes together—that will have the mutually beneficial effect of supporting and sustaining economic growth.

Ultimately, the best thing we can do in the face of a more competitive China is to restore our own economy and

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address our fiscal deficit and growth outlook. And that can only be achieved through fundamental reforms based on bipartisan cooperation.

The era of overconsumption in the United States is gone forever. And with hindsight, we can see that, like all bubbles, it was unsustainable. As American families repair their balance sheets, consumer spending will not lead growth as it has in the past. But our economy is highly resilient. And our problems are of our own making. Our continued leadership will be a function of our ability to make required policy adjustments.

You can lead the way. It is our choices that matter most as we seek to remain globally competitive and economically strong.

JULY 2012

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The Atlantic Council is a nonpartisan organization that promotes constructive US leadership and engagement in international affairs based on the central role of the Atlantic community in meeting today's global challenges.

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