

SEPTEMBER 2017

Parallel Perspectives on the Global Economic Order

A U.S.-China Essay Collection

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SHANGHAI INSTITUTES FOR INTERNATIONAL STUDIES

A Report of the

CSIS SIMON CHAIR IN POLITICAL ECONOMY AND SHANGHAI INSTITUTES FOR INTERNATIONAL STUDIES

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A Report of the
CSIS Simon Chair in Political Economy
and the Shanghai Institutes for International Studies

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Preface

The United States and China are the world's two largest economies. Over the coming decades, no two countries will have a greater impact on the global economic order—the system of institutions, rules, and norms that govern international economic affairs. A global economy that delivers strong, sustainable, balanced, and inclusive growth will depend on such a well-managed order. More than ever before, Washington and Beijing must work together to identify potential areas of cooperation, as well as manage our differences.

It is this collaborative mission that has inspired the deep and productive relationship between our two institutions, the Center for Strategic and International Studies (CSIS) and the Shanghai Institutes for International Studies (SIIS), for many years. Since 2015, we have cohosted the U.S.-China Dialogue on the Global Economic Order, a track 1.5 dialogue that has sought to build mutual trust, enhance communication, identify issues, and propose solutions. The series of semiannual workshops, alternating between Beijing and Washington, has covered a wide range of topics across the global economic order including trade, investment, finance, and climate change. The dialogue has drawn scholars, former policymakers, and current officials from the United States and China across a wide range of institutions and disciplines.

This essay collection harvests some of the rich bounty of our two-year dialogue. Scholars from the United States and China have contributed parallel essays presenting their respective positions on a wide variety of topics in the global economic order. We hope that this collection will generate new ideas that scholars, policymakers, and citizens in both countries can use to solve the most urgent problems in the global economy.

John J. Hamre
President and CEO
CSIS

Chen Dongxiao
President
SIIS

Acknowledgments

In November 2015, CSIS formally launched the U.S.-China Dialogue on the Global Economic Order in partnership with the Shanghai Institutes for International Studies (SIIS). The dialogue has since held four workshops—two in Beijing in the fall of 2015 and 2016, and two in Washington in the spring of 2016 and 2017. We would like to thank the U.S. and Chinese workshop participants who generously gave us their time and insights, and who, directly and indirectly, have helped shape these essays. The contents of the essays reflect the views of the authors themselves, and not of other workshop participants, their institutions, or CSIS and SIIS.

Several members of the CSIS staff contributed to the production of this essay collection. Daniel Remler provided a steady hand as chief editor. Elizabeth Keller provided tireless coordination and administrative support throughout the process. David Parker provided invaluable drafting and research support. Casey Rothberg and Eva Zhang contributed considerable time and energy to the final manuscript. Finally, we would like to thank Ye Yu of SIIS for her constant support in coordinating both the dialogue and the essay collection.

The dialogue and this essay collection were made possible by the generous support of the Carnegie Corporation of New York (CCNY). We are especially grateful to Stephen Del Rosso and Aaron Stanley, for their confidence in us and for their commitment to scholarly dialogue between the United States and China.

Matthew P. Goodman
William E. Simon Chair in Political Economy
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Introduction: The United States, China, and the Global Economic Order in 2017

Kevin Nealer

International polling and the politics of the past year both suggest a high level of anxiety among global populations about personal and economic security, as well as the impact of globalization. Participants in the U.S.-China Dialogue on the Global Economic Order have sought to put the U.S. and Chinese economies in proper perspective and to understand the responsibility of the world's two largest economies in promoting stable global development, while expanding opportunities for their populations at a time of unparalleled technological change.

Despite real concerns about the impact of globalization on both countries, the United States and China benefit from generally consistent and successful policies, favorable economic fundamentals, and a shared commitment to managing both macroeconomic and security risk. American and Chinese policymakers and thought leaders are managing the consequences of success—not failure—in the opening decades of this century, because of the policy choices of the late twentieth century.

Yuval Noah Harari, author of the book *Sapiens*, notes that, “For the first time in history, more people die today from eating too much than from eating too little; more people die from old age than from infectious diseases; and more people commit suicide than are killed by soldiers, terrorists and criminals combined.”¹ As Harari suggests, it is useful to remind ourselves of some positive underlying realities:

- Both countries benefit from falling energy prices, expanding alternative energy production that could outpace carbon energy reliance within two decades, and stable supplies of hydrocarbons. And—at least prior to the 2016 U.S. election—both regarded mitigating carbon's impact on the global environment as a high priority.
- The United States has emerged from the financial crisis and subsequent deleveraging with respectable job creation and record-breaking equity market performance. Corporate earnings are credible, despite suboptimal growth and lower-than-expected wage and productivity gains. The corollary is low inflation.
- Chinese policies avoided the global financial crisis and subsequent recession. China has seen the largest mass movement of people in human history in the past three

¹ Yuval Noah Harari, *Sapiens: A Brief History of Humankind* (New York: Harper 2015), <https://www.amazon.com/Sapiens-Humankind-Yuval-Noah-Harari/dp/0062316095>.

decades, with over 500 million migrating from the countryside to urban areas and, concomitantly, into the country's middle class. It has begun the challenging process of managing slower growth, thus far avoiding the worst impacts of the withdrawal of government stimulus.

- While both nations face very different kinds of border migration challenges, in neither country are those risks overwhelming institutions and posing the economic threats that undermine politics and government capacity in Europe, the Middle East, and Africa.
- Domestic terrorism has been a manageable risk in both countries. There have been fewer than 200 terror-related deaths in the United States since 2001, and nearly 800 in China since then, most concentrated in the Xinjiang region.² While the public in both countries expresses understandable alarm at the terror threats, the Islamic State and al Qaeda are very different from terrorist entities of the previous decades: first, neither is supported by nation states as part of a Cold War surrogate struggle; and second, both are targeted by every security service and military of every nation. The danger these groups pose is to public confidence, not to economic fundamentals.
- Regional Asian security issues present genuine challenges to the U.S.-China relationship, but there are no current violent contests in the region that undermine essential regional stability. Border disputes present real risks to growth and development, as well as mutually beneficial exploitation of resources, but Washington takes no position on those contests while insisting on peaceful resolution and the maintenance of commercial traffic. Taiwan relations remain a policy difference, but all parties agree that the issue will be decided by Chinese on either side of the Strait. The Korean Peninsula is the most significant source of regional insecurity, but Chinese and U.S. interests and priorities on this issue—though not identical—have never been more closely aligned.

The Global Economic and Political Outlook

The global economic backdrop to the U.S.-China relationship is benign, reflecting modest growth but with several possible headwinds. Recent projections by the International Monetary Fund (IMF) are optimistic, with a projected rise in global growth of 3.5 percent and higher into 2018. Investment, manufacturing, and trade are all expected to recover.

The Eurozone is perhaps two years out of cycle with the United States but is now experiencing resilient job growth (with unemployment now at its lowest since 2009) and demand that has eluded Europe for several years. Weaker export demand from China and slowing credit demand may signal renewed softness later in the year, but EU growth in the first quarter of 2017 showed a marked improvement over recent trends, outperforming the United States by two to one. Political conditions in Europe—in a defensive position since the

² Global Terrorism Database, "United States: Incidents Over Time," June 2017, <https://www.start.umd.edu/gtd/search/Results.aspx?country=217>; Global Terrorism Database, "China: Incidents Over Time," June 2017, <https://www.start.umd.edu/gtd/search/Results.aspx?country=44>.

United Kingdom's Brexit vote—benefit from centrist election victories in Holland and France in advance of a German general election in September.

Meanwhile in Japan, low unemployment (at a 22-year record low) and the fastest export growth in two years supports improving business sentiment. While overall growth remains modest, the third-largest economy is buoyed by a weak currency, accommodative monetary policy, and healthy global demand. Security on the Korean peninsula and maritime disputes will, however, continue to dominate political and economic concerns within the region.

The Middle East and North Africa continue to face lower—though recovering—oil prices. Despite a backdrop of regional instability and lagging tourism in Egypt and elsewhere, nonoil sectors are experiencing modest growth. Sub-Saharan Africa is expected to experience modest growth in 2017 as well but will remain vulnerable to global factors—such as China's slowdown and policy uncertainty in the United States and Europe—as well as structural and governance issues.

Latin America emerged from a two-year recession in early 2017, though political risk in Brazil and the Venezuelan crisis have been negative for the region and may produce spillover effects.

Rising U.S. interest rates and the prospect of trade protectionism are significant risks for a modest global recovery. But despite the global populist and nationalist trend, major Asian and European economies have restated their commitment to free trade and to multilateral issues such as combating climate change.

Tensions in the U.S.-China Relationship

The most notable headwinds in the U.S.-China relationship may relate to changes in the basic assumptions about trade and investment sentiments.

The U.S. Chamber of Commerce's report "Made in China 2025: Global Ambitions Built on Local Protectionism" noted that Beijing's ambitious initiative "aims to leverage the power of the state to alter competitive dynamics in global markets in industries core to economic competitiveness," thus "skewing the decision-making process for companies that must decide where products are made and innovation takes place."³

A report by the European Chamber of Commerce expressed similar concerns, noting that, "Despite the rhetoric of the Third Plenum's *Decision* of 2013—which strongly advocates market forces—it seems that the Chinese Government is determined to maintain a prominent role in guiding the economy. This is highlighted by the large number of domestic and international market share targets that have been set, along with references to 'indigenous innovation' included in the multiple planning documents related to CM2025. The appearance of 'indigenous innovation'—along with mentions of the need to realize 'self-sufficiency'—is particularly concerning—suggests that Chinese policies will further skew the competitive

³ U.S. Chamber of Commerce, *Made in China 2025: Global Ambitions Built on Local Protectionism*, 2017, 7–8, https://www.uschamber.com/sites/default/files/final_made_in_china_2025_report_full.pdf.

landscape in favor of domestic companies. The European Chamber believes that all companies should receive equal treatment under Chinese law, regardless of their nationality.”⁴ These reports were issued as foreign investors have confronted rising wages in China, diminished profit margins, and greater domestic competition across a range of industry sectors.⁵

The 2016 U.S. election brought to Washington an administration that, for the first time in over a century of American politics, explicitly challenged the free trade orthodoxies that have been foundational to the modern American economy. China has its own politics, with the important 19th Party Plenum in the fall of 2017. Since normalization of relations in 1979, the American agenda with China—and U.S. regional interests—have been consistent and predictable. American policy goals, alliance relationships, and the focus on economic development and trade have characterized every U.S. administration’s agenda, regardless of political party.

In the months since the Trump administration’s arrival, neither the president nor any member of his cabinet has offered the customary statement outlining the fundamental goals and objectives of American foreign policy in general, or Asia policy in particular. This has raised questions about those policies, and the persistence of the American agenda and interests in the region. These questions take on an urgency, coming as they do following the Trump administration’s decision to abandon the foundational economic objectives in the Trans-Pacific Partnership.

Against this backdrop, participants in the U.S.-China Dialogue on the Global Economic Order will meet again this autumn to consider this landscape and suggest an affirmative agenda for economic relations between the world’s largest economies.

⁴ European Union Chamber of Commerce in China, *China Manufacturing 2025: Putting Industrial Policy Ahead of Market Forces*, March 2017, 1, <http://www.europeanchamber.com.cn/en/china-manufacturing-2025>.

⁵ Steve Johnson, “Chinese wages now higher than in Brazil, Argentina and Mexico,” *Financial Times*, February 26, 2017, <https://www.ft.com/content/f4a260e6-f75a-11e6-bd4e-68d53499ed71>.

01

Current State and Evolution of the Global Economic Order

A Grand Bargain to Strengthen the Global Economic Order

Matthew P. Goodman

The global economic order is under stress. The institutions and rules set up at the end of World War II to provide a framework for global prosperity are under mounting attack, for both failure to deliver and failure to adapt. But the order is arguably “too big to fail,” with a breakdown of these institutions and rules likely to cause broad economic harm. And critics have yet come up with an alternative set of arrangements that would deliver more benefit to more people. Thus the world’s largest economies—starting with the United States and China—have a strong incentive to work together to fix the current order rather than see it fall apart. The good news is that a grand bargain to achieve this objective may be achievable.

There have been two main lines of attack against the existing order. One comes primarily from within the advanced countries of the North Atlantic and holds that the institutions of postwar economic governance are no longer delivering strong, sustainable, balanced, and—above all—inclusive economic growth. The other comes from emerging states, which argue that governance structures set up over 70 years ago no longer reflect the actual distribution of economic weight in the world and are thus unfair.

To be sure, over the past decade since the world was rocked by financial crisis, global growth has been disappointing. Annual real GDP growth of the world economy between 2008 and 2016 averaged 3.27 percent, compared with 4.5 percent in the period between 2000 and 2007.¹ Europe and Japan, the world’s first- and fourth-largest economic areas, have only recently begun to emerge from the growth doldrums. The United States has been the star performer among large advanced economies yet has seen only mediocre growth of around 2 percent per annum since the global financial crisis. Meanwhile, China’s economy has slowed substantially (from admittedly unsustainable rates close to 10 percent annually).

¹ International Monetary Fund, *Report for Selected Country Groups and Subjects: World*, 2017, http://www.imf.org/external/pubs/ft/weo/2017/01/weodata/weorept.aspx?pr.x=64&pr.y=20&sy=1990&ey=2022&scsm=1&ssd=1&sort=country&ds=.&br=1&c=001&s=NGDP_RPCH&grp=1&a=1.

Moreover, inequality has grown in both advanced and emerging countries.² In the United States, the share of national income of the top 10 percent of the population rose from 35 percent to 47 percent from 1978 to 2015, while the share of the bottom half dropped from 20 percent to 12 percent. Similar trends were seen in China, where the share of the top 10 percent rose from 35 percent to 41 percent over the same period, while the share of the bottom half fell from 27 percent to 15 percent.

Behind these numbers is a growing sentiment, especially in advanced economies, that the workforce is not being prepared for the realities of a twenty-first-century economy that is both more globalized and undergoing rapid technological change. This has fed populism and was a major factor in two political earthquakes in 2016: the British vote to leave the European Union and the election of Donald Trump as U.S. president. Both Brexiters and Trump pointed to remote multilateral institutions, whether the European Union or World Trade Organization (WTO), as principal sources of voters' discontent.

Thus a leading threat to today's order is not from outside forces, but from within.

Meanwhile, rising states have a point about the unfairness of today's global economic governance. Emerging economies remain underrepresented in institutions like the International Monetary Fund (IMF) and World Bank. China, for example, accounted for nearly 15 percent of the global economy in 2016 but held only 6.09 percent and 4.56 percent, respectively, of the voting shares in those institutions. (It is worth noting that the United States, too, is underrepresented, holding only 16.5 percent of the shares of the two institutions against its roughly 25 percent weight in the global economy; it is European countries that retain disproportionate shares.)

The perceived unfairness of global governance has not only fed resentment and criticism from rising states; it has also encouraged them to block rulemaking efforts in existing institutions. India's upending of a multilateral deal on trade facilitation in 2013 is one example. And emerging countries have begun to set up alternative institutions, including the New Development Bank (NDB, the so-called "BRICS Bank") and the Asian Infrastructure Investment Bank (AIIB) initiated by China. Rising states appear to be moving along a spectrum of institutional choices described by G. John Ikenberry: from status quo stakeholder to authority-seeking stakeholder, institutional obstructionist, external innovator—and ultimately, as in the case of China's ignoring of international legal rulings on its island-building in the South China Sea, to outright opponent of existing institutional arrangements.³

Yet the criticism from both sides is exaggerated. In broad historical terms, the postwar economic order has delivered unprecedented prosperity, stability, and predictability for over 70 years—and continues to do so. Europe's postwar recovery and integration, Japan's growth miracle, China's spectacular rise over the past 40 years, the lifting of over 1 billion Asians out

² Thomas Piketty, *Capital in the Twenty First Century* (Cambridge Massachusetts: The Belknap Press of Harvard University Press, 2014), <https://www.amazon.com/Capital-Twenty-Century-Thomas-Piketty/dp/067443000X>.

³ G. John Ikenberry and Darren J. Lim, *China's emerging institutional statecraft: The Asian Infrastructure Investment Bank and the prospects for counter-hegemony*, Brookings Institution, April 2017, <https://www.brookings.edu/wp-content/uploads/2017/04/chinas-emerging-institutional-statecraft.pdf>.

of extreme poverty—none would have been possible without the underpinning of institutions and rules established in the wake of World War II.⁴

Moreover, the order has proved adaptable and has continued to deliver meaningful results, both in substance and institutionally. At the high-water mark of international cooperation following the global financial crisis, G20 leaders at the London Summit in April 2009 agreed to provide \$5 trillion in new stimulus by the end of the year—and did. The G20 has also driven meaningful reforms in international rules on issues from bank capital to tax avoidance and evasion. The addition of the Chinese renminbi (RMB) to the basket of currencies in the IMF's special drawing rights (SDR) facility in 2016 is another example of the order's substantive adaptability.

There have also been important reforms in institutional processes. The elevation of the G20 to leaders' level, and the implicit downgrading of the G7 as the "steering group" for the global economy, was a major shift in the center of gravity of global governance toward the emerging world. China hosted the G20 in 2015, and India will do so in 2018. Promised adjustments in "shares and chairs" at the World Bank were implemented shortly after the G20 agreed to these at the Toronto Summit in 2010.⁵ Similar reforms at the IMF admittedly took longer, due to foot-dragging in the U.S. Congress, but these eventually came into effect in 2016.⁶ Meanwhile, the existing order has been able to accommodate the establishment of new institutions led by emerging states, such as the NDB and AIIB.

The burden on critics of the existing order is to come up with a set of institutional arrangements, rules, and standards that would produce broader benefits. American or British nationalists may prefer unilateral or bilateral approaches but are unlikely to find that those deliver better economic outcomes. China's leaders may have a preference for state capitalism or Internet sovereignty but are unlikely to find many followers if they insist that international arrangements be based on these approaches, particularly if they are tilted toward China's economic and political interests. Beijing seems to recognize the lack of acceptable alternatives: in establishing new institutions like the NDB and AIIB, Chinese officials have been at pains to say they are designed not to replace the existing order but to enhance it.

If the existing order is flawed but can still deliver and adapt, and if there are no good alternatives, then both the United States and China should want to preserve and reform it. This suggests the makings of a grand bargain between Washington and Beijing. Under this deal, the United States would continue working to give China a bigger seat at the table of global economic governance, while China would help to substantively improve the order for the benefit of all. Both would commit to support equitably governed, effective institutions and to follow agreed rules.

⁴ Max Roser and Esteban Ortiz-Ospina, "Global Extreme Poverty," Our World in Data, March 27, 2017, <https://ourworldindata.org/extreme-poverty/>.

⁵ G20 Research Group, "The G20 Toronto Summit Declaration," June 27, 2010, <http://www.g20.utoronto.ca/2010/to-communicate.html>.

⁶ International Monetary Fund, "Press Release: Historic Quota and Governance Reforms Become Effective," January 27, 2016, <https://www.imf.org/en/News/Articles/2015/09/14/01/49/pr1625a>.

A U.S.-China agenda for reform of the existing order should center on three priorities. The first is to improve the governance of existing institutions like the World Bank and IMF. This means both giving more “shares and chairs” to underrepresented countries and streamlining the operations of these institutions.

Second, Washington and Beijing should work together to update and strengthen the substantive rules of the global economic order. There are many areas of international economic activity—trade, investment, finance, etc.—where the rules are either out of date, not well enforced, or, as with much of the new digital economy, nonexistent. A healthy competition over the best approach to the rules, such as different trade arrangements in the Asia-Pacific region, is natural and salutary, as long as the end result is widely accepted and accessible by all.

The third, and arguably most important, agenda item for the United States and China is to prepare the global workforce for the challenges of the twenty-first century. Technological and broader societal shifts are fundamentally changing the nature of work. For example, one of the most common jobs in many countries today—truck driver—may be obsolete within the next two decades. Governments need to rethink the basic investments in education, training, and social safety nets needed to adapt to these new economic realities. Sharing experiences and policy solutions in these areas should be a core part of the agenda of the G20 and other international forums in which the United States and China play leading roles.

A grand bargain like this that strengthens the global economic order would support both President Donald Trump’s promise to “make America great again” and Chinese President Xi Jinping’s vision of “the great rejuvenation of the Chinese nation.” It is also essential to extending the unprecedented prosperity and stability the world has enjoyed over the past 70 years.

World Economic Order: Present and Future

He Fan & Ye Qianlin

The global economic landscape has undergone profound changes since the end of the Cold War. After the global financial crisis, the world economy entered a “new normal,” and there are mounting challenges that need to be managed. Unfortunately, the global governance system has not kept pace with the scale and complexity of these challenges.

The postwar architecture of world economy was to a large extent fashioned by the United States, with the hope of reconstructing a liberal international economic system. The International Monetary Fund (IMF), the World Bank, and General Agreement on Tariffs and Trade (GATT) laid the foundation for the postwar global economic order, and international trade and capital flows gradually started to resume. To solidify its supremacy in the shadow of Cold War, the United States supported the economic development of its allies through aid, such as the Marshall Plan aimed at Western Europe and enormous funding directed to Japan during the Korean War. In the 1970s, however, U.S. hegemony began to wane, as a host of developing countries arising from the postwar National Liberation Movement flocked to the United Nations, pressing for a so-called New International Economic Order that would be more in favor in Third World countries. Moreover, the collapse of the Bretton Woods system in 1973 meant that the United States had to rely more on macroeconomic policy coordination mechanisms with other developed countries to maintain the international monetary order.

The eruption of the 1997–1998 Asian financial crisis sparked extensive suspicion of the manner of governance adopted by the IMF and the “Washington Consensus” behind it, and accelerated a rising awareness of regional cooperation across Asia. The outbreak of the 2007 subprime mortgage crisis in the United States, as well as the 2010 sovereign debt crisis in Europe, changed the long-established belief that developed economies are immunized from financial crises. As the international economic system has become increasingly incapable of dealing with the detection, prevention, and treatment of crises caused by the wave of globalization, regional or cross-regional economic governance platforms are playing an ever more important role. This development can be seen in the multilateralization of the Chiang Mai Initiative, the strengthening of the BRICS, and the rise of mega-regional free trade agreement negotiations like the Regional Comprehensive Economic Partnership (RCEP), Trans-Pacific Partnership (TPP), and Trans-Atlantic Trade and Investment Partnership (TTIP).

Despite numerous challenges, the primary architecture of world economy remains largely unaltered. And the reform of the current international economic system should focus on three main issues.

First, the United States’ superpower status is challenged by its comparative decline in strength. U.S. gross domestic product (GDP) was in the lead until 2003 when it was overtaken by the European Union (EU). According to statistics released by the World Bank,

U.S. GDP amounted to 30.6 percent of the world's total in 2000, whereas by 2015 the figure had fallen to 24.3 percent.¹ At the same time, the U.S. share of international trade and investment has dropped considerably. Despite the monetary hegemony that the U.S. dollar has maintained for decades, the creation of the euro has undermined its absolute dominance, which, together with the simmering debt problem plaguing the United States, will gradually shake its status as a safe "currency haven." Plus, as the lukewarm economy and rising unemployment have become its main concerns, the United States is no longer capable of driving global economic growth and is shifting its focus to transplanting the domestic crisis overseas in an attempt to maintain its competitiveness in global economy. In the realm of security and diplomacy, irresponsible behavior by the United States and some of its unsuccessful economic and diplomatic policies have also caused damage to the international order and the country's own leadership.

Second, the rise of emerging powers was expected to reorder the global economy's architecture. Since the beginning of the twenty-first century, developing countries have maintained rapid economic growth, and their united strength is approaching that of the Group of Seven industrialized countries (G7). According to IMF estimates, in 2001 G7 nations accounted for nearly 43.435 percent of the world's total GDP in terms of purchasing-power parity, but in 2015 their share declined to 31.5 percent. During the same period, the economic share held by BRICS countries has increased from 19.3 percent to more than 30.8 percent of the world's total.² Over the past several years, developing countries have become a new driving force in the global economy. Besides, they have begun to participate in top-level global governance design and thus play an increasingly important role in certain important global institutions. This situation is reflected above all in the rise of the Group of Twenty (G20), which encompass major developed and developing economies, and acts as the most important platform for international economic cooperation. Unfortunately, developing countries have still not gained the status or voice proportionate to their strength and the momentum of their economic growth in the international economic system. One reason is that emerging powers are facing the dilemma of "double identity" as large but developing countries. All in all, the redistribution of interests, obligations, and power entailed by the rise of developing countries will have an explosive impact on the international order. The question as to whether or not to accept and manage the rise of developing countries is key to deciding whether the current international system is elastic and stable.

Third, the new problems that have loomed large since the eruption of the global financial crisis called into question the liberal international economic system. As the principle of free trade marked the postwar global economic order, the past decades have witnessed large-scale economic globalization, and countries adopted reform measures and a policy of opening-up, handled international affairs in a cooperative manner, and coordinated effective

¹ World Bank, "GDP (current US\$)," 2017, <http://data.worldbank.org/indicator/NY.GDP.MKTP.CD>.

² International Monetary Fund, *Report for Selected Country Groups and Subjects: Major Advanced Economies (G7)*, 2017, <https://www.imf.org/external/pubs/ft/weo/2017/01/weodata/weorept.aspx?pr.x=50&pr.y=10&sy=1980&ey=2015&scsm=1&ssd=1&sort=country&ds=.&br=1&c=119&s=PPPSH&grp=1&a=1>; International Monetary Fund, *Report for Selected Countries and Subjects: Brazil, China, Russia, India, and South Africa*, 2017, <https://www.imf.org/external/pubs/ft/weo/2017/01/weodata/weorept.aspx?pr.x=16&pr.y=9&sy=2001&ey=2015&scsm=1&ssd=1&sort=country&ds=.&br=1&c=223%2C924%2C922%2C199%2C534&s=PPPSH&grp=0&a>.

policies. However, globalization has been ebbing in the wake of the global financial crisis for it revealed economic imbalances, inequality, and other social conflicts that had been concealed by rapid global growth. What's worse, side effects of the global financial crisis began spilling from the economic and financial to the social and political sector, causing turmoil in some regions and countries. Having suffered from global financial woes, widespread unrest, and internal conflicts, people across the world became more concerned with injustice in the distribution and consumption of global wealth, and the pursuit of equity and justice has become an irreversible and increasingly popular trend.

As the United States predominance in the global economy is expected to decline further now that China will be becoming the world's biggest economy by 2024, developing countries expand, and the new problems are fermented, the global economic order enters a seemingly fragmented stage. Some may point to the downside of China's rise and are concerned that China intends to challenge the dominant status of the United States in the global economic order. It's hardly the truth. Admittedly, the Asian Infrastructure Investment Bank (AIIB) and Belt and Road Initiative are likely to reshape the economic geography in the affected regions and thus exert an influence on the global economic landscape, but it doesn't necessarily mean that China has the ambition to replace U.S. leadership in the global economy. Instead, China aims to abide by current global rules and institutions while assuming deserved responsibilities commensurate with its international status. It's not only because emerging powers, including China, have all benefited a great deal from the postwar global economic order and a peaceful international environment, but more importantly, the international community is calling for a new approach to growth and a competitive outlook with tolerance for the development of other countries as the core value, which means absolute authority in the global economic order must become a thing of the past.

Indeed, every bit of change in the global economic order entails the redistribution of international responsibility as well as international power. Emerging powers, including China, should encourage a perspective that tolerates development across the world. Cultivation of such a core value will help emerging powers undertake international responsibilities proportionate to their current national strength and historical suffering from colonialism, and prevent them from being trusted with responsibilities and obligations beyond their capacity. At the same time, such an attitude toward the development of other countries will also demand that developed countries undertake their responsibilities, fulfill their commitments, and pay more attention to the reasonable demands of less-developed countries. This will certainly have a global impact and will translate into a more inclusive global economic order in the near future.

02

Macroeconomic Policy Coordination

U.S.-China Macroeconomic Policy Coordination: A MAP Without Daggers

David Loevinger & Spencer Rodriguez

“When the map is unrolled, the dagger is revealed [圖窮匕現].”—Chinese Proverb

Unlike in the Chinese proverb, where a map hides danger, we think the G20 MAP (Mutual Assessment Process), which G20 leaders created at the 2009 Pittsburgh Summit “[to ensure] that *collective* policy actions benefits all,” still represents an opportunity.¹ The benefits of collective actions were highlighted when the United States, China, and other major economies took actions to stabilize global financial markets in early 2016—following the first Federal Reserve rate hike since the Lehman shock. However, cooperation on macroeconomic policies remains more of an exception than a rule, with policymakers taking concerted actions only when they have an economic dagger hanging over their head.

Economic research has long cited the mutual benefits of greater macroeconomic cooperation.² In an increasingly interconnected global economy, one country’s macroeconomic policies impact other economies, for better or worse. Because of these spillovers, policymakers who only take into account the impact of their policies on their own economies will lead to suboptimal global economic outcomes. Moreover, given the rapid transmission of investor sentiment across financial markets, relying on actions by individual countries can be insufficient to forestall panics and their accompanying contagion.

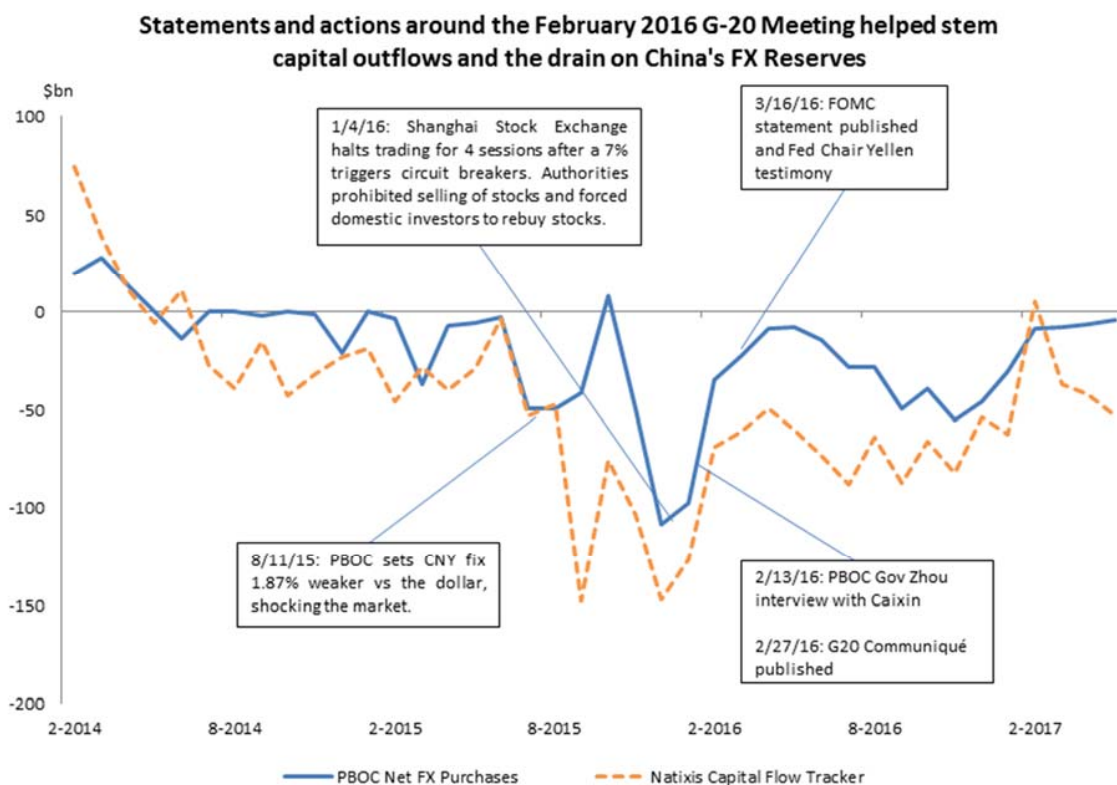
Collective Actions Helped Stem the Chinese Renminbi (RMB) Market Panic of 2016

Following what was perceived as a highly market-unfriendly response to stock market volatility in the summer of 2015, China undertook a relatively modest adjustment of the Chinese yuan exchange rate. This, combined with a lack of market communications, fears of

¹ International Monetary Fund, *The G20 Mutual Assessment Process (MAP)*, April 20, 2017, <https://www.imf.org/en/About/Factsheets/Sheets/2016/07/27/15/48/G20-Mutual-Assessment-Process-MAP>.

² Jeffrey A. Frieden, “Macroeconomic Rebalancing in China and the G20,” *China & World Economy*, 24, no. 4 (2016): 15–33, http://scholar.harvard.edu/files/jfrieden/files/frieden2016_cwe_published.pdf.

a material slowdown of China's economy, expectations that the U.S. Fed would hike policy rates aggressively, and an ongoing anticorruption campaign, led to large capital outflows from China and losses of foreign exchange reserves (with the People's Bank of China selling over \$300 billion between August 2015 and January 2016). China appeared to be on the precipice of a self-reinforcing financial panic, with capital outflows leading to a further depletion of foreign exchange reserves, undermining confidence in China's ability to maintain currency market stability, leading to further outflows.



Source: Bloomberg, Natixis

Moreover, given China's linkages to other economies, other currencies were hit adversely, particularly in commodity-based economies. In the United States, a stronger dollar stemming from a global flight to safety threatened to tighten U.S. monetary conditions and renew deflationary pressure. To stem the market panic, absent policy responses from other major economies, China would no doubt have had to spend significantly more foreign exchange reserves and impose more draconian capital controls. Fortunately, China may have catalyzed greater cooperation by announcing that it was shifting from a peg managed against the dollar to a peg managed against a basket of currencies. This signaled to other central banks that China would no longer be as willing to follow the dollar, and thus import tighter monetary conditions in response to unilateral efforts to ease monetary conditions (in the case of Japan and the European Union) or tighten monetary conditions (in the case of the United States).

In the run-up to, during, and after the February 2016 G20 Finance Ministers and Central Bank Governors' meeting in Shanghai there was consensus among major G20 members for collective statements and actions to stem market volatility, though we doubt there was ever an explicit agreement. Perhaps the most critical action was People's Bank of China (PBOC) Governor Zhou Xiaochuan's interview in *Caixin*, breaking months of silence, in which he stated that "keeping the stability of the renminbi exchange rate to a basket of currencies is the major goal" and that there is "no basis for persistent RMB depreciation."³ In addition, in the Shanghai meeting communiqué, the G20 finance ministers agreed to "consult closely on exchange markets"—a phrase that had only previously appeared in G7 statements.⁴ Also important was the March statement by the U.S. Federal Reserve that "The Committee expects that economic conditions will evolve in a manner that will warrant only gradual increases in the federal funds rate," citing "global economic and financial developments, [which] continue to pose risks."⁵ Chairwoman Janet Yellen stressed in her March 2016 post-Federal Open Market Committee (FOMC) press conference that the "decision partly reflects the implications for the U.S. economy of the global economic and financial developments."⁶ The language boosted perceptions that the Fed would be more sensitive to the impact of its actions on international markets, lowering market expectations for the path of Fed rate hikes, weakening the dollar, and reducing pressure on the RMB.

The implicit "Shanghai Accord" demonstrates how mutually beneficial policy actions can be induced when there are shared objectives and the cost of inaction to key actors is high. Absent these conditions, macroeconomic policy coordination has and will likely continue to be more of the exception than the rule. Some institutions, such as the U.S. Federal Reserve, are legally mandated to target domestic economic outcomes and have to justify taking into account the international impacts of their policies indirectly through the effects of these impacts on their U.S.-centered objectives. In addition, the greater number of domestic actors involved in policy coordination, the more difficult it becomes to include coordination with foreign actors as a priority. For this reason, the prospects for policy coordination are greater for monetary than fiscal policy. However, the PBOC's lack of legal and operational independence and the collective nature of major monetary decisions hamper China's ability to coordinate monetary policies internationally.

Expanding Cooperation beyond Government

Macroeconomic policy coordination should go beyond just government officials and include other economic agents so their actions are less at cross purposes. Research has highlighted

³ Xiaochuan Zhou, "Transcript of Governor Zhou Xiaochuan's Exclusive Interview with *Caixin Weekly*," Interview by *Caixin Weekly*, The People's Bank of China, February 14, 2016, <http://web.archive.org/web/20160218065526/>.

⁴ Ministry of Finance of the People's Republic of China, "G20 Finance Ministers and Central Bank Governors Meeting," February 27, 2016, <http://www.g20.utoronto.ca/2016/160227-finance-en.html>.

⁵ Federal Reserve, "Federal Reserve issues FOMC statement," March 16, 2016, <https://www.federalreserve.gov/newsevents/pressreleases/monetary20160316a.htm>.

⁶ Federal Reserve, "Transcript of Chair Yellen's Press Conference," March 16, 2016, <https://www.federalreserve.gov/mediacenter/files/FOMCpresconf20160316.pdf>.

the benefits of greater central bank transparency.⁷ China's poor market communications in 2015 and the statements surrounding the Shanghai G20 meeting highlight how communications and forward guidance can impact the effectiveness of macroeconomic policies. Both the Fed and the PBOC have made considerable progress toward enhancing their transparency and improving their public communications, but each has room for improvement. The PBOC remains among the least transparent major central banks owing to the less transparent nature of Chinese policymaking, the more collective nature of major monetary policy decisions, and the lack of senior officials with capital markets, and particularly international capital markets, experience.⁸ While there is no shortage of talented Chinese nationals working in international capital markets, the government's anticorruption campaign has made it more difficult for them to take senior financial policy positions. We encourage the Chinese authorities to bring into senior financial positions more officials with capital markets and market communications experience.

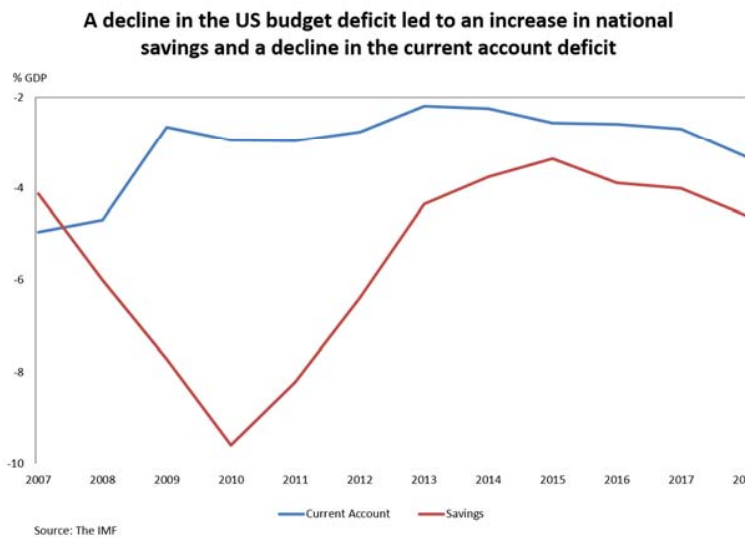
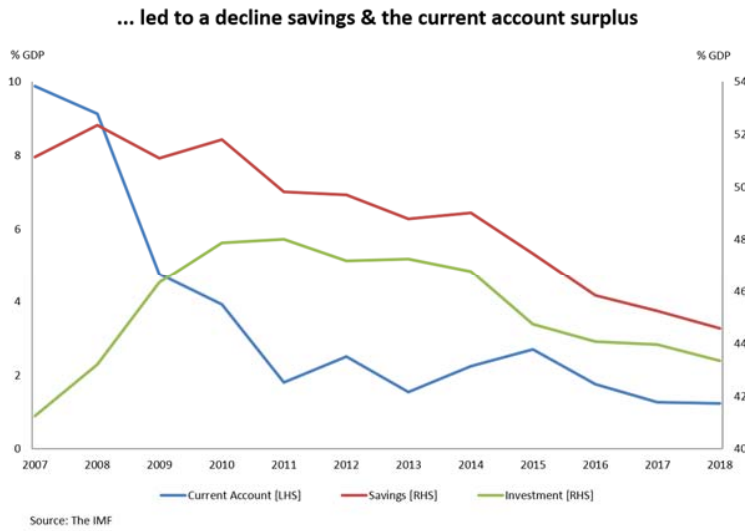
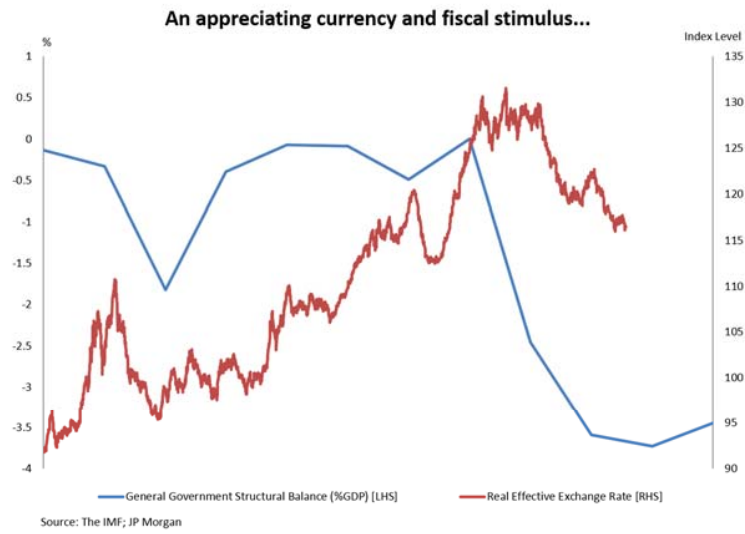
The Fed, on the other hand, is considered among the more transparent major central banks. However, while the PBOC continues to expand translations of major statements and reports, the Fed only publishes its statements in English. Given 1) the rising importance that the Fed places on its forward guidance and the attention it puts into every word of its FOMC statements, and 2) that English is not the primary language for most global investors, it is odd that the Fed provides so little guidance to the foreign media and analysts that translate its statements. We encourage the Fed to translate its major policy statements concurrently with the release of English versions.

Addressing External Imbalances: Challenges Ahead

One of the focuses of the G20's MAP is the reduction of global imbalances. Concerted actions by the United States and China, coordinated or otherwise, have led to important reductions in their external imbalances. In China the current account surplus has fallen dramatically as a percent of GDP, mainly through a sharp decline in the national savings rate. This resulted from policies to promote services (including tax reforms) and by implication consumption (as services are largely consumed), a boom in infrastructure and property investment, a material appreciation of the real effective exchange rate, a modest expansion of the social safety net, and an aging population. A similar trend can be seen in the United States, where the current account deficit declined as a percent of GDP, driven by a boost in energy production and an increase in national savings due to a decrease in the federal budget deficit.

⁷ N. Nergiz Dincer and Barry Eichengreen, "Central Bank Transparency and Independence: Updates and New Measures," *International Journal of Central Banking* 10, no. 1 (2014): 189–253, <http://www.ijcb.org/journal/ijcb14q1a6.pdf>.

⁸ Ibid.



The outlook for further progress in reducing external imbalances, however, is limited. In China, while an aging population will continue to put downward pressure on the savings rate, the current account surplus is likely at best to be stable (relative to China's GDP), which implies a rising global current account deficit with China (relative to non-China global GDP). Due to concerns over financial stability and to rising corporate debt and excess capacity, Chinese regulators are belatedly and correctly pressing to slow the growth of credit and investment. Also, at a time when China is tightening financial conditions by raising interest rates and slowing credit growth, its appetite for a further tightening of monetary conditions through an appreciation of its real effective exchange rate appears limited.

In the United States, the outlook is even worse. Despite an expressed preference for smaller bilateral imbalances with major trading partners, the current account deficit is likely to increase as rising U.S. policy rates and a shrinking of the Fed's balance sheet put upward pressure on the dollar and an aging population and rising entitlement and interest expenditures put downward pressure on private and public savings. While the outlook for U.S. fiscal policy remains uncertain, it appears highly likely that any near-term policy changes will further increase the current account deficit through a decline in public sector savings as the adverse impact on revenues from tax cuts is likely to exceed spending cuts. While a shift in income from lower- to higher-income households and lower taxes on corporate profits are likely to increase private savings, this is unlikely to be offset by the decline in public savings.

Looking Ahead

Macroeconomic coordination among countries can boost global growth and help forestall crisis, but is only likely if there are shared objectives and the cost of inaction is high. To promote better coordination of actions both among government and private actors, we think both the United States and China can improve their market communication, with the Fed translating more statements, and the PBOC governor and other senior finance officials making more regular public statements and press conferences. Given China's rising impact on global markets, it is also vital that China bring into senior policy positions more officials with international capital markets experience. Finally, we urge the new U.S. government to drop its focus on reducing bilateral imbalances, which is likely to be ineffective at best (as bilateral imbalances simply shift to other economies) and highly distortive at worst (through a rise in trade barriers). Washington also needs to recognize that Chinese efforts to mitigate financial risks may lead to a larger Chinese current account surplus in the near term.

Economic Rebalancing Should Be the Core of China's Supply-Side Reform

Wang Yuzhu

As it enters a "New Normal," China's economy is undergoing fundamental changes in its comparative advantages and its driving forces. Meanwhile, the interrelations between the government and market is also reshaping. Under the background of supply-side reform, China should reconsider the policy focus thus to achieve a sustainable growth. Generally speaking, the root of China's loss of a comparative advantage in manufacturing mainly stems from the rise of land prices and the rental cost of real estate, rather than the cost of labor, and tax cutting that is seen as the core of the supply-side reform of limited spaces for the local government. The way for China to achieve its comparative advantage is to rebalance its economy between rural and the urban regions, and between the coastal and inland regions.

The Loss of China's Manufacturing Comparative Advantage

Some people attribute the loss of China manufacturing's cost advantage to the rapid rise of Chinese labor costs under the "Lewis turning point." Actually, this is not true. For many enterprises, labor costs only account for around 5 percent on average of the total production cost, but the price of land and factory rental is much higher, accounting for nearly 20 percent, sometimes even higher. Due to the higher land rental price, these enterprises have to move away from the coastal, developed areas. Taking the company Huawei as an example as the most competitive company in China, it is also confronted with the land rental problem and wants to move out of Shenzhen. As China has put forward the Belt and Road Initiative, many companies are going out to seek a more competitive production base. According to one survey, as intelligent manufacturing develops labor costs can be largely substituted by robots. However, the land cost is always the first and the biggest concern for entrepreneurs in choosing their production bases. Many companies going out may pose a threat to China's domestic economy in the long run, even though these going-out companies' technical competitiveness is not very high, China's manufacturing is still mainly at the mid-lower level at present. This large-scale "going out" is a big challenge for China's economy in the future, which may lead to the domestic "industrial hollowing" phenomenon of developed countries' investment in foreign countries. Though high-level manufacturing only occupies a small proportion of the economy.

Limited Space for Tax Cutting in Promoting Economic Growth

China has had problems with the nominal tax rate and effective tax rate for a long time. Traditionally, tax evasion as an important means for small and medium-sized enterprises (SMEs) to maintain cost competitiveness has been a common problem in China. For example, several years ago, because of imperfect tax administration system, enterprises often used false invoices as the enterprise production expenditure, to offset the tax payment. In

addition, business operators of SMEs also bring their individual expenditures like cars and some large consumer goods to bill them as production costs in the name of the enterprise. In this way, the actual tax paid by enterprises is small.

In response to this, China embarked on tax reform, which has achieved a positive result. For example, in the last few years, tax control machines have been widely installed even in small restaurants and stores. Thanks to the reform, China's tax revenue has maintained double-digit growth despite the overall economic downturn since 2008. On May 1, 2016, China started replacing the business tax with a value-added tax. The value-added taxation system put almost all production and purchasing processes under the supervision of the tax system. As a result, few opportunities are left for enterprises to dodge taxes any more. For example, even though China put forward a series of tax reduction measures half a year later, due to stricter regulation measures China's actual tax revenue still saw strong growth. Therefore, with the increasing and tightening measures of tax administration and regulations, currently China's real effective tax rate is already extremely high for SMEs.

However, it is a paradox to further cut the tax rate, and there is limited space for local governments to cut taxes as a result of potential debt risks. At the moment, local governments are facing a serious situation for fiscal sustainability. Traditionally over the past decade, except for normal tax revenue, Chinese local governments' fiscal balance mainly depend on income from selling land, which is also called land finance. The size of land finance is almost the same as the normal fiscal income. Land finance comes from land leasing fees, and has played a significant role in financing the local governments' expansionary economic policies, and it also has been the main way to fill the local governments' fiscal income gap for a long time.

However, land resources are always limited, and in most of the cities the local governments do not have more land to sell now. Meanwhile, after two decades of rapid industrialization in China, there is a trend toward declining land demand. Taking the growth of local debt risk into account, the central government has implemented a series of strict regulations on local governments debt growth and strengthened strict measures on fiscal revenues beyond taxes. Against this backdrop, local governments are facing a heavy burden in maintaining a balance between fiscal revenue and expenditures. Therefore, considering those factors mentioned above, China has limited space for tax cutting. If tax cuts continue, local governments will have difficulty with financial sustainability unless they sell state-owned enterprises. However, this will result in the further decline of the share of the state-owned economy in the overall economy, and that will post a challenge to the socialist system.

Regaining Comparative Advantages through Rebalancing Policies

Considering that the rise of land and real estate prices is irreversible, and that large-scale tax cutting is also not pragmatic, rebalancing policies are needed in both a geo-economical and social-economical way.

From the geo-economical perspective, one of the best ways to mitigate land rental and enterprise production costs is to transfer the production bases to mid-west areas with lower land prices. Today, it shows a great achievement in inland regions in manufacturing development. Rebalancing should be focused on more preferential policies to attract more capital and laborers into the central and western regions. Currently, as the industrialization process goes on, the central and western regions are confronted with many problems, such as a lack of labor, capital, technology, and other production factors. Several years ago, Foxconn had already started to use a large number of robots in its production base located in Henan Province. Therefore, policies are strongly recommended to facilitate those regions to give full play to Developed Advantages. Taking intelligent manufacturing as an example, in keeping pace with the coastal regions, the central government should promote intelligent manufacturing industry policies and related pilot measures in central and western regions as well.

On the other hand, rebalancing policies in the current dual economic system are also strongly needed, as China has nearly half of its population living in rural areas, and they are not equally treated in many ways. Actually, China's internal consumption economy has large space to grow. Currently, the growth potential of China's consumption economy is not dependent on creating extra economic growth, but it will become more and more dependent on China's reforms in the fields of finance and income distribution, especially in the field of pensions in rural areas.

Nearly half of the population is still living in rural areas, and their income is only one-tenth of those people who work in cities. At present, it is roughly estimated that elderly people with rural household registration have only a \$30 subsidy each month, but in a city like Shanghai elderly people with city household registrations have up to \$300 per month. Thus, the consumption ability of those who live in rural areas is greatly restricted. In addition, there is a large part of the elderly population living in rural areas lacking in the ability to work. However, in Premier Wen Jiabao's service term the overall coverage of pensions has been achieved. But till now, China's pension system is still in a "dual track" system.

So, if we can narrow the gap between the rural areas and cities and solve the problem of the dual-track pension system, elderly people in rural areas will be a large consumption group. With the improvement from \$30 to \$300, the marginal consumption rate would be gradually increased. Currently, our policy is still gradually increasing the pensions of people in cities rather than immediately solving the dual-track dilemma. Actually, a lot of ways can be used to solve this problem, and it depends on how we are going to effectively design our pension policies. The Chinese central government is such a powerful government that it can do a lot of things in designing socially reasonable and economically sustainable policies.

03

Financial Regulation

Living in Two Worlds: Chinese and U.S. Financial Regulation

Douglas J. Elliott¹

China and the United States have been living in two different worlds over the last decade in terms of the direction of financial regulation, and this is likely to continue for some time. One reason this matters is that Chinese banks are playing an increasingly large international role, making it important to coordinate financial regulatory approaches while taking account of differing national conditions. Why has the direction of regulation varied across the two countries? The United States was the epicenter of the global financial crisis (GFC) of 2007–2009. China, for its part, experienced few direct effects, although the indirect ones were large. This contrast in itself triggered differentiated responses, but financial regulation would have varied anyway, given the huge differences in the structure and conditions of the financial sector in the two countries.

The United States entered the GFC with a highly sophisticated financial ecosystem in which banks played an important role, but interacted heavily with nonbanks and markets that collectively provided well over half of the nation's credit and other financial services. This system used complicated instruments and markets that had developed over decades, including extensive use of derivatives. The pressure testing produced by the crisis highlighted quite a number of flaws in the overall system. As a result, the U.S. response was to enact a wide-ranging set of regulations and laws designed to fix the specific problems and to create a "macroprudential" oversight mechanism to watch out for future systemic risks.

In contrast, China did little to respond directly to what it viewed as a Western crisis that did not reflect any flaws in China's own financial system. China largely experienced the GFC as an external event with major internal impacts, the biggest of which was a huge drop in foreign demand for its products. The economy slowed noticeably, but primarily in the same ways that it would have been affected by a major world recession triggered by a nonfinancial crisis. China had a considerably less sophisticated and complicated financial ecosystem and made much less use of derivatives and other complex instruments. At the time of the crisis, the great bulk of credit in China was provided by banks through traditional loans. Further,

¹ The author is a partner at the management consulting firm of Oliver Wyman. The views expressed here are his own and do not necessarily reflect the views of his firm or his partners.

Chinese government entities owned the large majority of the shares of the banks and significantly influenced their overall lending policies.

Effects of the Financial Crisis on Financial Regulation

Global Standards

Many of the wide-ranging changes the United States introduced were driven by the adoption of new global standards for bank capital and liquidity requirements. The leaders of the G20 countries, dominated by the nations most affected by the crisis, stepped forward to mandate that global standard-setting bodies lead the movement toward stronger and more effective financial regulation within member states. They empowered the Basel Committee on Banking Supervision to revise bank capital standards to be much tougher and to create a new set of quantitative liquidity requirements for banks. They also created the Financial Stability Board (FSB) to oversee standards for all aspects of the financial systems, including coordination with the Basel Committee.

The biggest changes came through the Basel Committee, including: higher minimum capital ratios; tougher definitions of what counts as capital for banks; myriad technical changes that also increased capital requirements; a new liquidity coverage ratio (LCR) to ensure banks could survive a liquidity crisis for 30 days; and a net stable funding ratio (NSFR) to limit the extent to which banks could borrow short term and lend long term. In combination, these rules make banks substantially safer, but also increase their net cost of funding considerably.

China signed onto the changes to global standards, but they have had a relatively limited impact on China's financial system as it exists today. Capital levels already exceeded the new requirements in general, most of the more technical changes focused on activities that are modest in China, and the new liquidity requirements were geared to be supportive of traditional deposit-based funding models, such as those used by most Chinese banks.

U.S. National Regulation

At the national level, Washington also legislated other major changes through the Dodd-Frank Act, covering a wide range of topics, including:

- Creation of a council of U.S. regulators, the Financial Stability Oversight Council;
- A mandate to apply "enhanced prudential supervision" to systemically important financial institutions, both banks and nonbanks;
- Revised rules for dealing with troubled banks;
- Risk retention rules for mortgage securitizations;
- Tougher mortgage underwriting standards;
- Toughened requirements for credit-rating agencies;

- Establishment of a new Consumer Financial Protection Bureau (CFPB);
- Limitations on the ability of the Federal Reserve to lend in a crisis; and
- Tougher limits on credit exposure to a single counterparty.

Chinese National Regulation

The Chinese response was different. Prior to the GFC, China had been moving methodically toward building a financial system that mimicked a Western model that appeared to be highly successful. The crisis caused a sharp reevaluation of the value of the Western approaches. Further, the Chinese government chose to use bank lending as the major form of economic stimulus postcrisis. While Western regulators were implicitly and explicitly encouraging greater caution about credit risk in their countries, China was actively encouraging their banks to find ways to get to “yes” on loan approvals.

Even if the Chinese had been minded to closely follow the new Western approach to tightening regulation, large swathes of these new regulations were almost irrelevant to a Chinese financial system that simply did not use the type of sophisticated instruments and approaches that had blown up in the United States and Europe. For example, changes to derivatives regulations and the supervision of rating agencies would have made little difference in the short term to a Chinese system that did not rely heavily on either.

Instead, China focused on further developing its financial system and continuing the move toward more commercial decisions and less intervention by the government and Communist Party. At the same time, the creation of new commercial opportunities also brought new risks, such as from “shadow banking,” which have required new regulations and more nimble supervision. For example, banks began to take advantage of the regulatory arbitrage offered by the opportunity to sell “wealth management products” (WMP) that effectively took loans off balance sheet while funding them relatively cheaply, since investors almost universally assumed that no bank would be allowed to default on the promised returns. Regulators have taken a series of actions to limit this regulatory arbitrage, but clever actors have found new ways to do versions of the same thing, such as switching initially from using bank WMPs to trust company WMPs and then to equivalents offered by funds managers.

Internet-based lending is another area that brings both real opportunities and risks. China has seen a massive level of experimentation by the private sector, and it is crucial that regulators keep pace with these developments.

The Future of Financial Regulation in the United States and China

The United States is engaged in a major reevaluation of the costs and benefits of the massive wave of regulation produced after the GFC. The new administration clearly believes these must be recalibrated to cut the costs that have been imposed on banks, and ultimately the larger economy, while retaining the core safety benefits. Despite the rhetoric, such as the call to “repeal Dodd-Frank,” the large majority of postcrisis regulation appears likely to survive.

There will be important changes, including elimination or considerable loosening of some regulations, but the overall approach is likely to stay intact.

China faces a different set of issues, revolving around different risks. Accurately determining the level of bad loans in the system and ensuring they do not endanger the system as a whole will be a major emphasis for regulators. This will require continuing efforts to thwart regulatory arbitrage, cut back on restructuring of loan terms that defer problems without solving them, and the gaming of definitions, as well as applying tough supervision more generally. Transparency will also be critical, so that all stakeholders can be confident of the accuracy of balance sheets.

On a more hopeful note, China's financial system continues to mature, with market-based financing becoming more important. Institutional investors are growing in influence and sophistication, which is essential for the appropriate development of financial markets. Beyond these two points, there are many other challenges and opportunities for China's regulators as the country's financial system changes in ways that mirror the rise of the country as a whole and the growth of its private sector and its markets.

Interactions between the United States and China on Financial Regulation

China presents a unique situation for global financial regulators. It is the first time in recent history that banks from an emerging market nation are becoming major international lenders. This presents a quandary. Since the creation of the first Basel capital accord in 1988, regulators in the major financial centers have attempted to maintain a safe global system and a reasonable competitive balance by ensuring that the big international lenders face similar cost burdens from capital requirements and, later, liquidity requirements. After the GFC, these capital and liquidity standards became even more detailed and tougher. As such, it is important that the requirements be appropriate for the jurisdictions of all the major international lenders. This works reasonably well for North America, Europe, Japan, and most other advanced economies around the world, because they have similar enough systems.

However, China is different and is likely to remain so for years to come. The right regulatory environment for a country whose economy and financial system are still rapidly evolving, and where there is substantial state control through share ownership and other mechanisms, will differ from that for the existing major financial centers. Balancing the need for a level global playing field in a safe global financial system with the specific needs of China will be important and difficult.

The other area of interaction between the United States and China is in regard to American banks operating in China. The government and regulatory community in China explicitly agree that international banks should be able to compete with local players. And, yet, foreign market share in banking has remained at about 2 percent for many years, despite a strong appetite for expansion.

Recommendations

U.S. and Chinese regulators are appropriately focused on quite different issues today and will, and should, remain that way for years to come. Washington is in the process of digesting the massive postcrisis regulatory changes and searching for appropriate cost/benefit tradeoffs between safety and economic growth. Beijing is focused on the combination of the many challenges and opportunities presented by a growing and evolving financial sector, alongside current issues of excessive bad loans.

At the same time, both countries and the larger global community need to find a way to allow Chinese banks to expand to be among the largest international lenders without creating incentives for taking excessive risk. This will require sorting out what parts of the global standards truly need global application to large banks that lend overseas, what parts can be tailored to specific national circumstances and to what extent, and what parts really only apply well to banks in the West or with similar systems.

In theory, the Basel Committee and the FSB have already done this. However, it is clear that emerging countries have had too little influence on global standards. This is partly because the West felt a far more urgent need for the new standards, partly because emerging nations have not stepped up to the extent they ought to, but also in quite substantial part because the West is used to running these committees and has not reached out sufficiently for input. For example, the LCR and NSFR rely on a definition of “high-quality liquid assets” (HQLA) that was too closely tailored to Western institutions and markets. This was brought to the attention of the Basel Committee relatively early on, but only modest efforts were made to provide alternative methods for defining or creating HQLA.

The United States and other Western nations need to make a more active effort, in their national discussions with China and in global bodies, to understand and accept the genuine needs of China. They need to be willing to accept approaches that achieve the common purposes in a manner better suited to China.

At the same time, China needs to fully recognize the value of the global standard setters and to work harder to push for global approaches that work for all the major global lenders. This includes truly accepting the need to eventually adopt those standards. Right now, there is some suspicion that China has played a less active role because it views the standards as advisory and not truly a common statement of shared principles. Despite the differences in conditions, many of the global reforms are appropriate for China as well and local regulators would benefit from putting them in place.

It would also be helpful to both nations if Chinese authorities made more of an effort to find ways to overcome the many structural barriers to foreign expansion in Chinese banking markets. Many of these are not the result of government policy, rather they reflect existing relationships and practices that are difficult for foreigners to compete against. However, the benefits for China as a whole make it worthwhile for regulators to more actively work against these barriers. Such a move would also reduce frustrations that might lead other countries to be less open to Chinese banking operations.

Financial Regulation Reform and Financial Stability

Zhao Xijun

How Important Is Financial Regulation to Financial Stability?

The G20 has played an important role in linking financial regulation and stability. The origin and the development of the G20 is closely related to addressing the financial crisis through global governance. The mechanism of the G20 Finance Ministers and Central Bank Governors Meeting was initially set up to prevent the recurrence and spread of a crisis similar to the Asian financial crisis in 1997, then the mechanism of G20 was upgraded to a leaders summit in 2008 under the suggestion of French president Nicolas Sarkozy and British prime minister Gordon Brown due to the subprime mortgage crisis in the United States, and the then-U.S. president George W. Bush agreed to organize the first summit.

As we know, the nature of a financial crisis is an unstable financial market and an unstable economy. What people can do is to bring them back into a normal and stable situation. But how can this be achieved? The first and most important thing is to understand what has caused the crisis and how the crisis has developed. Based on this analysis, appropriate measures can be taken, and then implemented.

The 2008 Washington Summit analyzed the root causes of the crisis as following: "Policy-makers, regulators and supervisors, in some advanced countries, did not adequately appreciate and address the risks building up in financial markets, keep pace with financial innovation, or take into account the systemic ramifications of domestic regulatory actions."¹ The 2009 London Summit also concluded: "Major failures in the financial sector and in financial regulation and supervision were fundamental causes of the crisis."²

Although numerous factors contributed to the crisis, inadequate regulation was the first and most cited reason. The G20 then proposed the "Common Principles for Reform of Financial Markets" and the improvement or enhancement of financial regulation was placed as a core position.³

As the first G20 summit suggested: "we will implement reforms that will strengthen financial markets and regulatory regimes so as to avoid future crises. Regulation is first and foremost the responsibility of national regulators who constitute the first line of defense against market instability." The action was called "Enhancing Sound Regulation," which touched upon areas such as regulatory regimes, prudential oversight, risk management, promoting integrity in

¹ G20 Research Group, *Washington Summit: Declaration of the Summit on Financial Markets and the World Economy*, November 15, 2008, <http://www.g20.utoronto.ca/2008/2008declaration1115.html>.

² G20 Research Group, *London Summit: Leaders' Statement*, April 2, 2009, <http://www.g20.utoronto.ca/2009/2009communique0402.pdf>.

³ G20 Research Group, *Washington Summit*.

financial markets, strengthening transparency and accountability.⁴ And from then on, financial regulation and stability have been linked closely together by G20.

What Have We Done Since the Global Financial Crisis?

Apart from the first G20 summit, seven summits have been organized since then and every summit has discussed financial regulation without exception.

The 2009 London Summit emphasized that: “We will take action to build a stronger, more globally consistent, supervisory and regulatory framework for the future financial sector.” The action was called “Strengthening financial supervision and regulation” and aimed to reshape regulatory systems so that authorities could identify and take account of macro-prudential risks; extended regulation and oversight to all systemically important financial institutions, instruments, and markets, including hedge funds; and established a new Financial Stability Board (FSB) with a strengthened mandate to provide early warning of macroeconomic and financial risks and the actions needed to address them.⁵

The 2009 Pittsburgh Summit took the action called “Strengthening the International Financial Regulatory System,” and enhanced and expanded the scope of regulation and oversight, with tougher regulation of over-the-counter (OTC) derivatives, securitization markets, credit rating agencies, and hedge funds.⁶ The scope of regulation was extended to protect consumers, depositors, and investors against abusive market practices.

The 2010 Toronto Summit proposed a four-pillar regulation reform plan that addressed capital and liquidity, more intensive supervision, resolution of financial institutions, addressing systemically important financial institutions, financial sector responsibility, financial market infrastructure and scope of regulation, and accounting standards.⁷

The 2010 Seoul Summit proposed some core elements of a new financial regulatory framework, and to strengthen global financial safety nets to overcome sudden reversals of international capital flows.⁸

The 2011 Cannes Summit proposed to reform the financial sector and to enhance market integrity to reinvigorate economic growth, create jobs, ensure financial stability. Comprehensive regulation measures were considered to be taken on global systemically important financial institutions (G-SIFIs), on shadow banking, and on compensation practices.⁹

⁴ Ibid.

⁵ G20 Research Group, *London Summit*.

⁶ G20 Research Group, *Pittsburgh Summit: G20 Leaders’ Statement*, September 24–25, 2009, <http://www.g20.utoronto.ca/2009/2009communiqu0925.html>.

⁷ G20 Research Group, *G-20 Toronto Summit Declaration*, June 27, 2010, <http://www.g20.utoronto.ca/2010/to-communique.html>.

⁸ G20 Research Group, *Seoul Summit Document*, November 12, 2010, <http://www.g20.utoronto.ca/2010/g20seoul-doc.html>.

⁹ G20 Research Group, *Cannes Summit Communiqué: G20 Leaders’ Summit*, November 4, 2011, <http://www.g20.utoronto.ca/2011/2011-cannes-communique-111104-en.html>.

The 2012 Los Cabos Summit emphasized the implementation of the structural and regulatory reform agenda to enhance medium-term growth prospects and job creation, to build more resilient financial systems, and to foster financial inclusion. The reform priorities were granted to areas such as: the Basel Committee capital and liquidity framework; the framework for G-SIFIs, resolution regimes, over-the-counter (OTC) derivatives reforms, shadow banking, and compensation practices.¹⁰

The 2013 St. Petersburg Summit concluded the achievements of financial regulation to date as follows: (1) implementation of new global capital standards (Basel III); (2) completion of the necessary frameworks for OTC derivatives to be traded on exchanges or electronic trading platforms, centrally cleared, and reported; (3) identification of global systemically important banks and insurers, and agreement to subject them to heightened prudential standards to mitigate the risks they pose; (4) implementation of agreed tools and procedures for the orderly resolution of large, complex financial institutions without taxpayer loss; and (5) progress in addressing potential systemic risks to financial stability emanating from the shadow-banking system.¹¹ It stated that “coordinated action by the G20 has been critical to tackling the financial crisis and putting the world economy on a path to recovery.”¹²

What’s Going on and the Road Ahead

Too many things are still in progress, for example, tackling systemic risk, building more resilient financial institutions and ending too-big-to-fail, increasing transparency and market integrity, filling regulatory gaps and addressing the risks from shadow banking, promoting continuously functioning financial markets, strengthening market infrastructure and reforming credit rating agencies, tackling money laundering and terrorist financing, enhancing financial inclusion, financial education, consumer protection, and internet finance.

As long as these are not completed, a stable financial market should not be expected. The ultimate objective of promoting financial regulatory reforms is to reduce moral hazard and systemic risk, and to foster a stable financial system that supports sustainable and balanced economic growth. From my point of view, a stable financial system requires not only adequate regulation, but also appropriate macroeconomic policies, and sustainable and balanced economic growth requires much more, for example, we need finance for innovation, we need finance for infrastructure investment, and we need finance for environmental protection.

¹⁰ G20 Research Group, *Los Cabos Summit: G20 Leaders Declaration*, June 19, 2012, <http://www.g20.utoronto.ca/2012/2012-0619-loscabos.html>.

¹¹ G20 Research Group, *Saint Petersburg Summit: G20 Leaders’ Declaration*, September 6, 2013, <http://www.g20.utoronto.ca/2013/2013-0906-declaration.html>.

¹² *Ibid.*

04

International Financial Institutions

Toward Better Multilateral Development Banks: Can the United States and China Lead Together?

Nancy Lee

In the broadest sense, the multilateral development banks (MDBs) present the United States and China with the same value proposition. MDBs leverage development resources, helping both countries share the burden of financing development with others. MDBs promote growth and poverty reduction, increasing economic opportunity for both countries in frontier and emerging markets. They concentrate collective development experience, data, and technical expertise. MDBs are key actors in responding to global shocks, crises, or natural disasters that affect the economic performance of both countries. MDB work in vulnerable states can forestall conflict, reducing security and migration risks that directly or indirectly impact both countries. And MDBs offer both countries convenient mechanisms for managing multidonor contributions for addressing urgent global challenges.

Yet these overarching common interests have tended to be overshadowed by differences in priorities with respect to operational means and development ends. MDB governance changes reflecting China's ascendant role in the global economy have been slow. China's interest in rapid increases in infrastructure funding, often tied to its own construction companies, has not meshed well with MDB environmental, social, fiduciary, and procurement safeguards. In response, China has ramped up its own bilateral development programs and led efforts to create two new development banks, the Asian Infrastructure Investment Bank (AIIB) and the New Development Bank (NDB). But the creation of new institutions is a costly and time-consuming lift. They are certainly a reasonable outgrowth of the changing landscape of global economic power. But to regard them as substitutes for existing institutions would be to waste decades of accumulated human, institutional, and financial capital. Efforts by the two countries to strengthen both the existing and new institutions and focus them on agreed priorities offer, or should offer, attractive ways to pursue common aims.

This purpose of this note is to provide a realistic analysis of where MDBs have made progress in improving performance and governance, the risks and challenges they and their shareholders confront today, possible areas of U.S.-China collaboration, and a specific

recommendation for a joint effort. This note draws heavily from a recent Center for Global Development Panel Report.¹

MDB Reform Progress

Despite criticism from both creditor and borrowing countries, the MDBs as a group are stronger institutions than they were a decade ago, as shareholders, clients, research, global needs, and resource constraints have driven change. While most would agree that the pace of change has been too slow, MDBs (along with the International Monetary Fund) deserve substantial credit for important improvements in macroeconomic and financial management; the quality and efficiency of social transfers; an enhanced focus on women and girls (emerging from MDB research); unique cross-country databases in areas such as poverty, enterprise behavior, and financial inclusion; and better global standards for results measurement, environmental and social safeguards, and fiduciary and procurement systems.

All have more lending capacity—capital increases were negotiated in the World Bank and in the regional development banks in the wake of the global financial crisis. In fact, size and reform were very much intertwined; capital increases are always action-forcing events for reform progress.

With support from the G20, some of the institutions are also using their balance sheets more efficiently. The merger of the Asian Development Fund balance sheet into the Asian Development Bank's core balance sheet has effectively tripled the ADB's capital and expanded overall lending capacity by 50 percent.² Similarly, the 18th replenishment of International Development Association (IDA) blends donor grant contributions with market-issued debt, secured by IDA's loan assets. With this innovation, IDA achieved its largest lending capacity in history—\$75 billion.³

And the MDBs, particularly the World Bank, are still the go-to institutions for mobilizing, managing, and allocating resources to respond to urgent challenges—for example, the global financial crisis, climate change (the Climate Investment Funds), global health (the Advance Market Commitment, the International Finance Facility for Immunizations), food security (the Global Agriculture and Food Security Program), and the refugee crisis (the Global Concessional Financing Facility).

¹ Center for Global Development, *Multilateral Development Banking for This Century's Development Challenges: Five Recommendations to Shareholders of the Old and New Multilateral Development Banks*, 2016, <https://www.cgdev.org/sites/default/files/multilateral-development-banking-report-five-recommendations.pdf>.

² Nancy Birdsall, Scott Morris, and Enrique Rueda-Sabater, *Review of 'Enhancing ADB's Financial Capacity to Achieve the Long-Term Strategic Vision for the ADF'*, Center for Global Development, 2014, <https://www.cgdev.org/sites/default/files/CGD-Assessment-Birdsall-Morris-RuedaSabater-ADB.pdf>; Indu Bhushan and Alain Borghijs, *Innovatively using the Asian Development Bank's balance sheet to eradicate poverty*, Brookings Institution, 2015, <https://www.brookings.edu/blog/future-development/2015/05/27/innovatively-using-the-asian-development-banks-balance-sheet-to-eradicate-poverty/>.

³ World Bank, *Global Community Makes Record \$75 Billion Commitment to End Extreme Poverty*, December 15, 2016, <http://www.worldbank.org/en/news/press-release/2016/12/15/global-community-commitment-end-poverty-ida18>.

Risks and Challenges Today

But the post–World War II world and the world of today are fundamentally different in ways that require the MDBs to evolve much further to remain core development actors.

First, there is the dramatic shift in the *distribution of economic power*. Countries that borrow from these institutions now account for two-thirds of the global economy. The logic of affording these countries a stronger voice at decisionmaking tables is obvious. Yet, governance systems at the MDBs have been slow to change.

Second, it is fair to say that there is *less confidence in traditional policy orthodoxy* from the North—both in the South and in the North. Asian countries regard their growth and poverty-reduction track records as clear evidence of the validity of different development models. Rising populism in the North is undercutting trust in the value of open markets for trade and investment. MDB policy conditionality often places them at the center of these debates. Yet, despite policy differences, both China and the United States ought to share a strong interest in maintaining the MDB technocratic, evidence-based approach to policy advice. Multilateral institutions offer degrees of political separation from policy discussions that governments and bilateral institutions do not.

Third is the *proliferation of alternatives to MDBs* for both finance and technical expertise. As many have noted, private global capital flows dwarf official flows, and the gap between official flows and what is needed to achieve the Sustainable Development Goals (SDGs) will never be filled with public development funds. This recognition is driving a fundamental shift in thinking about how to assess MDB performance. Where MDBs were once judged by the volume of finance they themselves offered and disbursed, they are now increasingly judged by how much they catalyze from other sources—from the private sector and from domestic resource mobilization.

A fourth difference is in the *geographic distribution of the poor*. The poverty-reduction success of China, India, and other emerging markets means that twenty-first-century poverty will increasingly be concentrated in countries with the most difficult environments and the weakest records in sustaining growth. By 2030, an estimated 40 to 60 percent of the world's poor will be living in states now deemed fragile.⁴ MDB poverty reduction performance, therefore, will increasingly be judged in places where effectiveness is hardest to achieve.

Finally, early indications from the new U.S. administration suggest a major change in *attitude toward multilateral global governance and institutions*. The “America First” approach to economic and security matters and the administration’s proposed budget point to more emphasis on bilateral relations and arrangements, and more reliance on “hard” investments in defense than on “soft power.” An actual U.S. retreat from its unique role in leading and

⁴ Laurence Chandy, Natasha Ledlie, and Veronika Penciakova, *The Final Countdown: Prospects for Ending Extreme Poverty by 2030*, Brookings Institution, 2013, https://www.brookings.edu/wp-content/uploads/2016/06/The_Final_Countdown.pdf; Alison Burt, Barry Hughes, and Gary Milante, *Eradicating Poverty in Fragile States: Prospects of Reaching The ‘High-Hanging’ Fruit by 2030*, World Bank, 2014, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2479667.

supporting the multilateral system would be a seismic change. The damage done would be compounded by a Europe inwardly focused on its own internal divisions. While these developments would create opportunities for China, they would come at a time of significant instability, danger of expanded conflict, and global fragmentation—a risky time to take on the mantle of, and responsibility for, leadership of the global multilateral system.

Prospects for U.S.-China Cooperation

At this moment of high uncertainty in U.S.-China relations, proposals for cooperation in the MDB context need to be grounded in areas where mutual interest is strong. Such areas might be found where there is:

- A desire on the part of both countries for financial burden sharing on an urgent issue(s);
- A common view of MDB weaknesses for which both countries seek a solution; or
- An internal challenge of political significance where multilateral efforts might be of some help to both countries.

Here are a few illustrative possibilities.

A strong case can be made for mutual interest in *sharing the burden* of financing challenges that are global in scope but now seriously underfunded because no one country is able, or has the incentive, to take them on alone: examples are *global public goods* in areas like climate change, health, and agricultural research. While the United States and China are likely to assign different priorities to different global public goods—for example, climate change—the economic and political logic of using multilateral institutions to pool and share funding responsibility is clear.

A second issue of shared interest is enhancing MDB effectiveness in *mobilizing private finance* for investments. China wants greater leverage from its MDB contributions and its coinvestments in MDB projects by state institutions, as well more growth-enhancing MDB activity in frontier markets where its presence is expanding. For its part, the United States, given its private-sector-led economy and market perspective, is better placed to advance innovative ideas for greater leverage.

A third shared objective is increasing investment in *sustainable infrastructure*, including regional infrastructure, central to growth and economic opportunity. The gap between estimated developing country infrastructure needs of an additional \$3 trillion per year and annual MDB infrastructure support of \$50 billion is enormous.⁵ And private finance for

⁵ Amar Bhattacharya, Jeremy Oppenheim, and Nicholas Stern, *Driving Sustainable Development Through Better Infrastructure: Key Elements of a Transformation Program*, Brookings Institution, 2015, <https://www.brookings.edu/wp-content/uploads/2016/07/07-sustainable-development-infrastructure-v2.pdf>; Chris Humphrey, *Infrastructure Finance in the Developing World: Challenges and Opportunities for Multilateral Development Banks in 21st Century Infrastructure Finance*, Global Green Growth Institute, 2015, <https://www.g24.org/wp-content/uploads/2016/05/MARGGK-WP08.pdf>.

infrastructure largely bypasses poor countries: IDA countries received less than 4 percent of the value of infrastructure projects with private participation in developing countries from 2011–2015.⁶

China and the United States could take the lead in pressing MDBs—old and new—to collaborate, both internally and with each other, to crowd in private investment, including in poor countries. This means bringing together all the tools in MDB arsenals for increase catalytic impact and probability of success: project development grants; coordinated policy and regulatory support; standardized debt and guarantee products that create diversified pools of assets capable of attracting institutional investors; currency risk-sharing instruments; political risk insurance; and more support for innovations in low-cost service delivery to serve poor and off-grid populations.

A fourth issue concerns an internal challenge for both countries: *higher inequality* and its political consequences. Both countries struggle to connect marginalized populations to the benefits of growth. The MDBs are well placed to help both high- and low-income countries craft the complex strategies needed in response.

Finally, both countries confront *rapid changes in the twenty-first-century composition of jobs and skills*, related to globalization and technological change. An estimated 38 percent of current U.S. jobs will not exist in 2030.⁷ As incomes in China continue to grow, it will confront these issues, likely sooner than expected. China and the United States could take the lead in urging the MDBs to develop tools to help countries adapt proactively and prophylactically.

Recommendation

It is hard to judge now how much traction any of these potential areas of shared interest might garner. But it seems clear that this is a time to set limited and achievable goals in the MDB area, which is greatly overshadowed in bilateral relations by security issues and trade. It would be best to choose one area where the case for collaboration is relatively easy to make, where chances for success are reasonable, and where there is a need for U.S.-China leadership.

We suggest that area is the establishment of a *World Bank window for global public goods*. As proposed in the CGD Panel Report, this new window could be established in a way that addresses U.S. interests in avoiding additional contributions to the Bank as well as Chinese interests in an enhanced governance role.⁸ The report proposes a funding level of \$10 billion a year for the window. There would be no increase in traditional donor assistance budgets. Rather, the funding would come from expanded World Bank income as IDA reflows are

⁶ Fernanda Ruiz-Nunez, *PPI Investments in IDA Countries, 2011 to 2015*, World Bank, 2016, https://ppi.worldbank.org/~/_media/GIAWB/PPI/Documents/Data-Notes/PPI-in-IDA-Countries-2011-2015.pdf.

⁷ Richard Berriman and John Hawksworth, "Will robots steal our jobs? The potential impact of automation on the UK and other major economies," UK Economic Outlook, 2017, <http://www.pwc.co.uk/economic-services/ukey/pwcukey-section-4-automation-march-2017-v2.pdf>.

⁸ Birdsall, Morris, and Rueda-Sabater, "Review of 'Enhancing ADB's Financial Capacity to Achieve the Long-Term Strategic Vision for the ADF.'"

leveraged, reallocation of some donor contributions to the window as countries graduate from IDA, emerging market donor contributions, and perhaps capital contributions from emerging markets to endow the window. A separate governance structure could be established that gives China an enhanced role, along with other emerging markets.

The result would be a new piece of multilateral architecture that serves multiple purposes: (1) funding critical activities of urgent global importance that are now greatly underfunded; (2) shifting some IDA funding to better uses rather than have funding decline as the number of IDA countries declines; (3) giving China and emerging markets the opportunity to exercise significant control over the new entity without having to fight shareholder dilution battles; and (4) giving the new U.S. administration the political opportunity to point to China and others as shouldering more of the burden of financing these activities, an objective it has stressed in the cases of NATO and the United Nations.

China-U.S. Cooperation for a More Effective Multilateral Development Bank System

Ye Yu

Multilateral Development Banks (MDBs) are crucial instruments for global development cooperation. They have the advantages of mobilizing and convening financial resources combined with technical knowledge, backed by political support. The Organization for Economic Cooperation and Development (OECD) has listed nine reasons for countries to engage with multilateral agencies: economies of scale; governance based on global development principles and standards; political neutrality and legitimacy; abundant capital and knowledge resources; advisory services and technical assistance; low transaction costs; contribution to global public goods; global presence; and effectiveness and efficiency.¹ But they have suffered from irrelevance since the 1990s. It was after the global financial crisis (GFC) in 2008 that the MDB system was revitalized and even restructured by major shareholders under the G20 framework. The United States and China, as the largest traditional and emerging shareholders of the system respectively, had some frictions in the previous years, but are back on the right track exploring opportunities for cooperation now.

Major Trends in the Evolution of the MDB System

Resource Mobilization: From Capital Increase to Efficiency Enhancement

Enhancing the role of MDBs for the world economy has been an important issue discussed by the G20 leaders since they first met at the end of 2008. The core issue is to increase financing resources for MDBs. In the first two years, the G20 focused on pushing forward quota reforms and mobilizing public resources from shareholder countries, including through general capital increases, selective capital increases, and replenishments for concessional lending facilities of MDBs. About \$350 billion in capital increases was mobilized for the MDBs, allowing them to nearly double in size.² The reform package approved by the World Bank Development Committee in April 2010 enabled an additional 3.13 percent of World Bank voting power to be transferred to developing and transition countries after the 1.46 percent adjustment in the first phase of reform in 2008. This is an unfinished journey toward the goal of an equitable voting power structure, however. According to the commitments made by the World Bank governors in Istanbul in 2009, the new round of review of World Bank voice based on a dynamic formula was due in 2015.

In recent years, the focus was shifted to leveraging market resources by better utilizing the existing balance sheets. The 2015 Antalya Summit endorsed the Multilateral Development

¹ OECD Development Assistance Committee, *What do we know about multilateral aid? The 54 billion dollar question*, http://www.oecd.org/development/aid-architecture/13_03_18%20Policy%20Briefing%20on%20Multilateral%20Aid.pdf.

² G20 Research Group, *The G20 Toronto Summit Declaration: June 26–27, 2010*, 5.

Banks Action Plan to Optimize Balance Sheets, calling for MDBs to consider the following five measures:

- Increasing developing lending for higher capital efficiency;
- Deploying exposure exchanges to reduce concentration risks;
- Developing financial innovations of concessional windows for improved use of liquidity (at the World Bank, African Development Bank, and Inter-American Development Bank);
- Evaluating structured instruments for sharing risks with private investors in nonsovereign operations;
- Considering net income measures for improved capital position.

This Action Plan laid down the basic framework for the past two years' G20 priorities for the MDBs. The 2016 G20 Hangzhou Summit reviewed its progress.³ But as Helmut Reisen rightly noted, the MDBs' balance sheet optimization needs to be approached carefully, case by case.⁴ The African Development Bank, for example, has less potential to increase its leverage ratio compared to the World Bank.

However, we have witnessed an even more dramatic evolution of the MDBs. While the traditional MDBs continue to evolve, a new set of MDBs have been initiated by emerging economies, such as the Asian Infrastructure Investment Bank (AIIB) and the BRICS New Development Bank (NDB). Different from the last set of South-South MDBs led by oil-exporting countries in 1960s–1970s, this new set of MDBs has more technical grounding as they are led by emerging economies that have achieved development through industrialization. While new resources and knowledge will be mobilized for the benefit of global development, new competition and coordination challenges also inevitably arise.

Resource Allocation and Priorities: From Crisis Response to Infrastructure Financing and Sustainable Development

MDBs played an important role in responding to the crisis in the early years after the GFC. This can be seen from the dramatic increase in the International Bank for Reconstruction and Development's (IBRD) commitments from 2009 to 2010. However, with the crisis having eased, MDB lending also shifted toward more long-term projects. The G20 leaders called for a comprehensive reform of the mission, mandate, and governance of MDBs in Pittsburgh in September 2009, including strengthening support for food security, human development

³ G20 Research Group, *MDB Response to the G20 Action Plan for MDB Balance Sheet Optimisation: July 2016*, <http://www.g20chn.org/English/Documents/Current/201608/P020160815361155807206.pdf>.

⁴ Helmut Reisen, *On the G20 call for MDB Balance-Sheet 'Optimization'*, T20 Germany, April 11, 2017, <http://blog.t20germany.org/2017/04/11/on-the-g20-call-for-mdb-balance-sheet-optimization/#more-1323>.

and security in poorest countries, private-sector-led growth, and infrastructure and transition to a green economy.⁵

Probably most significantly, infrastructure financing became an important priority for the G20 development agenda and for MDBs as well. In Seoul in 2010, the G20 leaders endorsed the multiyear “Action Plan on Development” asking MDBs to “work jointly to prepare action plans that increase public, semi-public and private finance and improve implementation of national and regional infrastructure projects, including in energy, transport, communications and water, in developing countries, Low Income Countries (LICs) in particular.”⁶ The MDB Working Group on Infrastructure was established by the World Bank, Asian Development Bank, African Development Bank, European Investment Bank, Inter-American Development Bank, and Islamic Development Bank. One background analysis and one action plan were agreed to at Cannes in 2011.⁷ The Action Plan listed eight measures:

- Improving project preparation funds (PPFs) effectiveness;
- Developing catalytic regional projects;
- Expanding technical assistance through expanded PPP practitioners’ networks;
- Increasing incentives for MDB staff to engage in PPP transactions and regional projects;
- Piloting an Africa infrastructure marketplace;
- Improving procurement practices to facilitate collaboration with the private sector;
- Launching a global infrastructure benchmarking initiative;
- Scaling up the construction sector transparency initiative (CoST).

With the launching of the two new MDBs focusing on infrastructure financing, this MDBs-infrastructure nexus was further strengthened. Two relevant platforms were established: the Global Infrastructure Facility (GIF) under the World Bank⁸, and the Global Infrastructure Hub (GIH) in Sydney in 2014.⁹ The G20 Hangzhou Summit in 2016 asked the MDBs to provide a

⁵ G20 Research Group, *Leaders’ Statement: The Pittsburgh Summit September 24–25, 2009*, 3, 4, <https://www.treasury.gov/resource-center/international/g7->

⁶ G20 Research Group, *G20 Seoul Summit Leaders’ Declaration: November 12, 2010*, <http://www.g20.utoronto.ca/2010/g20seoul/html>.

⁷ MDB Working Group on Infrastructure, *Supporting Infrastructure in Developing Countries*, June 2011, <http://documents.worldbank.org/curated/en/297061468343728311/pdf/655610BR0v20Se0Official0Use0Only090.pdf>; MDB Working Group on Infrastructure, *Infrastructure Action Plan*, October 2011, <http://www.g20dwg.org/documents/pdf/view/19/>.

⁸ “Global Infrastructure Facility: Update for G20 Leaders,” November 2014, http://www.g20.utoronto.ca/2014/GIF_update_g20_leaders.pdf.

⁹ “G20 Global Infrastructure Initiative,” http://www.g20.utoronto.ca/2014/g20_note_global_infrastructure_initiative_hub.pdf.

joint declaration to increase financing for infrastructure,¹⁰ though the quantitative targets they gave were not mandatory.

In addition to infrastructure, there are many more challenges for the MDBs to respond to. Poverty will continue to stay with us as a big challenge for an extended period of time, while new challenges have also received more attention: inequality, the infrastructure gap, food security, climate change, and fragile and conflict affected states (FCS), to name a few. The 2030 Sustainable Development Agenda newly endorsed by the United Nations covers 17 goals and 169 indicators for the 5Ps (people, planet, prosperity, peace and partnership). The MDBs must adapt themselves to better respond to these new demands. More importantly, how MDBs engage on the ground to respond effectively to the needs of developing countries at different stages of development will also need to evolve.

China-U.S. Cooperation

Not surprisingly we have seen competition and collisions between the United States and China on the MDBs. First is about ownership. China believes its voting power in the World Bank is not representative of its position in the world economy, while on the other hand, the United States is not ready to join in the AIIB launched by China. Second, the two countries also hold relatively different views regarding the priorities of the MDBs. While China favors more resources allocated to infrastructure financing, the United States puts more emphasis on social sectors. But differences are not that fundamental as it appears, since China is ready to approach a much more diversified agenda when its overseas interests are getting more comprehensive. The United States does not question the legitimacy of the infrastructure agenda either. But the United States is indeed very critical about the social and environmental standards of the two new MDBs backed by China in infrastructure financing.

Fortunately, confrontations between the two countries are much fewer now. The two countries signed a strategic agreement on development cooperation during President Xi Jinping's visit to the United States in September 2015. The two leaders committed to meaningfully increasing investment in the existing MDBs while supporting the new initiatives. They also reached a political compromise on MDB standards.

China has kept its promises and consistently increased its contributions to the legacy MDBs, such as the International Development Association (IDA) and African Development Fund (ADF), the World Bank and Asian Development Bank's soft loan windows. But the U.S. commitment to multilateralism was put in serious question when President Trump came to office. He is expected to cut spending on international organizations, including the MDBs. But the U.S. retreat on financial contributions for the MDBs has been a long process historically without harming its influence on the MDBs' policies. MDBs remain an even more important platform for China and the United States to coordinate on policies dealing with global challenges when China's global position keeps rising. Here are several possible choices.

¹⁰ "MDBS Joint Declaration of Aspirations on Actions to Support Infrastructure Investment," <http://www.g20chn.org/English/Documents/Current/201608/P020160815360318908738.pdf>.

First is on infrastructure financing, where the two countries should constructively engage with each other to improve standards and guiding principles for the MDBs. In addition to the MDBs themselves, they can also strengthen bilateral engagement. At the Belt and Road Forum on May 14, 2017, President Xi announced his decision to establish a multilateral development financing cooperative center to enhance complementarities between China's bilateral financing mechanisms and the MDBs.¹¹ This is a perfect platform for MDBs and Chinese bilateral agencies such as the China Development Bank and China Ex-Im Bank to have regular dialogues on standards, among other things.

Second, on the "Women Entrepreneurship Fund" jointly proposed by Ivanka Trump and World Bank president Jim Yong Kim for the G20, the United States and China should actively support its launch by making the primary financial commitments.¹² Third, China and the United States can also have more strategic coordination on other global challenges, such as climate change financing, fragile states, and refugee issues, even though the Trump administration has turned its back on some of these.

¹¹ "Full text of President Xi's speech at opening of Belt and Road forum," Xinhua, May 14, 2017, http://news.xinhuanet.com/english/2017-05/14/c_136282982.htm.

¹² "Ivanka Trump, "World Bank Discuss Women Entrepreneur Fund," Associated Press, April 26, 2017, <https://www.voanews.com/a/ivanka-trump-world-bank-women-entrepreneur-fund/3827085.html/>.

05

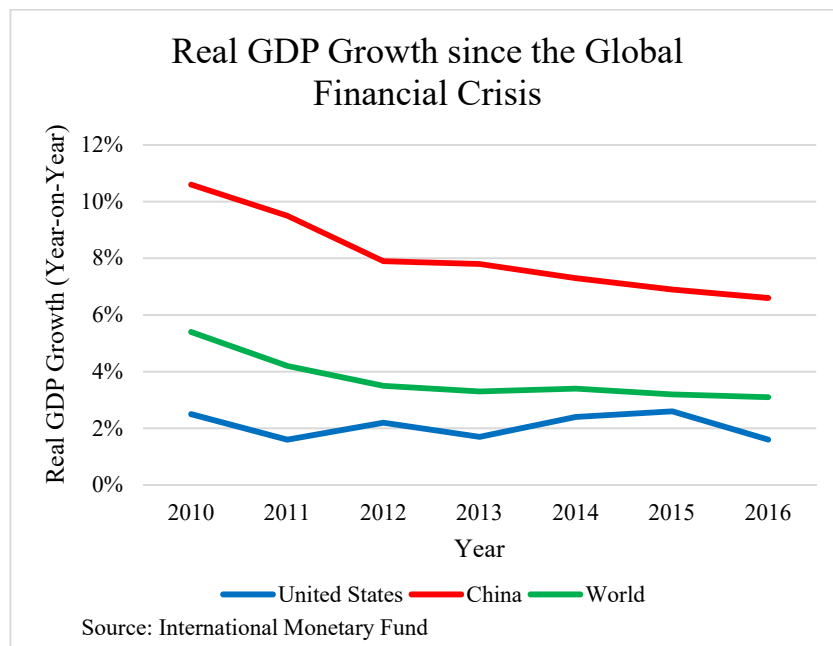
Global Trade Policy

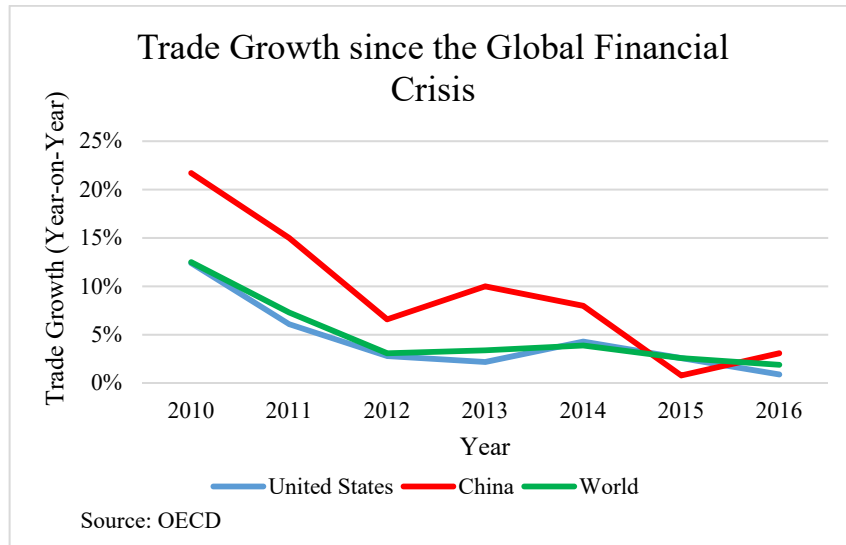
Opportunities for U.S.-China Trade Cooperation

William Reinsch

Postcrisis Progress

Since the 2009 financial crisis there have been significant changes in the global economy as well as in the U.S.-China bilateral economic relationship as both nations focused on economic recovery. The global economy has been characterized by recovery but in most cases, slower growth generally and slower growth in trade.





After years of increasing bilateral trade, and increasing U.S. deficits, the global slowdown may be starting to affect the U.S.-China trade relationship. It is too soon to predict a trend, but there are indications the period of rapid growth in the bilateral deficit may be slowing.



These changes in trade parallel changes in the way our two countries have approached the trading system. For the United States, the world's evolution to a global supply chain model assisted by rapid technological change has produced benefits for multinational corporations and their employees but at the same time has increased the number of Americans who see themselves disadvantaged by trade. That creates enormous political pressures to take care of our own first and to abandon the multilateral system we have spent 70 years creating and in effect running. One can see echoes of both in the statements of the new administration.

Conversely, China, which has been the world's biggest beneficiary of globalization in terms of lifting millions of people out of poverty, has until recently taken a skeptical attitude toward

a multilateral system it had no say in creating, but has begun to step up and portray itself as the potential new leader of the system. Look at Xi Jinping's remarks at Davos and Chinese comments in Chile last April and one sees a government claiming a bigger seat at the table.¹ Look at its Asian Infrastructure Investment Bank (AIIB) and One Belt, One Road (OBOR) initiatives and one can see a nation prepared to devote significant resources to promoting global economic growth (albeit in a way that provides major benefits to China).

This portends a change in the global pecking order that would be consequential if it actually occurs, and it raises the issue of the Thucydides Trap which has reemerged as a popular discussion topic as well as a genuine concern.² It will really be up to the United States to defuse the tensions that will grow as China asserts itself.

Bilateral Risks and Challenges

Despite some leveling off at the macro level, the past five years have featured significant growth in the number of economic irritants that have plagued the relationship, both in terms of difficulties Americans encounter doing business in China and in terms of the impact Chinese imports have on the U.S. economy and jobs. This growth has exacerbated the dilemma facing U.S. companies doing business in China, and it has complicated policymaking in the United States.

The American business community initially strongly supported Chinese accession to the World Trade Organization (WTO) in the belief that it would increase their access to a potentially very large market and that WTO accession would push China to more fully integrate itself into the developed world trading system by accelerating internal economic reforms and, in former United States Trade Representative Robert Zoellick's words, to become a "responsible stakeholder."³ Signals sent by the top Chinese leaders at the time, Jiang Zemin and Zhu Rongji, encouraged that optimism.

Subsequent developments, however, have not fulfilled expectations. The pace of reform slowed during the term of Hu Jintao and Wen Jiabao, and Xi Jinping and Li Keqiang have launched new programs that pose significant challenges for foreign companies doing business in China.

These policies—which are not a secret—appear intended to extract the maximum amount of technology and know-how from Western companies, create viable Chinese companies to compete with them, support those companies through a range of discriminatory tactics, and eventually either force Western companies out of the country or confine them to a relatively small share of the Chinese domestic market while competing with them there, in the United

¹ Stephen Fidler, Te-Ping Chen, and Lingling Wei, "China's Xi Jinping Seizes Role as Leader on Globalization," *Wall Street Journal*, January 17, 2017, <https://www.wsj.com/articles/chinas-xi-jinping-defends-globalization-1484654899>.

² Graham Allison, "The Thucydides Trap: Are the U.S. and China Headed for War?," *Atlantic*, September 24, 2015, <https://www.theatlantic.com/international/archive/2015/09/united-states-china-war-thucydides-trap/406756/>.

³ Robert B. Zoellick, "Whither China: From Membership to Responsibility? Remarks to National Committee on U.S.-China Relations," U.S. Department of State Archive, September 21, 2005, <https://2001-2009.state.gov/s/d/former/zoellick/rem/53682.htm>.

States, and in third countries. The dilemma for many U.S. companies is that notwithstanding these limitations, they are profitable. Their share of the Chinese market may be small in percentage terms, but the economy is so large that even a small share is significant.

As a result, American companies remain in China making money but are increasingly unhappy at their situation while at the same time reluctant to protest to either the Chinese or U.S. government for fear of retaliation from the former.

At the same time, the impact of Chinese imports into the United States has also grown. Historically, debates about imports have followed a predictable path with protectionist forces, usually led by the affected industries demanding relief and the business establishment, along with most economists, arguing that the benefits of free trade outweigh the impact of imports on specific sectors and that job losses are due more to technology changes and the resulting productivity improvements than imports.

While the latter remains generally true, the widely read 2016 study by David Autor, David Dorn, and Gordon Hanson has reopened the debate by, for the first time, providing evidence supporting the argument that Chinese imports cost jobs.⁴ No one, including the study's authors, has argued that its findings can be generalized beyond China, and there have been some suggestions that the impact is largely finished in any event. Regardless of whether the latter is true, there appears to be growing acceptance in business and academic circles of the study's conclusions, which has, in turn, legitimized the already ongoing search for new tools to deal with the problem.

For space reasons, this paper will focus on multilateral tools, but both countries also have bilateral and unilateral options available as well.

Prospects for Cooperation

Multilateral: One of the things we have learned about China is that it is uncomfortable being an outlier. Multilateral efforts that include the European Union, Japan, Australia, New Zealand, and other countries in the region have sometimes had more success in changing Chinese policy than bilateral efforts.

A current example of that approach is the G20 initiated Global Forum on steel overcapacity. Reaching an agreement will not be an easy task, but it has promise since a multilateral forum allows China to argue domestically that responsibility for the problem is spread widely, and it is easier to make concessions as part of a group rather than individually.

WTO: Similarly, in a more structured context, using the WTO for both negotiations and dispute settlement is another constructive, albeit lengthy, way to address issues that are bilateral but also impact others. With respect to negotiations, the failure of the Doha Round, in part but not entirely due to U.S.-China differences, has pushed

⁴ David H. Autor, David Dorn, and Gordon H. Hanson, "The China Shock: Learning from Labor-Market Adjustment to Large Changes in Trade," *Annual Review of Economics* (2016), <http://www.ddorn.net/papers/Autor-Dorn-Hanson-ChinaShock.pdf>.

negotiation proposals in the direction of plurilaterals. These “coalitions of the willing” offer an opportunity for further trade liberalization that, if successful, will draw other participants into a larger multilateral framework. The updated Information Technology Agreement (ITA-2) was recently concluded successfully, and conclusion of the Environmental Goods Agreement (EGA) awaits resolution of changes demanded by China. Conclusion of this agreement would be win-win-win: good for the environment, trade liberalization, and market access for Chinese and American manufacturers.

At the same time, China’s reluctance to make significant concessions in both these cases delayed the negotiations, created doubts about the eventual outcome, and convinced the United States to resist letting China join the Trade in Services Agreement (TiSA) talks for fear the same thing will happen again. In the absence of a more forthcoming Chinese approach, that same scenario is likely to play out in future plurilateral cases being considered.

Dispute Settlement: It appears that the Trump administration will use the WTO dispute settlement process aggressively and will continue the Obama administration’s crusade against “overreach” by the Appellate Body—rules and interpretation that go beyond the limits of what was negotiated in the Uruguay Round. China will probably reflexively oppose these efforts, but as the third most frequent respondent (after the United States and the European Union), it would have a lot to gain from the stricter interpretation of the rules the United States is advocating.

Multilateral Institutions: Washington has an opportunity to validate China’s growing footprint on the international stage by supporting its initiatives in the AIIB and OBOR and facilitate it by encouraging further reforms in the World Bank and International Monetary Fund that give it a larger voice.

Investment: Negotiations on a Bilateral Investment Treaty (BIT) are on hold, but there is doubt that the administration will resume them and also widespread skepticism in the American business community that it will be possible to reach an agreement that adequately addresses their concerns. An alternative is to try to restart the talks on a Multilateral Agreement on Investment that stalled in the late 1990s. A multilateral agreement would likely benefit both countries, but the political obstacles to it are as great now as they were 20 years ago. In addition, China will have to contend with growing congressional sentiment to further restrict its investments in the United States.

Recommendations

1. *Recognize, validate, and encourage Chinese global leadership:* As noted above, recent statements by Xi Jinping indicate China’s desire to play a leadership role on the global stage. This is a potentially positive development that the United States should encourage and attempt to channel into constructive directions.

2. *Move disputes into a multilateral framework:* As in the case of steel overcapacity, chances for resolution are greater in a larger group. In addition, many of the Chinese laws and regulations that American companies complain about are not so much anti-American as they are antiforeign. They may be affecting U.S. companies first and foremost, but others will be affected as well, and their governments need to deal with that.
3. *Launch a global campaign to improve global intellectual property protection:* Intellectual property is the foundation of American competitiveness, and protecting it is the key to our ability to maintain our position of global economic leadership over the long term. However, IP theft threatens not only the United States but developed economies and individual innovators throughout the world, and China is the chief culprit. U.S. officials have given the speech many times, but there is still a need to enlist allies in a campaign to address theft and other unauthorized transfers more aggressively.
4. *Resume BIT talks:* Ultimate agreement on a text may be unlikely, but the issues involved are important ones for both sides and deserve airing. The talks would also provide a framework for a broader discussion of trade and investment issues in a negotiating context, which could prove useful in light of the failure of the 100-day action plan announced at the Mar-a-Lago summit in April 2017 to produce significant results.⁵

Conclusion

While there may be some signs that macroeconomic conditions are improving, bilateral trade grievances have grown, and the political climate, at least in the United States, has grown markedly worse. It is particularly important that the two countries work harder to address their particular grievances in order to ensure that the political concerns do not grow and take control of the policy process.

⁵ "U.S., China Fail to Agree on Trade Issues, Casting Doubt on Other Issues," Reuters, July 20, 2017, <https://www.nytimes.com/reuters/2017/07/20/business/20reuters-usa-china-trade.html>.

Managing Bilateral Trade Policy: A Quest for Rebalancing the Global Economy?

Shen Minghui

Intraregional Trade at a Glance

The international trade of most East Asian economies has witnessed a higher growth rate than the world average in recent decades. East Asian economies have successfully integrated themselves into globalization and the world economy as well. As a result, East Asian economies' exports to the rest of world increased from \$219.9 billion in 1980 to \$4.69 trillion in 2015, and their imports increased from \$250.3 billion in 1980 to \$4.069 trillion in 2015. Correspondently the share of East Asian economies' exports of world exports doubled from 13.6 percent in 1980 to 32.1 percent in 2015, and the share of East Asian economies' imports of world imports also increased from 15.6 percent in 1980 to 27.9 percent in 2015.

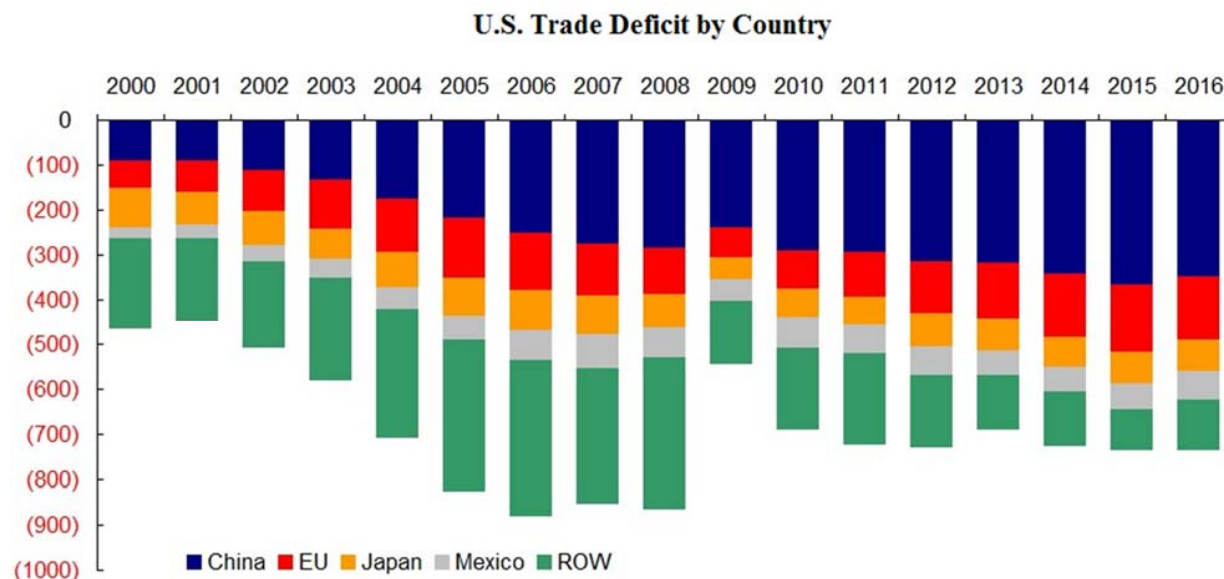
Benefiting from export-oriented models and dramatically high trade growth, East Asian economies have been successful in fueling economic growth. Most East Asian economies except Japan significantly raised their respective shares of world GDP. However, growth of processed intermediate goods fell rapidly from 31 percent to 1.3 percent in 2014 and contracted 6.8 percent in 2015. And intermediate goods trade by value contracted 13.2 percent in 2015, affecting Asia's overall trade performance as well. As a result, trade growth by volume fell from 3.5 percent in 2014 to 2.3 percent in 2015 in Asia, much sharper than the decline in global trade from 2.8 percent to 2.7 percent in the same period. In addition, Asia's trade growth has consistently fallen below its GDP growth since 2012, consistent with the global trend.¹

An Explanation for the U.S. Trade Deficit with China

The United States is the most important market for China's exports. Exports to the United States in 2016 were about \$389.7 billion, accounting for about 20 percent of China's total exports. However, China only imported \$135.6 billion in 2016 from the United States and this accounts for only 10 percent of China's total imports. Looking at the details, China exported \$165 million in primary goods, \$420 million in processed goods, \$3 million in parts and components, \$11 million in capital goods, and \$551 million in consumer goods in 1980. And today China's exports of capital goods surged to \$158 billion and consumer goods surged to \$166 billion, accounting for 35 percent and 36 percent of total exports, respectively. China's imports from the United States are quite diversified. China imported \$29 billion in primary goods, \$58 billion in intermediate goods, and \$55 billion in final goods in 2015. These

¹ Asian Development Bank, *Asian Economic Integration Report 2016: What Drives Foreign Direct Investment in Asia and the Pacific?*, 2016, 16–17, <https://www.adb.org/sites/default/files/publication/214136/aeir-2016.pdf>.

imports vary greatly from fuels, chemicals, drugs, electronics, transport to food and living animals, etc.



Source: Calculations made using IMF DOTS database.

The U.S. trade deficit in goods with China has grown from 0.8 percent of GDP in 2000 to 2.0 percent of GDP in 2016, equivalent to almost half the overall trade deficit for the United States and most of the current account deficit.

However, the bilateral trade number fails to fully explain the impact of trade with China on the U.S. economy. Considering global industrial supply chains, China is an assembler instead of a final market. Meanwhile, East Asian economies become increasingly interdependent and integrated through pro-foreign direct investment (FDI) policy regimes, export-led models, unilateral liberalization, and East Asian production networks. The intraregional trade share of East Asia turns out to be fairly high due to the above factors. The overall intraregional trade share of East Asia climbed from 41.1 percent in 1990 to a pre-crisis peak of 53.0 percent in 2004, before it fell slightly to 49.2 percent in 2015.

Although China's share of intra-East Asian trade decreased to about 35 percent, it is still a key variable in East Asian intraregional trade patterns. All the other East Asian economies increased their share of exports to China by several multiples, and China has become their top export destination, or an important merchandise trade deficit country, for its East Asian neighbors in recent years, which contributes to the continuous increase in intraregional trade in East Asia. For this reason, the "decoupling" thesis notes that East Asia can sustain its self-contained economic growth dynamism rather than its dependence on traditional external consumption market like the United States.²

² Yung Chul Park and Kwanho Shin, "Economic Integration and Changes in the Business Cycle in East Asia: Is the Region Decoupling from the Rest of the World?," *Asian Economic Papers* 8, no. 1 (2009): 107–140, <http://www.mitpressjournals.org/doi/abs/10.1162/asep.2009.8.1.107>.

The fallacy of the “decoupling” thesis was revealed by the global financial crisis in late 2007: all East Asian economies including China, which is expected to support regional trade growth, experienced severe slumps in exports and economic downturns due to the contraction of external demand.³ In fact, East Asian economies are integrated with each other through regional production networks, which operate by separating a production chain into small parts and then assigning each to the most cost-efficient location. This means that production processes are fragmented into multiple slices and located in different economies in East Asia. Some steps take place within a single firm (or firms of the same group) that has operations in different economies, while others involve arm’s-length transactions among different firms in several economies. As noted by Prema-chandra Athukorala and Archanun Kohpaiboon, the “decoupling” thesis based on horizontal specialization ignores the regional production networks and the corresponding fragmentation-based trade in East Asia, and leads to misleading conclusions.⁴

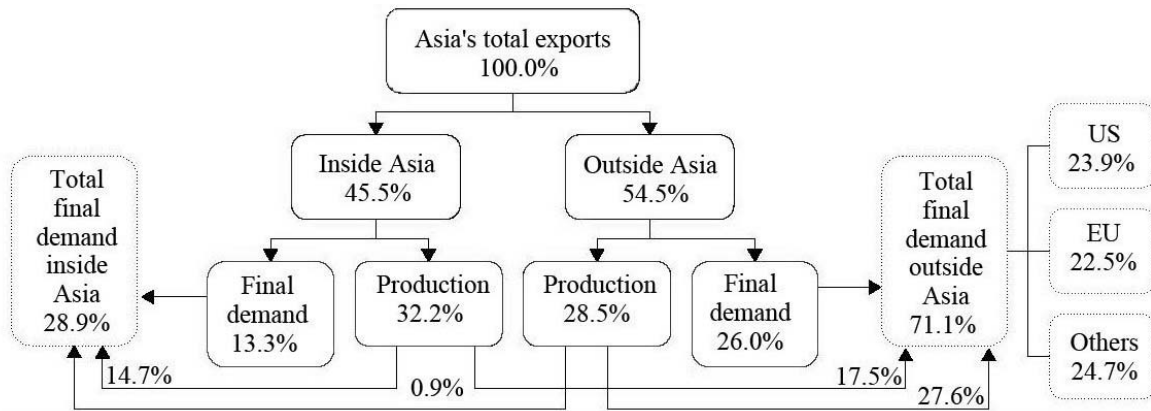
A breakdown of China’s trade with East Asia will show us a comprehensive interpretation of China’s role in East Asia, with almost half of Chinese imports coming from East Asia and most (71 percent) of these imports are of intermediate goods. Although East Asia is not the main market for China’s exports, 51 percent of China’s exports to East Asia were of final goods in 2015. And this trend is quite stable. It indicates that China’s regional role as an assembly plant is being strengthened, and a role as a final consumption market for East Asia is correspondingly weakened. In addition, China’s role in the global context is similar to that in East Asia.

Based on a detailed input-output analysis of Asia’s intraregional exports, the Asian Development Bank gives a clearer and more precise explanation, indicating that 54.5 percent of Asia’s exports are directly shipped to external markets like Europe and North America, and 71.1 percent ultimately end up there, when the parts and components of exports are fully taken into account. Put another way, Asia only accounts for 28.9 percent of final demand for its own total exports.

³ Prema-chandra Athukorala and Archanun Kohpaiboon, “Intra-Regional Trade in East Asia: The Decoupling Fallacy, Crisis, and Policy Challenges,” Asian Development Bank Institute Working Paper Series 177, 2009, <https://think-asia.org/bitstream/handle/11540/3765/2009.12.11.wp177.intra.regional.trade.east.asia.pdf?sequence=1>.

⁴ Ibid.

Asia's exports depend significantly on non-Asian final demand

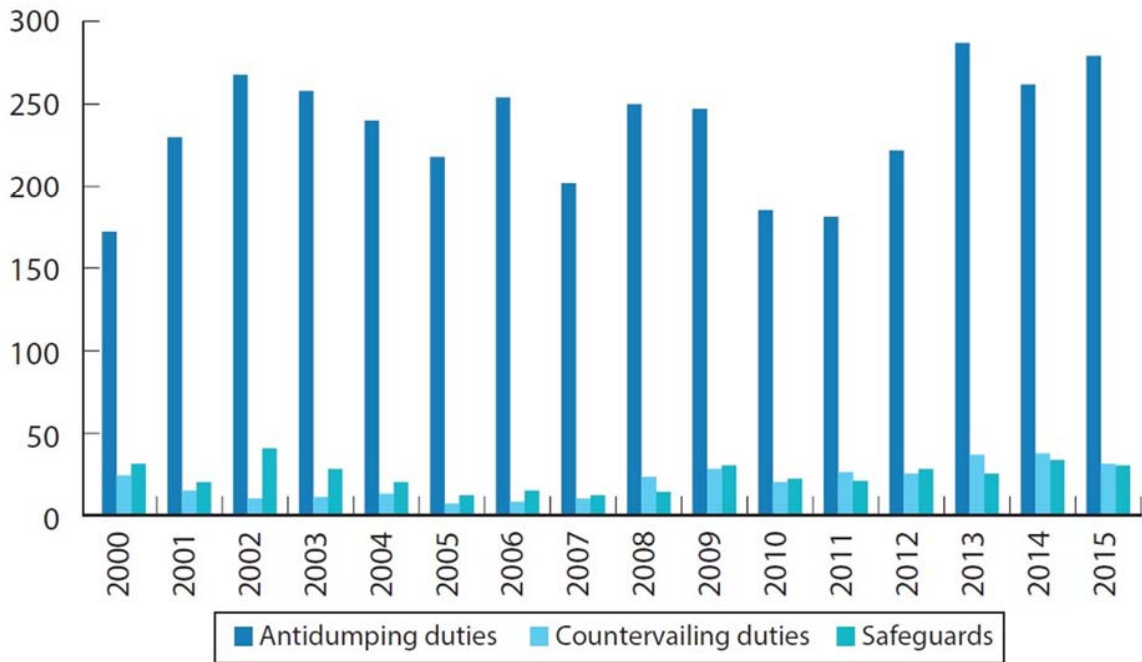


Source: Asian Development Bank, *Institutions for Regional Integration: Toward an Asian Economic Community*

In fact, the Organization for Economic Cooperation and Development (OECD) also estimates that about one-third of Chinese exports could be attributed to foreign content. More importantly, the study suggests that the foreign content of goods assembled and reexported from China is about 50 percent in some key sectors including computer equipment, electronics, and electrical machinery. Adjusting the trade balance to account for the value-added content of exports cuts the U.S. trade deficit with China in half, to about 1 percent of GDP.⁵

⁵ Oxford Economics, "Understanding the US-China Trade Relationship," U.S.-China Business Council, 2017) <https://www.uschina.org/sites/default/files/Oxford%20Economics%20US%20Jobs%20and%20China%20Trade%20Report.pdf>.

Number of Trade Remedy Measures Affecting Asia



Source: Asian Development Bank, *Asian Economic Integration Report 2016: What Drives Foreign Direct Investment in Asia and the Pacific?*

As a result, the United States’ rising deficit with China contributes to rising protectionism in the United States and then globally. The Asian Development Bank highlighted a fast-growing number of trade remedies against Asia around the world. In particular, antidumping duties are the most popular measures imposed on Asian exporters.⁶ Among these Asian economies, China, the Republic of Korea, and Taipei, China, are the economies most affected by the above trade remedies. For instance, China suffered much from trade remedies imposed by the United States for years. Antidumping duties imposed by the United States on China account for 40 percent of its total antidumping duties measures. And countervailing duties imposed by the United States on China also account for 40 percent of its total countervailing duties measures.

⁶ Asian Development Bank, *Asian Economic Integration Report 2016*, 33–35.

Trade Remedy Measures Imposed by the United States

Economy Affected	In force			Initiation	
	Anti dumping	Countervailing	Special Safeguards	Anti dumping	Countervailing
China	98	35	173	17	16
ROW	168	32	173	37	43
Total	266	67	173	54	59

Notes: Safeguard measures are applied to all WTO members.

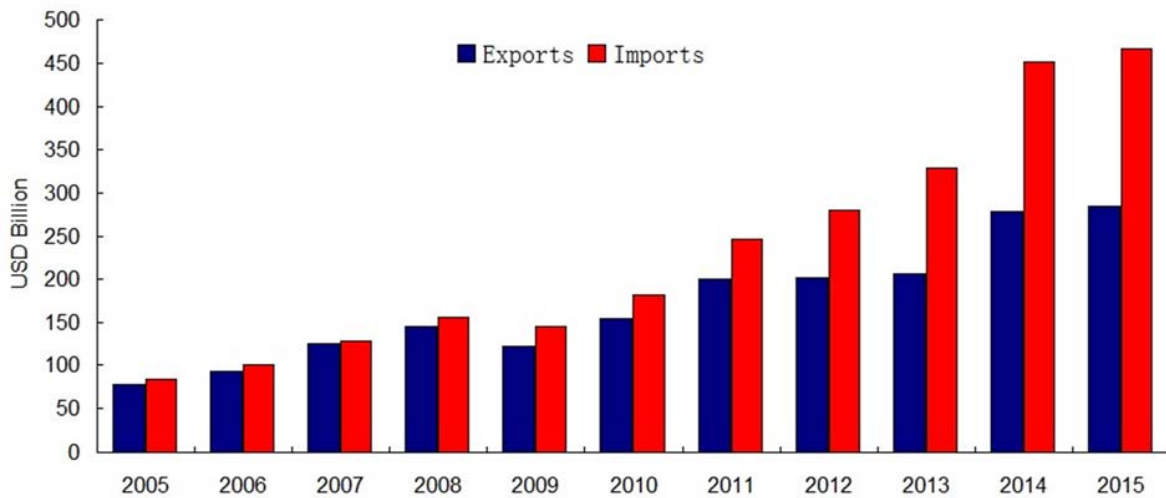
Source: Calculations based on data from WTO.

Managing Bilateral Trade Policy

More and more policymakers in East Asian economies have realized that the pre-crisis export-led growth model is unsustainable and East Asian economies, and China especially, must rebalance growth toward regional and domestic demand. Recognizing the regional absence of an adequate substitute for an external final demand market in the short run, one region-wide Free Trade Agreement is needed to provide extra final demand market for East Asia through trade creation and to help East Asia cope with negative shocks from outside. The ongoing negotiation in East Asia is the Regional Comprehensive Economic Partnership (RCEP). The RCEP is expected to help China to rebalance its exports and therefore decrease its trade surplus with the United States.

Unlike trade, direct investment will make the Chinese economy more integrated with the other economies. China considers the “Silk Road Economic Belt and Twenty-first Century Maritime Silk Road” (hereafter the BRI) as a new step to make its economy further integrated with the global market by investing abroad and therefore more balanced with the global economy. As the BRI is oriented toward development cooperation, it enables China to look for new economic opportunities by developing infrastructure networks, building industrial zones and many other projects with the countries in the region. While many of the labor-intensive manufacturing factories in China need to reallocate to low-cost places to maintain competitiveness, the developing countries in Asia and Africa have great demand to develop their own manufacturing capacity by using their advantage in low-cost labor. Different from the traditional model of moving dirty industries out, China will build new industries together with the local countries as all the projects under the BRI framework are to be designed and built jointly by China and the host countries. This new kind development cooperation differs from traditional aid and market-based reallocation of outdated production capacities. The BRI is aimed at promoting the orderly and free flow of economic factors, the highly efficient allocation of resources and deep integration of markets, encouraging the countries in BRI regions to coordinate economic policy and carry out broader and more in-depth regional cooperation of higher standards, and jointly create an open, inclusive, and balanced regional economic cooperation architecture that benefits all.

Chinese Trade in Commercial Services, 2005-2015



Source: Calculations made using WTO Statistics database.

Services is a fast-growing sector for both the United States and China. The United States has a surplus with China of about 0.2 percent of GDP in trade in services, up from 0.02 percent in 2000. Nowadays, China is interested in developing its services sector and participating in the Trade in Services Agreement (TiSA). More importance needs to be attached to services by both governments to help deepen bilateral trade relations. Multilayered measures including bilateral economic dialogue, bilateral investment treaty, and TiSA should be taken into consideration urgently to avoid potential trade war between the two major economies.

In retrospect, the new ITA negotiations (ITA2) and the Environmental Goods Agreement negotiations could not be successfully concluded without China-U.S. cooperation. The Environmental Goods Agreement negotiations within the WTO framework launched in 2014 also rely heavily on a consensus between China and the United States. In the future, the new round of building the global trade system is unlikely to succeed without consensus and cooperation between China and the United States. On the other hand, the multilateral trading system remains the ideal trading platform that can easily accommodate the two major economies. In this sense, the WTO is the most important economic relation between China and the United States. China and the United States have a common stake in supporting a strong and resilient multilateral trading system.

06

U.S.-China Bilateral Economic Relations

A New Era of Uncertainty in U.S.-China Economic Relations

Amy P. Celico

Our economic relationship with China has never been so important to the United States, and our economies have never been so intertwined—with ever more opportunity for expansion. It took real political leadership in Beijing and Washington 20 years ago, along with a hugely supportive American business community, to set our economic relationship on this incredible growth trajectory through negotiation of China's World Trade Organization (WTO) accession in 2001, resulting in U.S. goods and services trade with China growing from only a little more than \$100 billion in 2000 to an estimated \$659.4 billion in 2015. Investment ties, too, have grown and diversified, with Chinese investment in the United States outstripping U.S. investment in China for the first time in 2015.¹

Unfortunately, along with this expansion in the scale and scope of our economic ties, the imbalance in U.S.-China trade has continued to grow. And our economic relationship has become more contentious over the past decade, with our two countries disagreeing on what rules should govern access to our respective economies. In the aftermath of the global financial crisis, protectionist policies in both countries—and around the world—have increasingly challenged accepted principles and rules for trade. The United States and China both have more to gain from enhancing our economic relationship and continuing to act in concert to promote global economic growth, but this will require commitments from both countries to find common ground on contentious trade and investment issues, including how national security considerations should impact market access policies. Like 20 years ago, political leaders in both countries will face tough calls to take our economic relations to a renewed level of mutual benefit.

Bilateral Economic Relations Since the Global Financial Crisis

China's incredible growth trajectory over the past 20 years brought significant and distinct opportunities for the United States. In the immediate aftermath of China's WTO accession,

¹ Rhodium Group, *China Investment Monitor: Tracking Chinese Direct Investment in the U.S.*, 2017, <http://rhg.com/interactive/china-investment-monitor>.

China's lowered barriers and low-cost labor market made it a top destination for American manufacturers, and our companies invested heavily in China to make products to sell in global markets. Later, in the wake of the global financial crisis, China emerged as a major consumer market, growing at a remarkable pace in large part due to the Chinese government's commitment to reform and its investments in becoming an "innovative society." Consumption is expected to drive a greater portion of future Chinese economic growth, again assisted by government policies that encourage consumer spending and investment in strategic emerging industries.²

The development of cooperative channels, including multilateral forums like the G20, to deal with shocks to the global economic system in the wake of the global financial crisis provided the United States and China with a new way to broaden our economic ties beyond bilateral trade to also discuss fundamentals of the global economic system. Indeed, this necessity for cooperation became a new foundation for our overall bilateral relationship. Over the eight years of the Obama administration, few issues on the global stage were effectively managed without U.S. and Chinese joint leadership, from stabilizing the global economy, to negotiating a nonproliferation deal with Iran, to combating the effects of climate change. Together our two countries touted the importance of multilateral institutions and a strong free trade agenda to promote economic integration and stability. Much of this focus on the benefits of globalization led to growth in our two economies, and it also led to deepened bilateral dialogue as the United States and China also grappled with similar challenges—proliferation of public debt, aging populations, infrastructure needs, productivity concerns, and the impact of environmental degradation.

But despite our successes together helping to stabilize global markets and grow our bilateral trade relationship, the tide in the United States—and elsewhere around the world—is turning away from global economic integration and toward nationalism and enhanced protectionism. Why? Imbalances in trade ties and the displacements resulting from the global financial crisis showcase the losers in a more globalized economic system. And these losses have created anxiety in the United States and other developed and developing economies. Meanwhile, Washington and Beijing express increasingly divergent views toward the rules governing economic issues, like the role of the state in markets and how the digital economy should be managed. Many have become skeptical, if not downright dismissive, of the ability of global governing institutions to help ensure all countries adhere to the same open, rules-based trade practices. In this environment, many countries, the United States included, have begun to consider new ways to protect their domestic economies from perceived and real unfair trade practices.

For example, from an American perspective, progress has slowed in China in recent years on key economic initiatives launched by China's accession to the WTO, including commitments on market access liberalizations, greater regulatory transparency, unfettered national treatment, and enhanced IP protection—all fundamentals that support China's own economic development as well as its positive relationship with the United States. And while trade flows have continued to grow, the ability of American companies to compete in China

² Organization for Economic Cooperation and Development, *OECD Economic Surveys: China*, March 2017, <http://www.oecd.org/eco/surveys/china-2017-OECD-economic-survey-overview.pdf>.

has been increasingly hindered by Chinese rules that promote domestic companies and limit foreign participation in the China market, including, for example, delayed market approvals, investment restrictions, and new industrial policies requiring technology transfer and data localization for foreigners to remain in the market. To put in place rules that protect U.S. investors against discrimination and arbitrary treatment (with the United States promising the same for Chinese investments), Washington and Beijing undertook Bilateral Investment Treaty negotiations in 2008, but these negotiations have stalled repeatedly, due to resistance in both countries at different times.

To address these concerns in the bilateral economic relationship, the United States and China enhanced the Strategic and Economic Dialogue and tried to use the G20 to promote a reinvigorated trade agenda, but our two countries—the twin engines of global growth—continue to struggle over principles and rules governing enhanced economic integration and ways to promote the benefits of trade. This has allowed protectionist voices in both our countries to advocate closing our economies off rather than be hurt by the limitations of a free trade agenda.

A New Administration's Goals for U.S.-China Economic Relations

The current, decidedly more protectionist sentiment in the Trump administration reflects a growing perception that American workers, consumers, and companies have been hurt by globalization and trade deals negotiated in the past, which allow artificially cheap goods to flood the U.S. market and leave American companies vulnerable to unfair competition abroad. During last year's American presidential campaign and since his election, President Trump has focused on renegotiating trade agreements and reducing trade deficits to protect American companies and workers and remedy unfair trade practices. With China, many were worried the new administration might take unilateral action over our \$347 billion trade deficit.³

Given this background, it was reassuring when, on March 1, the Office of the U.S. Trade Representative (USTR) released a surprisingly conventional President's 2017 Trade Policy Agenda, prioritizing: 1) opening foreign markets to U.S. exports, 2) enforcing U.S. trade laws, and 3) negotiating trade agreements that benefit American workers, businesses, farmers, and ranchers.⁴ And with the Chinese government, the Trump administration is already pushing on two fronts—to remove market access restrictions harming U.S. exporters and investors in China, and to enhance protections against unfair trade coming from China into the U.S. market.

³ U.S. Department of Commerce Bureau of Economic Analysis, *International Data: U.S. International Transactions, Expanded Detail by Area and Country*, June 20, 2017, <https://www.bea.gov/iTable/iTable.cfm?reqid=62&step=1#reqid=62&step=7&isuri=1&6210=1&6200=3&6211=28>.

⁴ Office of the U.S. Trade Representative, *The President's 2017 Trade Policy Agenda*, March 1, 2017, <https://ustr.gov/sites/default/files/files/reports/2017/AnnualReport/Chapter%201%20-%20The%20President%27s%20Trade%20Policy%20Agenda.pdf>.

The trade imbalance and North Korea were President Trump's two priority topics for discussion with President Xi when they met in Florida in April 2017, issues President Trump continues to explicitly link. While the Mar-a-Lago Summit was successful in reducing tensions on both issues and did allow the new administration to pivot from its combative campaign rhetoric about China to a more cooperative tone for dealing with challenges in the bilateral economic relationship, there clearly are tough times and more uncertainty ahead in the economic relationship.

A new U.S.-China "Comprehensive Economic Dialogue" (CED) was established at the presidents' Mar-a-Lago summit to guide our bilateral cooperation, splitting apart the strategic and economic tracks of the Obama administration's Strategic and Economic Dialogue, and elevating cybersecurity and people-to-people exchanges into four distinct pillars. The economic pillar is cochaired on the U.S. side by the secretaries of commerce and treasury and on the Chinese side by Vice Premier Wang Yang. The CED first met in Washington in July, concluding with an unprecedented absence of public commitments to specific actions.

Following the Mar-a-Lago Summit and a disappointing first CED meeting, Trump administration officials have reiterated that, if the United States cannot achieve balanced trade by convincing China to reciprocate higher levels of market access, then more defensive means will be adopted. Concerned about global overcapacity, the administration has already begun investigations into whether imports of aluminum and steel are detrimental to U.S. national security, under Section 232 of a 1962 Trade Expansion Act. More recently, the Trump administration is also considering an investigation under Section 301 of the 1974 Trade Act to examine whether China's intellectual property protections and technology transfer requirements constitute unfair trade practices that burden U.S. commerce. All three of these investigations could result in imposition of unilateral sanctions against imports to the United States, and there are rumblings these actions could start a trade war. Distinct from years past, the American business community is more divided on China, and some industries are unlikely to fight for stability in the bilateral economic relationship unless they see the prospect for real progress on the market access challenges they face in China.

Prospects for Cooperation Going Forward

Even with a commitment to cooperate on areas of disagreement, Washington and Beijing are headed for continued difficult times in our economic relationship, as both countries seek to enhance protections of our domestic markets *and* promote enhanced trade and investment ties. The U.S. government wants American companies to enjoy the same level of market access in China as Chinese companies enjoy in the United States, and the Chinese government wants more assurance that the U.S. market remains open for its companies' investments. Enhancing openness to our respective markets was one point made by both sides in Mar-a-Lago summit discussions about ways to remedy our current trade imbalance, but there are sticking points on both sides, including how national security issues should be allowed to justify market access restrictions.

In the United States, there is broad, bipartisan support to enact tougher policies with China on economic issues to rebalance and expand our economic relationship, including instituting the principle of reciprocity to govern trade and investment policies with China and for increased national security-based scrutiny of Chinese investments in the United States. It will be difficult for Washington to push both for widening access to the China market and restricting access to ours, but the current imbalance in market access between our two countries is no longer sustainable for American policy makers and our companies. The Chinese government's responsiveness to addressing the trade imbalance will be at least as important as the way the Trump administration chooses to push for reciprocity. Positive Chinese proposals could channel the Trump administration's push for reciprocity toward more mutual openness—a solid foundation for the bilateral economic relationship. A less responsive China would force the Trump administration to choose between implementing reciprocal restrictions on China's market access in the United States or accepting an imbalanced *status quo*, a politically untenable position for President Trump unless he continues to offer China some kind of trade concessions in return for assistance reining in North Korea's nuclear and missile program.

As was the case in the 1990s, political leadership will be necessary to make the difficult domestic decisions to take our bilateral economic relationship to a new level. Secretary of State Tillerson has said that U.S.-China relations have reached a "pivot point" after more than four decades of "no conflict," while Chinese Foreign Minister Wang Yi has called on both sides to use President Trump's planned fall trip to China to help "map out relations for the next 50 years."⁵ One area ripe for action must be a recommitment by both sides to pursue a high-standard Bilateral Investment Treaty. Our two presidents should also recommit to use the G20 to promote market access liberalizations that can remedy some of the challenges brought on by global economic integration. Rising above the fray, both the United States and China have a profound long-term interest in committing to an expanded, mutually beneficial bilateral economic relationship, as our two presidents affirmed in April 2017. But to achieve such an outcome, both sides will need to resist a continued focus on protectionism, make some difficult domestic policy decisions, and renew their commitment to the benefits of an open trading system, for the good of both our countries and the global economy.

⁵ Ministry of Foreign Affairs of the PRC, "Wang Yi Meets with Secretary of State Rex Tillerson," August 2017, http://www.fmprc.gov.cn/mfa_eng/zxxx_662805/t1483164.shtml.

The Trump Administration's Trade Policy and Sino-American Economic Relations

Song Guoyou

Donald Trump was elected the president of the United States. And "Buy American, Hire American" has become his openly declared core concept of governance. As soon as he took office, the Trump administration officially withdrew from the Trans-Pacific Partnership agreement, and called for a renegotiation of the North American Free Trade Agreement, which indicates the rise of U.S. trade protectionism. Since the outbreak of the financial crisis 10 years ago, U.S. trade protectionism has become a major uncertainty in the healthy development of the global economy, affecting Sino-U.S. economic and trade relations.

Trade Protectionism

International trade has long been an essential engine of global economic growth. After World War II, the relatively open trade policies and liberal trade philosophy worldwide constituted the basic strength promoting the global economy. However, in recent years international trade growth has been lower than global economic growth. International trade has failed to be a positive factor in global economic growth, and, on the contrary, has become an obstacle. The United States, as the world's largest economy and the largest importer, plays a vital role in international trade. If the Trump administration were to embrace trade protectionism, it would make already weak global trade worse, and thus make it more difficult for global economic growth to get support from trade growth.

What we should be worried about more is that the trade protectionism embraced by the United States based on its own economic interests may bring out underlying trade protectionism globally. The United States' unilateral trade protectionism would definitely affect the normal trade interests of other countries, and thus other economies would either resist reluctantly, retaliate correspondingly, or even follow actively. Trade protectionism may be adopted worldwide.

U.S. trade protectionism would not only affect global trade, but also negatively influence global economic governance. In line with the concept of trade protectionism, the Trump administration holds that the multilateral mechanisms of economic governance, such as the World Trade Organization and the G20, have little effectiveness, and moreover do harm to U.S. economic interests. Therefore, Trump prefers to solve economic problems through unilateral and bilateral approaches. The Trump administration doesn't show a strong will in global multilateral coordination, and this may block grand economic policy cooperation among big states. Thus, global economic governance will probably be stagnant. For example, Trump has rejected the Paris Agreement, the cornerstone of global climate change, which arouses much worry.

Focusing exclusively on its own interests, the United States seems to have descended from a promoter to an obstacle of globalization, which will hinder global trade growth and frustrate global economic governance. The international economic system under protectionism will erode the foundation of the global economy, and the economies, including the United States, will find it difficult to get the best resources allocation from globalization.

Makes No Difference

The Trump administration believes that the huge trade deficit in foreign trade is the crux of the various economic problems of the United States, claiming that rather than getting more economic benefits from international trade, the United States has been experiencing the departure of manufacturing, huge trade deficits, and declining economic competitiveness because of international trade. Thus, Trump and his team argue that the United States should reverse the “unfair” distribution of trade benefits by trade protectionism to revive the manufacturing sector and strong economic growth. In fact, despite the large scale of foreign trade, it has little impact on the GDP of the United States. According to the World Bank, imports and exports of the United States in 2015 accounted for only 28 percent of its GDP, about 48 percent of the world average, the lowest in all major economies.¹ Considering that the impact of trade on the U.S. economy is relatively small, it is hard to say that trade is the major “cause” of the U.S. economy’s problems.

For such a large economy like the United States’, the real “cause” needs to be found from the inside. In short, the fundamental causes of its current economic struggles lie in the deep problem of economic, political, and social structures in the United States. The problem of its economic structure is mainly reflected in two imbalances: first, the imbalance between the real economy and the virtual economy. The proportion of agriculture and manufacturing in the U.S. economy declines year by year, while the proportion of services increased. The virtualization of the U.S. economy is too high. The second imbalance is between savings and consumption. The U.S. national savings rate is too low, and the debt ratio is quite high. It is a typical overdraft economy. If these two major economic structural imbalances can’t be alleviated, it will be impossible for the United States to get out of its economic dilemma. The problem of political structure could be observed in its intensified political polarization. The positive adjustment of economic structure requires effective cooperation between political forces. However, opposing parties in American domestic politics are increasingly polarized. The Democrats and the Republicans define national interests based on their respective party standpoints, making national policies by partisan preferences. Shortly after Donald Trump from the Republican Party took office, his administration adjusted healthcare reform, financial reform, and energy policies of the previous Obama administration in the opposite direction, which had only been implemented for a couple of years. And this shows that it’s been very difficult to unite behind a general consensus in the context of current U.S. politics, which not only makes it almost impossible to correct structural economic illnesses in a systemic and continuous way, but also wastes valuable time in reforming and increasing the cost of policy implementation, and becomes a drag on economic restructuring. The social problem is the increasingly serious polarization between rich and poor. According to

¹ World Bank, “Trade (% of GDP),” 2017, http://data.worldbank.org/indicator/NE.TRD.GNFS.ZS?name_desc=true.

statistical data, the United States has already emerged from the financial crisis. However, life for most people in the United States hasn't turned subsequently better. The wealth of the middle class continues to shrink, and the living conditions of people at the bottom are becoming more difficult. But in the meantime the wealth proportion of the richest is increasing. A differentiated and even torn society can't create a stable foundation for economic development.

The argument that the trade deficit causes job losses among U.S. manufacturing workers is also questionable. A majority of studies suggest that the most critical reason for the loss of manufacturing jobs in the United States is the increase in automation and the job replacement of other technological factors, rather than the trade deficit. Not to mention that a series of economic linkages, including imports of goods from abroad and sales in the United States, also create tens of millions of jobs. The number of jobs created by imports is even bigger than the number of jobs brought about by exports.

Trade protectionism has historically proved to be the wrong choice. It takes results as reasons to accuse foreign trade and the trade imbalance as "unfair," rather than to face up to and formulate appropriate public policies to deal with the increasingly serious domestic economic, political, and social structural problems. And it would be of no help to solve its own problems.

Undermining U.S. Interests

The Trump administration, driven by "American interests first," hopes to reduce imports, increase exports, and thus improve its international balance of payments through policies of trade protectionism. This move will have a certain influence on the economies of other countries. Especially for those with close trade ties to the United States, the short-term impact could be great. However, trade protectionism cannot truly solve the problems of the United States, and moreover will also cause great losses to the United States.

First, trade protectionism would actually harm the investment interests of U.S. multinational corporations. The Trump administration cares about the country's domestic economic interests. As criticized by the U.S. business mainstream, it is a narrow view. In fact, U.S. economic interests have long extended beyond national boundaries. American multinationals are the biggest beneficiaries of globalization. They expand globally and extend their strength. These multinational companies have gained the greatest benefits of globalization and trade liberalism. When the United States waves its protectionist sticks at other countries, the major loss for those countries is the quantity of trade, while the loss of U.S. multinational companies will be their trade interests. In the extreme cases of trade war, U.S. multinationals are likely to be the target of other countries in their trade retaliation.

Second, U.S. economic competitiveness will also be hurt. In the short term, it seems possible to support U.S. domestic industries and enterprises that lack competitiveness by adopting protectionism to restrict the imports of products from other countries. However, competition is the essential way for an industry to grow. The greater the protection for those industries and enterprises that lack competitiveness, the less competitive they will be. In

contrast, industries and businesses of other countries that are being competed with will take more measures to improve their competitiveness. The different consequences will further widen the economic competitiveness gap between some industries and enterprises in the United States and in other countries.

Third, U.S. global economic leadership will be severely weakened compared to other countries. The United States, which has become the world's number one and played the leading role in making global economic rules, relies on its open market and the idea of a free economy it promotes. Putting aside whether the conclusion is correct or not, the only thing that the Trump administration calculates is their own gains and losses in trade. He and his team have measured neither the macro benefits that the United States gained as the leader of the global economy, nor the strategic benefits that are related to this position, and have never considered the impact of trade protectionism on other countries and the global economy. An increasingly inward, closed and selfish America could not lead other countries to the future, and even its allies would abandon the protectionist America.

In the era of globalization, if the United States were to embrace trade protectionism, all countries would be losers. The United States, as the largest economy and the country that gains the most benefits, will also suffer huge losses. What the United States needs to do is not to go farther on the wrong path of trade protectionism, but to effectively enhance economic competitiveness through structural reforms. Benign competition rather than vicious protection is the right way for the U.S. economy.

Promote Sino-U.S. Cooperation

Trade war is not an option for settling Sino-U.S. disputes in economic and trade relations, and those issues can only be resolved through negotiations. In order to deal with bilateral economic and trade issues, President Xi Jinping and President Trump agreed to solve the economic disputes between China and the United States through the Comprehensive Dialogue mechanism and have made a "Hundred Days Plan" to carry out economic and trade cooperation after meeting in Florida in April 2017.

In general, with the first Xi-Trump meeting and the Comprehensive Dialogue as a new starting point, combined with the formulation of the Hundred Days Plan, Sino-U.S. economic and trade cooperation should focus on the following key areas in the Trump era:

1. *Work on the distribution of benefits:* Profits are the fundamental driving force in economic and trade relations, and the complaints of the United States over Sino-U.S. economic and trade relations are based on the belief in an imbalanced distribution of benefits, that is, China gets more, and the United States receives relatively less. But China argues that the distribution of economic and trade interests is a win-win and fair, and thus the United States has also gained a lot of benefits. So, what's the real situation? To answer this question requires research that both sides can generally accept in a short period of time. Only by the objective analysis of the current situation of the distribution of benefits could the biases and criticisms of both countries in

economic and trade relations be eliminated, and measures to promote Sino-U.S. economic and trade be specifically made.

2. *Identify policy distortions:* After accurately acknowledging the distribution of economic and trade interests, the two sides should discuss the sources of those interest. The distribution of most economic and trade interests is just and normal, and mainly reflects the globalization of the division of labor and the differences in factor endowment of the two countries. For these interests, even if the distribution between China and the United States were imbalanced, the two countries can only accept them. Focus should be put on the imbalance in benefits distribution caused by policy distortions, and the U.S. dissatisfaction with China mainly stems from this. For example, the United States has criticized China for its so-called manipulation of the RMB exchange rate, government subsidies, and policies toward state-owned enterprises, and argues that it's these policies that lead to the imbalance of bilateral trade. Meanwhile, China argues that it is the United States' unfair export restrictions on high-tech products to China and the overly strict direct investment review mechanism that cause Sino-U.S. economic and trade problems.
3. *Adjust domestic structures:* Sino-U.S. economic and trade relations are fundamentally an extension of the domestic economic development structures of the two countries, so the problems in economic and trade relations cannot be solved only through adjusting bilateral ties. In order to alleviate the economic and trade contradictions between China and the United States, both countries need to find the root problem in economic and trade relations from the perspective of domestic economic development, and promote the adjustment of domestic economic structures through the sustainable development of bilateral economic and trade relations. Ignoring domestic economic problems and relying on adjustments in bilateral economic and trade relations and the domestic economic restructuring of other countries are not sincere ways to solve problems. Taking into account the fact that China and the United States are close in economic power, there are no such negotiating skills that could force the other party to accept an unfair offer.
4. *Promote measures of cooperation:* In no case would the mainstream of public opinion and business organizations of either China or the United States like to see Sino-U.S. economic and trade confrontation. Thus, both sides and even the international community hope to see practical solutions come out, which is of vital importance in enhancing strategic mutual trust in the economic and trade areas and strengthening the grand direction of Sino-U.S. cooperation in the future. The working teams of both China and the United States should be theoretical as well as pragmatic, taking either small profits or the overall situation into consideration, and through close cooperation, put forward project programs and policy adjustments that both sides are satisfied with.

07

International Investment Policy

Prospects for U.S.-China Cooperation on Global Investment Policy

Scott Miller¹

Introduction

Despite the important role that foreign direct investment (FDI) plays in the global economy, there remains no coherent multilateral regime for the governance of investment. Addressing this governance gap is unlikely to occur without the cooperation of the United States and China. While a more coherent international investment regime would benefit both countries, current trends in the bilateral relationship, and challenges to the authority of international investment agreements (IIA), suggest that the prospects for reaching any effective multilateral agreement are worsening with time. Policymakers in the United States and China should recognize these constraints and focus their energies in multilateral forums on reestablishing a consensus on FDI governance and the treatment of foreign investors. In the near term, the two countries should focus on domestic policy reform in order to enhance medium-term prospects for reaching agreement.

Trends in Foreign Direct Investment

It is difficult to overstate the role that FDI has played in shaping the modern structure of the global economy and global value chains. FDI flows have helped to drive growth, spread knowledge and new technologies, share management skills, boost employment, and raise productivity.² Lowering barriers to cross-border investment and providing fair treatment for those investments have also been a major historical priority for the United States and the institutions of the global economic order, premised on the grounds of both economic efficiency and the idea that enhanced economic integration through investment would help promote peace. As of end-2016, the global stock of FDI was estimated at more than \$26 trillion,³ which the World Bank classifies into four primary types: national resource seeking;

¹ The author would like to thank David Parker and Daniel Remler for their research and drafting support.

² FDI Flows, *United Nations Conference on Trade and Development*, http://unctad.org/en/Pages/DIAE/Investment%20and%20Enterprise/FDI_Flows.aspx.

³ United Nations Conference on Trade and Development, Annex table 04: FDI outward stock, by region and economy, 1990–2016, in *World Investment Report 2017: Investment and the Digital Economy*, June 2017, <http://unctad.org/en/Pages/DIAE/World%20Investment%20Report/Annex-Tables.aspx>.

market seeking; efficiency seeking; and strategic asset seeking.⁴ Each of these types presents different opportunities from the standpoint of economic policymakers. However, in general, a country's openness to FDI correlates positively with economic growth.⁵

The 2008 global financial crisis led to a significant fall in annual flows of FDI worldwide, declining from nearly \$2 trillion in 2007 to roughly \$1.2 trillion in 2009. This fall was particularly steep in FDI flows to developed countries and the subsequent recovery has been slow and uneven.⁶ Even as global gross domestic product (GDP) has risen more than 18 percent above its pre-crisis peak,⁷ projections from the United Nations Conference on Trade and Development (UNCTAD) estimate that the global volume of FDI flows will reach almost \$1.8 trillion in 2017, still below peak levels reached a decade earlier. Developed countries will receive roughly 60 percent of this investment while developing countries, after experiencing a decline of nearly 15 percent in annual flows during the previous year, are expected to see a return to growth.⁸

The International Investment Regime

Relative to other aspects of the global economic order (such as trade), governance of FDI is fragmented and underdeveloped. In the aftermath of World War II, negotiators of the Havana Charter made a first effort at developing a multilateral investment agreement in 1949. However, disagreements between developed, developing, and socialist countries on issues such as a minimum standard of treatment for foreign investors prevented even a draft agreement from emerging. As discussed in greater detail below, the disagreements that lead to the failure of this original attempt have proven persistent, preventing the successful negotiation of any binding multilateral agreement in the nearly seven decades since. The most recent of these efforts was the unsuccessful attempt to negotiate a Multilateral Agreement on Investment (MAI), which took place from 1995–1998 under the auspices of the Organization for Economic Cooperation and Development (OECD).

The regime that has emerged in place of any multilateral agreement is a patchwork of international investment agreements (IIAs) negotiated on a bilateral basis. The first formal bilateral investment treaty (BIT) was negotiated in 1959 between Germany and Pakistan, with the primary objective of mitigating political risk (e.g., expropriation, nationalization) for German investors. This pattern, whereby developed countries utilized BITs as a tool for

⁴ Christine Zhenwei Qiang, Roberto Echandi, and Peter Kusek, *Maximizing potential benefits of FDI for competitiveness and sustainable development: World Bank Group report on investment policy and promotion diagnostics and tools*, World Bank Group, May 2017, 12–18, <http://documents.worldbank.org/curated/en/736501494499554704/pdf/114863-WP-PUBLIC-9-5-2017-17-30-2-FINALIPPAIMFDIREPORT.pdf>.

⁵ Joshua Aizenman, Yothin Jinjark, and Donghyun Park "Capital Flows and Economic Growth in the Era of Financial Integration and Crisis, 1990-2010," National Bureau of Economic Research, October 2011, <http://www.nber.org/papers/w17502.pdf>.

⁶ "Global Investment Prospects and Trends," in *World Investment Report 2017: Investment and the Digital Economy*, United Nations Conference on Trade and Development, June 2017, http://unctad.org/en/PublicationChapters/wir2017ch1_en.pdf.

⁷ "World Economic Outlook, April 2017: Gaining Momentum?," International Monetary Fund, April 2017, <http://www.imf.org/en/Publications/WEO/Issues/2017/04/04/world-economic-outlook-april-2017>.

⁸ "Global Investment Prospects and Trends," in *World Investment Report 2017*, 2.

enhancing the security of their investments and developing countries used them as a tool for enhancing their attractiveness to foreign capital, would characterize the vast majority of subsequent agreements. As of end-2016, there were more than 3000 IIAs in force worldwide, mostly negotiated in the interval between the end of the Cold War and the onset of the global financial crisis. These agreements vary in scope, coverage, and specificity, with later agreements typically featuring more precise language and larger carveouts. The only point of broad agreement is the International Centre for Settlement of Investment Disputes (ICSID) Convention, in which 136 signatories agreed to a common mechanism for dispute settlement.

Sources of Persistent Disagreement

For mainstream economists and economic policymakers, the logic of a simpler and more coherent multilateral regime for governing FDI is clear and compelling. A consistent set of international rules, balancing the rights of investors with the power of governments to regulate in the public interest, would improve the efficiency of global capital allocation. In turn, this would produce global growth that is more rapid, sustainable, balanced, and inclusive. A range of case studies, including that of the United States,⁹ and sophisticated econometric estimates have provided evidence in favor of this general argument, while also highlighting the importance of appropriate supporting policies to maximizing potential gains.¹⁰

Compared to the near-consensus on the need for such a multilateral framework, relatively few governments have held consistent positions on how to best regulate FDI in practice, or the utility of a binding multilateral agreement to govern it. During the Cold War, the most obvious divide was between a pro-market West, led by the United States, and the socialist economies of the Soviet bloc. Perspectives of nonaligned countries varied significantly, with governments adopting stances and development strategies that reflected a balance between domestic political economy pressures and their position within the larger Cold War framework. IIAs proliferated and grew more complex, reflecting both the gradual growth in the demands of host countries for more sharing of benefits and a range of legal innovations developed to help de-politicize disputes and enhance investment security.¹¹ These included codes of conduct for investors and investor-state dispute settlement (ISDS) mechanisms, respectively.

The end of the Cold War, when the collapse of the Soviet Union suggested that a generalized version of the Western market economy might have entered permanent ascendance, also marked a high point in terms of both bilateral negotiations and support for a multilateral agreement. In a single 10-year period, from 1990 to 2000, the number of IIAs grew more

⁹ Michael V. Seitzinger, *Foreign Investment in the United States: Major Federal Statutory Restrictions*, Congressional Research Service, June 17, 2013, <https://fas.org/sgp/crs/misc/RL33103.pdf>.

¹⁰ Roberto Echandi, Jana Krajcovicova, and Christine Zhenwei Qiang, *The Impact of Investment Policy in a Changing Global Economy: A Review of the Literature*, World Bank, October 2015, <http://documents.worldbank.org/curated/en/664491467994693599/pdf/WPS7437.pdf>.

¹¹ Armand De Mestral and Céline Lévesque, *Improving International Investment Agreements* (New York: Routledge, 2012), <https://www.amazon.com/Improving-International-Investment-Agreements-Routledge/dp/0415671973>.

than fivefold, from less than 400 to over 2000. On the multilateral front, the Asia-Pacific Economic Cooperation (APEC) economies released the APEC Non-Binding Investment Principles in 1994.¹² Negotiations to establish a multilateral agreement on investment (MAI) were launched the following year and, for a time, appeared to making progress. Nonetheless, a deal ultimately proved elusive: the OECD-based talks collapsed in 1998 and, at the World Trade Organization ministerial in Cancun five years later, investment issues were removed from the multilateral agenda.¹³

The core issue that prevented (and continues to prevent) negotiation of a binding multilateral investment agreement is differences between nation-states over the role of government in the economy and the standard of treatment accorded to aliens. At its most basic, an investment agreement is a check on the power of government. As a contract that defines the rights of foreign investors, it defines and partially circumscribes the power of a state to act within its own borders. There has never been an international consensus (or even, in most states, a durable domestic consensus) over the extent of the state's power to regulate and whether the treatment of aliens ought to conform to some international standard. This is why the collapse of the MAI negotiations in 1998 was caused not by disagreements over obscure legal arcana, but over core principles of investment protection: definitions of investment; degree of liberalization; rules governing indirect expropriation and fair compensation; cultural exceptions; and free movement of firm assets across borders.¹⁴

Recent Trends and Developments

Today, it is clear that momentum in favor of international investment liberalization peaked in the 1990s and early 2000s. This is evident even as the number of formal investment liberalizing measures enacted worldwide continues to outpace the number of new restrictions.¹⁵ One reason for this trend is the resurgent popularity of state capitalism, which is sharpening disagreements between market and nonmarket economies over the appropriate role of the state in the economy.¹⁶ Another is the continued diffusion of economic power, which has reduced the ability of the G7 economies to provide effective global economic management. Thus far, the far more heterogenous (and far less united) G20 has failed to establish itself as the premier forum for global economic governance. A third is

¹² Asia-Pacific Economic Cooperation, *APEC Non-Binding Investment Principles*, November 1994, <http://www.apec.org/Press/News-Releases/2010/~//media/965E37FDA6D848B4A0350D68D2A4BE1C.ashx>.

¹³ Edward M. Graham, "The MAI and the Politics of Failure: Who Killed the Dog?," in *Fighting the Wrong Enemy: Antiglobal Activists and Multinational Enterprises* (Washington, DC: Peterson Institute for International Economics, September 2000), https://piie.com/publications/chapters_preview/91/2iie2725.pdf.

¹⁴ "Recent Policy Developments and Key Issues," in *World Investment Report 2015: Reforming International Investment Governance*, June 2015, http://unctad.org/en/PublicationChapters/wir2015ch3_en.pdf.

¹⁵ United Nations Conference on Trade and Development, "Recent Policy Developments and Key Issues," in *World Investment Report 2017: Investment and the Digital Economy*, June 2017, http://unctad.org/en/PublicationChapters/wir2017ch3_en.pdf.

¹⁶ One illustration of this is the fact that the percentage of companies in the Fortune Global 500 that are state-owned has more than doubled over the past decade, from 10 percent to roughly one quarter. See PricewaterhouseCoopers, *State-Owned Enterprises: Catalysts for public value creation?*, April 2015, 9, <https://www.pwc.com/gx/en/psrc/publications/assets/pwc-state-owned-enterprise-psrc.pdf>.

the mounting backlash against many agreements already in place, which has even led some governments to abrogate their existing agreements (or simply allow them to expire).¹⁷

The ongoing debate in the developed world over ISDS usefully illustrates this third challenge. From 1959 to 2008, there were 326 publicly notified disputes under ISDS provisions, with developing countries featuring as respondents in a large majority of cases. In the subsequent decade alone, the number of known disputes has more than doubled,¹⁸ and many developed countries (including the United States) have been respondents in investment disputes.¹⁹ Considering completed cases, states have prevailed in formal disputes about twice as often as investors and investor awards amount to a small fraction of initial claims.²⁰ Nonetheless, the newly realized possibility that government actions can be challenged by foreign investors has generated huge political backlash, even in countries with long histories of openness to foreign investors. For those contemplating future negotiations, multilateral or otherwise, this suggests the worrying degree to which any consensus over international investment rules has already unraveled.

Prospects for U.S.-China Cooperation

Given the potential economic benefits, finding ways to strengthen the global investment regime would seem to be a common objective for policymakers in the United States and China. Indeed, there are reasons to expect that investment policy could provide future opportunities for U.S.-China cooperation. The United States has the largest stock of direct investment abroad of any single nation, while China's stock of outbound direct investment is rapidly increasing and could top \$1 trillion by 2020.²¹ The extent and expansion of their respective global investment footprints suggests that the United States and China may share a common interest in promoting a harmonized global investment regime that safeguards the rights of foreign investors against various forms of expropriation.

At the same time, near-term trends in the bilateral relationship echo the global trends described earlier, suggesting that cooperation is likely to prove elusive. For example, the Organization for Economic Cooperation and Development (OECD) ranked China among the most restrictive countries of the 62 covered in the 2016 edition of its FDI regulatory restrictiveness index.²² Notably, this reflects only the degree of *de jure* restrictiveness; it does not capture the full extent to which the role of the state in the Chinese economy has

¹⁷ "Recent Policy Developments and Key Issues," in *World Investment Report 2017*.

¹⁸ Investment Dispute Settlement Navigator. *United Nations Conference on Trade and Development, Investment Policy Hub*, <http://investmentpolicyhub.unctad.org/ISDS>.

¹⁹ For example, see Daniel Hurst, "Australia wins international legal battle with Philip Morris over plain packaging," *Guardian*, December 17, 2015, <https://www.theguardian.com/australia-news/2015/dec/18/australia-wins-international-legal-battle-with-philip-morris-over-plain-packaging>.

²⁰ Scott Miller and Gregory N. Hicks, *Investor-State Dispute Settlement: A Reality Check* (Washington, DC: Center for Strategic and International Studies, January 2015), https://csis-prod.s3.amazonaws.com/s3fs-public/legacy_files/files/publication/150116_Miller_InvestorStateDispute_Web.pdf.

²¹ Daniel H. Rosen and Thilo Hanemann, *An American Open Door?: Maximizing the Benefits of Chinese Foreign Direct Investment*, Rhodium Group, May 2011, http://rhg.com/wp-content/themes/rhodium/interactive/china-investment-monitor/RosenHanemann_AnAmericanOpenDoor_2011.pdf.

²² Organization for Economic Cooperation and Development, "OECD FDI Regulatory Restrictiveness Index Chart," 2016, <http://stats.oecd.org/Index.aspx?datasetcode=FDIINDEX#>.

expanded under the Xi Jinping administration. In the United States, the Trump administration has not yet provided a clear statement of its international investment policy, but presidential tweets have indicated clear dissatisfaction with the status quo. On Capitol Hill, there is active debate over reforming the U.S. national security investment review system, motivated in part by concerns over Chinese industrial policy. Meanwhile, U.S.-China BIT negotiations, launched in 2008, are stalled. Without major reforms to China's policies, it is unlikely that a completed treaty could attract the consent of two-thirds of the U.S. Senate.²³

These factors, as well as longstanding structural differences in the U.S. and Chinese economies, suggest that disagreements are likely to prove insoluble over the near term. Rather than launching any major new multinational initiative, the United States and China should instead seek to manage bilateral disagreements while utilizing discussions in the Asia-Pacific Economic Cooperation (APEC) and the G20 to assemble building blocks for future cooperation. The example of the 1994 APEC Non-Binding Principles on Investment offers one model for pursuing this route, and the 2016 Hangzhou Principles released by the G20 represent at least an endorsement of some useful basic principles.²⁴ However, the prospects for moving beyond rhetoric at the multilateral level are limited.

Prospects for bilateral cooperation will also depend heavily on the direction of policies in each country. If policymakers in China are serious about concluding an agreement with the United States, then they will need to recognize that the substantive differences between the United States and China are, for the most part, growing. Despite public commitments to "reform and opening up" by senior Chinese leaders, including President Xi Jinping's speech at Davos in January 2017, the overall policy direction of the Xi administration has been sharply mercantilist. At the same time, liberalization efforts, such as the Shanghai Free Trade Zone, have offered procedural reforms at best, with any genuine liberalization offset by protectionist policies and practices elsewhere. All of this has increased tension in the bilateral relationship and worsened near-term prospects for cooperation.²⁵

The United States faces a different set of challenges. There are legitimate security grounds for strengthening the capabilities of the Committee on Foreign Investment in the United States (CFIUS), the U.S. national security investment review body.²⁶ There is also a sound strategic logic to preserving the narrow security focus of CFIUS while developing a separate process and mechanism for pursuing better treatment for U.S. investors in China and elsewhere through select application of reciprocity.²⁷ However, reforms should not become

²³ Wayne M. Morrison, *China-U.S. Trade Issues*, Congressional Research Service, April 24, 2017, <https://www.hsdl.org/?view&did=800579>.

²⁴ G20 Research Group, *G20 2016 China: Annex III: G20 Guiding Principles for Global Investment Policymaking*, July 10, 2016, <http://www.g20.utoronto.ca/2016/160710-trade-annex3.html>.

²⁵ For example, see United States Chamber of Commerce, *Made in China 2025: Global Ambitions Built on Local Protections*, March 2017, https://www.uschamber.com/sites/default/files/final_made_in_china_2025_report_full.pdf.

²⁶ Matthew P. Goodman and David A. Parker, "The China Challenge and CFIUS Reform," *CSIS Global Economics Monthly*, March 31, 2017, <https://www.csis.org/analysis/global-economics-monthly-china-challenge-and-cfius-reform>.

²⁷ David Dollar, "What do China's global investments mean for China, the U.S., and the world?," Brookings Institution, May 18, 2016, <https://www.brookings.edu/blog/order-from-chaos/2016/05/18/what-do-chinas-global-investments-mean-for-china-the-u-s-and-the-world/>.

an excuse for protectionism, should not target any single country, and should not undermine the basic open investment policy that the United States has followed since the Reagan administration. Managed well, this might lay a foundation for future cooperative initiatives. However, considering the current domestic political backlash against globalization, expectations should be attenuated.

In short, even as the economic logic of greater cooperation on promoting a rules-based multilateral investment regime remains obvious, there is little near-term likelihood of meaningful progress (even on a bilateral basis).

Changes in Global Trade and Investment and Implications for China-U.S. Economic Relations

Xue Lei

Changing Landscape of Global Trade and Investment

The deepening of economic globalization has been a result of rapidly increasing global trade and investment flows. Before the 2008 Global Financial Crisis, global trade usually grew at twice the speed of global GDP growth, which has made global trade the “engine” of the world economic growth. In the meantime, the closer linkages between trade and investment also have made the two issue areas become more and more inseparable from each other, with China’s accession to the World Trade Organization (WTO) as a path-breaking moment for global trade and investment flows. The global relocation of production networks by multinational companies and China’s role as a global manufacturing hub had led to dramatic change of direction for trade and investment flows. However, with the world economy entering into the postcrisis era and China undergoing domestic economic transformation, such trading and investment patterns can no longer be sustained. What’s more important, the transformative and disruptive power demonstrated by the new technologies has fundamentally changed the transnational exchange of goods and services. A reflection on the modes and rules relating to global trade and investment for the future has been desperately needed.

Changing Nature and Pattern of Global Trade

The pattern of international trade in today’s world has changed dramatically from the era of merchandise trade in the twentieth century, to the era of services trade and digitalization in the twenty-first century, in particular in terms of the ways trade goes across borders. And it has brought great challenges to traditional ideas, norms, and rules relating to international trade and investment. Just taking a look at trade in services, when the General Agreement on Trade in Services (GATS) came into effect in 1994, one of the four modes of trade in services, “cross-border provision of services,” had not been given much attention. Now it has become a major mode in delivering services in global trade. According to the statistics of the United States Department of Commerce, in 2014 digitally delivered services accounted for over half of U.S. trade in services.¹ The digitalization of international trade has provided us with great opportunities and potential. Yet in the meantime it also brings great challenges to traditional understandings and concepts of trade issues as demonstrated in many WTO agreements, with the General Agreement on Tariffs and Trade (GATT) regulating merchandise trade mainly concerned with border tariffs, fees, and measures taken by product-import countries. Now focus has shifted to policy areas beyond or behind borders, which usually fall into the category of “WTO-plus” issue areas such as investment, competition policy, government

¹ Rachel F. Fefer, Shayerah Ilias Akhtar, and Wayne M. Morrison, *Digital Trade and U.S. Trade Policy*, Congressional Research Service, June 2017, 6, <https://fas.org/sgp/crs/misc/R44565.pdf>.

procurement, labor standards, and e-commerce.² In many cases, the evolution of technology has made it difficult to distinguish between imported products and domestic production, for instance the use of 3D-printers to make products. This has also called into question the current statistical system used in measuring international trade volumes. There's been increasing need for correctly calculating the trade flows in the digital age so as to keep us better informed of the general trend of trade flows.

Newly Found Attractiveness of Investment Agreements

With more and more trade going beyond or behind borders, trade negotiations also have to follow up with relevant rules applicable to the new situation. This needs to touch more upon domestic legislation and regulations, with market access and domestic rules becoming the priority issue to be addressed in trade and investment negotiations. Thus investment rules have been injected with a certain kind of new life. As the UNCTAD suggests, "Investment rules and regulations designed for the physical economy may need to be reviewed in light of new digital business models. This is most relevant in sectors such as retail, media and consumer finance."³ One vivid example is the focus of discussions and debates in relation to the negotiation on the Transatlantic Trade and Investment Partnership (TTIP) between the United States and the European Union. It has become a process endeavoring to achieve harmonization of domestic regulations and rules for the two major economies, with the debates surrounding the inclusion of an investor-state disputes settlement provision in the draft agreement unexpectedly reaching a boiling point. The considerations behind such debates have been well demonstrated by the fear of undue interference of third party nonstakeholders in the policymaking of domestic authorities.

Changing Political Landscape for Global Rules Governing Trade and Investment

At the international level, the multilateral trade system is faced with great difficulties in pushing forward new rounds of trade agreement negotiations. One of the reasons for the lack of progress lies in the substantial differences among the different trading groups, including the emerging role of middle-income developing countries such as China, India, and Brazil. For most developing countries, there have been feelings of frustration arising from the little achievements made under the Doha Development Agenda, which has been regarded as reciprocal benefits granted by the developed countries for their support in the establishment of the WTO. From the perspective of developing countries, the most urgent need is to fully grant the Quota-Free, Tariff-Free treatment to those least-developed countries, so as to make good use of the advantages of trade in promoting the industrialization process in those countries that has been crucial in meeting the poverty-reduction goals. The developing countries also insist on maintaining the current practices of reciprocity-based and single-undertaking in reaching new trade agreements at the WTO, which may give these countries more leverage in trade negotiations. Generally speaking, at

² Andrew L. Stoler, *Trade and Development Symposium: Perspectives on the Multilateral Trading System: WTOplus Issues in the Multilateral Trading System*, International Centre for Trade and Sustainable Development, December 2011, <http://www.ictsd.org/downloads/2012/02/andrew-stoler-wtoplus-issues-in-the-multilateral-trading-system.pdf>.

³ United Nations Conference on Trade and Development, *World Investment Report 2017: Investment and the Digital Economy*, 2017, 185, http://unctad.org/en/PublicationsLibrary/wir2017_en.pdf.

the global level the multilateral trade negotiation process has encountered certain bottlenecks constraining its rapid development, which have shown little sign of relief in the near future. This has prompted the shifting of focus to regional, sub-regional, mega-regional, or bilateral trade negotiations by the major economies and trading powers in the world.

At the domestic level, the benefits of free trade have not been distributed evenly across sectors and the countries. Actually, some nontrading sectors and disadvantaged sectors have suffered losses in the process of opening markets and importing competing products. The political dynamic behind the calculation of benefits and losses has caused the rising tide of political movements against free trade and globalization, with more governments taking policies reflecting more populist and protectionist thinking.

Prospect of U.S.-China Bilateral Economic Relations

As the two largest economies in the world, China and the United States are in different economic and policy cycles. China has entered into a stage of shifting from high-speed growth to moderate growth, as well as the structural transformation of its economy. In contrast, the United States seems to have entered another stage of robust postcrisis growth. Yet the recent stumble of the Trump administration in advancing its economic policy agenda has brought great doubt from the business community over whether the incumbent U.S. administration and the Republican-controlled Congress can really push forward pro-market tax, budget, and regulatory reform as promised in the presidential election campaign. The policy uncertainty has become one of the major factors with great potential to destabilize the world economy as well as China-U.S. economic relations. During the Mar-a-Lago meeting between President Xi and President Trump, both countries agree to launch a “hundred-day plan” to oversee economic and trade issues in bilateral relations and address the existing imbalances in trade. However, with the recent national security reviews taken in the steel and aluminum sectors, it has been made clear that the U.S. administration prefers a heavy-handed interventionist policy to protect some domestic manufacturing sectors from international competition. Frequent trade frictions among the major economies may be a more plausible scenario in the near future. To better manage such critically important bilateral economic relations, we need to further clarify and address the following conceptual and institutional issues.

Misperceptions of Reciprocity and Trade Rebalancing

Since the 2008 global financial crisis, rebalancing has become one central topic in China-U.S. bilateral economic relations, with the huge trade imbalances and Asian economies’ savings glut in the U.S. capital markets often blamed as one of the causes that triggered the financial crisis. In the meantime, another concept has become more prevalent in both U.S. policy and business circles, that is, reciprocity in bilateral economic and trade relations. Its major argument lies in the victimization of the United States as a losing party in bilateral economic relations with its concessions made not being rewarded with reciprocal benefits from the Chinese side. There are mainly two manifestations of this. One is mainly derived from the views of senior officials from the Trump administration who have an obsession with the trade deficits of the United States with its major trading partners. Another is concerned

with China's domestic policies on market access, innovation stimulation, etc. Multinational companies from the United States and Europe usually complain that their businesses have not received equal treatment in the Chinese market, with the American and European markets completely open to Chinese companies. However, just as German Chancellor Angela Merkel has said in response to the Trump administration's criticisms of Germany's trade surplus with the United States: "The fact that we have 10 times as much direct investment from Germany in the United States than there's American investment in Germany has, of course . . . a strong effect on the many jobs we create."⁴ Similar cases also happen in the Chinese market with many industrial sectors and consumer product market dominated by the brands of multinational companies from the United States and EU. This kind of monopoly status has often been ignored by people advocating for reciprocity in bilateral relations. Maybe we should go back to the basic economic theory of comparative advantage and make subsequent adaptations based on compromises achieved through bilateral negotiations. Any misperceptions in terms of reciprocity or trade imbalances can only cause undue interruption of stable and sustainable bilateral economic cooperation.

Institution Building in Bilateral Economic Relations

With the new China-U.S. Comprehensive Economic Dialogue coming into shape, there will be more predictability in terms of bilateral economic relations and trade disputes. To keep economic and trade relations more stable and sustainable in the long run, China and the United States need to continue with their unfinished work on the negotiation of the Bilateral Investment Treaty (BIT). During the Obama administration, both governments held lengthy talks and negotiations on the BIT, with the core concepts of a "negative list" and "pre-establishment national treatment" accepted by both sides. In this way, the major concerns and flash points in bilateral economic relations have been addressed, with market access and domestic regulations at the core of this negotiation process. Just as previously mentioned, such an investment treaty actually has taken some aspects of the role of a trade agreement. The achievements made in the BIT talks can provide a solid basis and are a great opportunity for the launching of a full and comprehensive bilateral free trade agreement negotiation. Only through institutional and legal arrangements can the potential uncertainty and instability in bilateral economic and trade relations be fully addressed, which will also be of great importance to smooth and stable global economic growth.

In summary, the world economy is undergoing great changes, with the top two major economies leading and influencing the changing trend of global production, trade, and investment. A stable bilateral economic relationship is also at stake for China and the United States. The future potential cooperation and institutional arrangement between the two countries will shape the prospects and framework of the global economic system. Such a high degree of interdependence and spillover effects should never be compromised with short-sighted partisan political interests.

⁴ Megan Cassella, "Politico Morning Trade: A Daily Speed Read on Global Trade News," *Politico*, June 28, 2017, <http://www.politico.com/tipsheets/morning-trade/2017/06/28/business-groups-sound-the-alarm-on-trumps-ex-im-pick-221088>.

08

Sustainable Development

A U.S.-China Partnership on the Sustainable Development Goals

Scott Morris

The Sustainable Development Goals (SDGs), formally adopted by the UN General Assembly in September 2015, represent wide scope and great ambition on the part of UN member states over the next 15 years to achieve development-oriented goals like access to clean water, quality education, and modern energy. While each member is committed to action under the SDGs, as a practical matter, there needs to be considerable leadership exercised by a smaller group of countries. And unlike the Millennium Development Goals, the donor-driven predecessor to the SDGs, this new generation of development targets also point to a different composition of leadership on the global stage.

Specifically, the SDG agenda will depend critically on the ability of the United States and China to work in concert to address many of the goals, and particularly to find a path forward on questions of financing this agenda.

The financing agenda that underpins the SDGs faces two challenges: mobilizing billions of dollars in official financing, and in turn, using those funds to further leverage trillions in private finance. The “billions to trillions” agenda will require leadership from the United States and China, both as bilateral donors and investors, and as shareholders in the multilateral development banks (MDBs).

China’s Emergence as a Bilateral and Multilateral Donor

For the United States, these bilateral and multilateral roles have been well defined over many decades. For China, both roles are newer.

China has become a key actor in the development landscape in recent years, both due to its successful domestic efforts to reduce poverty and through its growing bilateral investments abroad. But China’s seemingly sudden emergence as a leader on global development *policy* is in part a result of the Chinese government’s leadership in creating the Asian Infrastructure Investment Bank (AIIB) in the spring of 2015, which garnered support from a wide array of governments globally despite expressions of concern from U.S. officials.

The thinking in China that led to creation of the AIIB, as well as the New Development Bank (NDB) or “BRICS Bank,” appeared to take hold more firmly following China’s G20 presidency in 2016. After a decade plus of pursuing massive bilateral investment flows to developing countries globally, which has been accompanied by considerable political backlash (both in the West and in the developing countries themselves), the Chinese now seek to take a leadership role in policy circles, particularly in the multilateral institutions. Due partly to constraints on their shareholding in existing institutions, their strategy includes a focus on creating new multilateral institutions like the AIIB with significant governance roles for China. It remains to be seen whether this separate-track multilateral approach will better align their investment activities with the norms and approaches of the broader development policy community.

Nonetheless, this is a critical shift. For many years, China has sought to be both a commercial investor abroad and a “poor country” in official international development policy settings. Recognizing that these two approaches can no longer hold, China is now stepping forward aggressively, attempting to frame itself as a development policy leader, including as an aid donor. So far, China’s role as a bilateral aid donor remains modest. While China does not follow OECD definitions for development aid, estimates place its annual foreign aid between \$1–2 billion, or as little as under 5 percent of U.S. foreign assistance levels.¹

But particularly by “multilateralizing” its approaches through the AIIB and NDB, the Chinese hope to expand their influence in their own region and globally, to improve their engagements abroad (better projects with less corruption and higher standards) and to garner greater political legitimacy for those engagements in the eyes of the global community.

To the degree Beijing is seeking to multilateralize its engagements, Washington should be generally supportive, recognizing that such an approach acts as a useful check on the excesses that can occur in bilateral engagements. The SDGs serve as a useful anchor for both countries to pursue a new partnership globally.

Opportunities in a U.S.-China Development Partnership

Multilateral Partnership

The heightened global attention around the AIIB is an opportunity for both China and the United States to lead in growing, elevating, and modernizing all of the MDBs.² For the United States in particular, the most important strategic response to China’s creation of the AIIB should be a reassertion of U.S. leadership and ambition in the other MDBs. First and foremost, those efforts should be focused on more financing ambition in institutions like the

¹ He Wenping, “New Actors in International Development: The Case of China in Africa,” Brookings Institution, A Trilateral Dialogue on the United States, Africa and China: Conference Paper 1 and Responses, 2013, 3, <http://www.brookings.edu/~media/Research/Files/Reports/2013/08/us-africa-china-trilateral-dialogue/All-China-Aid-Papers.pdf?la=en>.

² Scott Morris, *Responding to AIIB: US Leadership at the Multilateral Development Banks in a New Era*, Council on Foreign Relations, September 1, 2016, <https://www.cfr.org/report/responding-aiib>.

World Bank, Asian Development Bank, African Development Bank, and Inter-American Development Bank.

The United States already has a leadership position in each of these MDBs, and collectively they operate on a much larger scale than the AIIB will. Importantly, new U.S. financing ambition at these MDBs would be welcomed by the Chinese and the rest of the developing world since they have been calling for an expansion of the institutions for some time, with the SDGs being the latest source of motivation. The “billions to trillions” agenda associated with the SDGs defines a leading role for the MDBs, leveraging their capital and grant resources to directly finance activities in a wide range of sectors and countries and to further leverage private flows by hedging risk at the project level and strengthening the policy environment.

The infrastructure agenda alone points to the need for considerable ambition at the MDBs. Leading economists have targeted an increase in annual MDB lending of \$200 billion a year to achieve sustainable infrastructure objectives (identified as part of the SDGs) over the next 15 years.³ U.S. support for an expansion of this magnitude would represent a modest increase in appropriated funds for the United States, no more than 1–2 percent of the current foreign assistance budget, and could be managed with better coordination of bilateral and multilateral allocations.⁴

Reflected in this is the fact that contributions to the MDBs represent extraordinary value both in the quality of MDB programming and in the financial leverage they provide: \$1 of “capital” in an MDB results in at least \$35 in MDB investments globally, a figure that rises if we count the additional private capital that can be leveraged by the MDBs.⁵

The United States should also seek to improve its relationship with China within the World Bank and the regional development banks. The United States has been needlessly irritating to the Chinese by emphasizing that the country should “graduate” from its MDB borrowing status. U.S. policymakers should be more accommodative of China’s role as a client of these institutions. MDB lending to China contributes to the broader SDG goals, both by directly achieving progress within China and by stimulating wider progress on key global public goods like climate resilience. China’s graduation could harm the World Bank and ADB financial models in the near term, which are currently anchored by significant lending to creditworthy China, and thereby constrain the bank’s capacity to lend to poorer countries and promote the SDG agenda globally.

³ Amar Bhattacharya, Jeremy Oppenheim, and Nicholas Stern, *Driving Sustainable Development Through Better Infrastructure: Key Elements of a Transformation Program*, Brookings Institution, July 10, 2015, <https://www.brookings.edu/research/driving-sustainable-development-through-better-infrastructure-key-elements-of-a-transformation-program/>.

⁴ Scott Morris and Madeleine Gleave, *Realizing the Power of Multilateralism in US Development Policy*, Center for Global Development, July 20, 2015, <https://www.cgdev.org/publication/ft/realizing-power-multilateralism-us-development-policy>.

⁵ MDBs can borrow against U.S. and other shareholder capital, typically at a rate of five to one. In addition, U.S. contributions are leveraged by those of other shareholders—for example, at the World Bank at a rate of seven to one.

Bilateral Partnership

The United States and China should also pursue bilateral development partnerships in third countries in support of the SDG agenda, recognizing that prospects in the near term are likely modest. Broadly speaking, U.S. bilateral assistance, which focuses largely on global health and humanitarian assistance, has little in common with China's bilateral programs, which have been meager when it comes to grant-based assistance but massive when it comes to lending for physical infrastructure investment. For example, President Xi's visit last year to South Africa came with an announcement of \$60 billion in new financing for the region. Most of that will constitute infrastructure-related loans and equity investment, with a relatively small share (\$5 billion) devoted to the grant-based assistance that defines the typical U.S. foreign assistance package.⁶

Nonetheless, as China moves to increase its role as a traditional donor, the United States can play a key role in encouraging more support for social and humanitarian programs through partnerships and technical dialogue, especially in countries and areas in which the United States and other traditional donors are not already engaged.

Further, the United States could usefully leverage its modest aid resources devoted to infrastructure by partnering with the Chinese on major projects in shared priority countries. In doing so, U.S.-valued norms and standards around these projects (for example, environmental and social safeguards) can be brought to bear where they might otherwise be missing, and in turn will tend to reinforce SDG-related objectives.

Specifically, Washington could deploy the Millennium Challenge Corporation (MCC), as its principal infrastructure aid agency, to engage systematically with China to expand the funding envelope for the best infrastructure projects in key low-income countries. MCC invests heavily in analysis to identify projects best placed to unlock growth with the highest economic returns, and in project design and due diligence. Collaborating with China on this "pre-diligenced" project pipeline would be a clear win-win. It would help China identify the best projects at low cost and it would help scale the scope and impact of MCC's work. The collaboration could encompass compacts in both Asia and Africa.

Finally, the United States and China should seek a more constructive partnership on aid-related aspects of engagement in fragile states. Cases like Sudan/South Sudan and Zimbabwe call for more effective collective action by the international community, and it will undermine that objective if China and the United States are not fully committed to multilateral cooperation. Important discussions in the years ahead about foreign assistance, debt relief, and MDB engagement in fragile environments will require an orientation from China that is better aligned with global norms and less driven by bilateral commercial interests, and an orientation from the United States that seeks to work with China as a partner.

⁶ Winslow Robertson and Lina Benabdallah, "China pledged to invest \$60 billion in Africa. Here's what that means.," *Washington Post*, January 7, 2016, <https://www.washingtonpost.com/news/monkey-cage/wp/2016/01/07/china-pledged-to-invest-60-billion-in-africa-heres-what-that-means/>.

Broadly speaking, the United States and China have the most important bilateral policy dialogue in the world. Following the creation of the AIIB, development issues factored more prominently into the regular dialogue. Today, even as politics in the United States shift, both countries would be well served, and would be doing a service to the developing world, by sustaining this dialogue, making explicit a new partnership in pursuit of the SDG agenda.

The Development and Transformation of China's Foreign Aid

Zhang Haibing

China's foreign aid has gradually changed itself from a backstage to a frontstage presence, from more simplified forms of capital, personnel, and material support to pluralized forms of assistance, from a bilateral aid-centric approach to more trilateral and multilateral development cooperation, and from an aid recipient rather than aid donor to an emerging major donor with much more influence.

The Development of China's Foreign Aid

Four Stages

There have been roughly four stages of development for China's foreign aid. The first phase covers the period from the early years after 1949 to the time of adoption of the Reform and Opening-up Policy. It had the obvious feature of ideologically colored foreign aid, mainly arising from the strategic need of vindicating national independence. The second phase corresponds to the launch of the Reform and Opening-up Policy, which used the aid as a complementary means to enhance the effect of the "blood-transmitting" approach used in cooperation with the recipient countries. It also led to a more comprehensive aid strategy with the combination of aid and investment followed by more trade and contracting projects. The third phase is the period of institutional building. Since the coming of the twenty-first century, China has paid more attention to the integrity and synergy in the aid cooperation with traditional recipient countries in the Asia, Africa, and Latin America regions. A series of forums were established and gradually developed, such as the Forum on China-Africa Cooperation, China-CELAC Forum, China-ASEAN Forum on Social Development and Poverty Reduction, etc. Since 2013, China's foreign aid has come into the important fourth phase of development, with China gradually growing into a major donor country, focusing more on the sharing of development ideas, experiences, and values rather than purely pecuniary and material aid. With the promotion of the Belt and Road Initiative, as well as the establishment of the Asian Infrastructure Investment Bank (AIIB) and New Development Bank (NDB), China's foreign aid has got more and more institutional and material support.

Motivations

There are mainly two factors arising from both home and abroad that have motivated the transformation of China's foreign aid. Domestically speaking, with the Chinese economy entering a "new normal," a new development concept has been laid out in the 13th Five Year Plan with the core principles of "innovative, coordinative, sustainable, open, and inclusive."¹

¹ National Development and Reform Commission, People's Republic of China, *An Overview of the 13th Five-Year Plan*, December 2016, http://en.ndrc.gov.cn/newsrelease/201612/t20161207_829923.html.

Compared with the past model of development mainly focusing on quantitative expansion, China now attaches greater importance to an innovation-driven sustainable development model, which gives more weight to the environmental impact of economic development in its consideration. Internationally speaking, the United Nations adopted the 2030 Sustainable Development Agenda, Paris Climate Agreement, and Addis Ababa Action Agenda in 2015. And the G20 Hangzhou Summit made great achievements in mainstreaming the development issue on its agenda. All the above-mentioned developments have brought new elements into China's foreign aid. China now has got ever more political willingness to play a certain kind of influential leadership role in global sustainable development.

Unique Feature

China's foreign aid has the unique feature of co-progressiveness characterized by its simultaneously learning, practicing, and sharing, which has close connection to the development road chosen by China. In the more than 30 years since the beginning of the Reform and Opening-up Policy, the approach of "crossing the river by feeling the stones" has always been one of the major means for China to explore its own development road. There is no existing model of development in the world for a country like China to learn and copy. China's development has been achieved through a cumulative process with constant learning, exploration, and experimenting. It has been a core feature in China's foreign aid to sum up its own development experiences and then share with other developing countries. Prof. Li Xiaoyun characterize such a process as parallel experiences transfer: "the so-called parallel experiences transfer means that, China transfers the development experiences experimented and verified in the previous development stages to African countries, and then continues with further experiments and promotion to make them adaptable to the local system in the recipient countries."² In practice, the Western approach of focusing on institution-building and change has not had the expected outcomes due to the mismatch between its long-term-oriented solutions and the urgent needs of near-term challenges. In contrast, China's partial and incremental development practices fit in well with local conditions for development. Therefore, despite its partialness, it's more effective and time-efficient, thus more conducive to poverty reduction and development.

Limitedness

The current level of China's foreign aid still mainly covers the partial sharing of development experiences and resources, with a lack of capabilities in sharing of China's own development theories and models. It's also been beyond China's economic capacity and social mobilization capabilities to provide a large scale of foreign aid. It will be difficult to remove the limits and restraints on China's international development aid. Prof. Justin Yifu Lin has made succinct observation on this: "China is unable to help other countries to achieve drastic development. On one hand, China's domestic reform has been incremental partial reform, which makes it capable of helping other countries in terms of partial reform of special economic and experimental zones. On the other hand, China is still not a knowledge

² Lu Nanfeng, "China's aid to Africa is neither 'colonial' nor 'redundant' in nature," *Pengpai News*, March 7, 2017, <http://www.cwzg.cn/theory/201703/34680.html>.

economy, which makes it impossible for it to help other countries transform into knowledge economies.”³

Transformation of China’s Foreign Aid

China’s foreign aid has entered into a critical transformation era. The main driver of this transformation process lies in China’s domestic development practices and a more comprehensive perception of development.

Conceptual Transformation

The conceptual transformation of development aid was a result of changes in China’s own development concepts and international development environment. The process of China developing from a poor and weak country at the beginning into the second-largest economy in the world has shown clearly the guiding principle of putting economic development as the key part of development. However, with increasing environmental and social challenges caused by economic development, China’s development concept has had to cover more comprehensive dimensions, which later led to the adoption of the concept of inclusive development with more focus on environmental protection and widespread social benefit.

What kind of development is good and sustainable development? The realization of equitable, inclusive, environmentally friendly sustainable development has become the primary concern in China’s domestic development and overseas development aid. China’s development aid concept has been supplemented with more ideas of sustainable development. The UN 2030 Sustainable Development Agenda just came in time, with China’s National Implementation Plan fully affirming such transformation in development concept. In March 2016, the Fourth Assembly Meeting of the Twelfth National People’s Congress adopted the Thirteenth Five Year Plan, integrating the sustainable agenda into the national mid- to long-term development plan and introducing the concepts of innovative, coordinative, sustainable, open, and inclusive development. These development concepts fit in well with the focus of the 2030 Sustainable Development Agenda on people, planet, prosperity, peace, and partnership.

Strategic Transformation

The Belt and Road Initiative has provided China’s overseas development aid with new conditions for its transformation. The long-term strategic goal of China’s foreign aid has not been limited to serving China’s foreign relations alone, with the much broader goal of building the Community of Common Future for Humankind being added. In his opening statement to the Leaders’ Roundtable of the Belt and Road Forum for International Cooperation, President Xi Jinping made an explicit elaboration of the goals of the Belt and Road Initiative: “We need to make joint efforts in addressing the challenges in world

³ Justin Yifu Lin and Yan Wang, *Going Beyond Aid: Development Cooperation for Structural Transformation*, (Cambridge: Cambridge University Press, 2017), <http://www.cambridge.org/us/academic/subjects/economics/economic-development-and-growth/going-beyond-aid-development-cooperation-structural-transformation?format=PB#voJgULiY3gVyJah6.97>.

economy, create new opportunities for development, seek new driving forces for development, and explore new space for development, so as to realize mutual complementarity, mutual benefit, and win-win solution. In this way, we can make sure our joint efforts oriented toward the goal of building Community of Common Future for Humankind. This was my original intention in presenting this initiative, and it's also the ultimate goal this initiative endeavors to reach.”⁴ The focus of China's foreign aid will tilt toward the countries and regions along the areas covered by Belt and Road Initiative.

Institutional Transformation

The debates on reforming the administration institutions and mechanism of China's foreign aid have been continuing for a long time. The current approach of the Department of Development Assistance of the Ministry of Commerce being the major administrator of China's foreign aid has shown to be more and more inappropriate. There are at least several weaknesses with this approach: first, the major competence of the Ministry of Commerce is mainly concerned with foreign trade and commercial practices. Therefore, locating the Department of Development Assistance under the Ministry of Commerce may show the outsiders an impression of China's foreign aid caring mainly about business interests. Second, as a unit subordinate to the Ministry of Commerce, the Department of Development Assistance has a relatively lower ranking in the government, which has caused a certain mismatch with real needs of China's participation in international development cooperation. Third, this approach cannot match the needs of strategic planning and implementation of foreign aid. Although the Regulation on Foreign Aid published by the Ministry of Commerce in 2014 has made certain institutional changes in addressing the problems, it cannot change the fact of relatively weak management of China's foreign aid. More and more scholars have advocated for improving institutions, laws, and regulations in terms of China's foreign aid, with a specific proposal on setting up a special foreign aid agency and relevant legislation.

Image Change

Changing the image of China's foreign aid has been complicated, which may require the involvement of more parties and higher level of information disclosure. To avoid misunderstanding by the international community, China needs to further clarify its political and strategic goals in foreign aid, showcase the international contribution of its aid, and China's efforts in vindicating international peace and development. The Press Office of the State Council published two white papers on China's foreign aid in 2011 and 2014 with systematic introduction of basic facts of China's foreign aid, which have become authoritative reference documents for observing and analyzing China's foreign aid. However, it's not enough to match the needs of the international community to understand China's foreign aid only through white papers and policy documents. To improve the image of China's foreign aid, it needs the joint efforts of both the government and business community. The government needs to improve its information communication and

⁴ Ministry of Foreign Affairs, People's Republic of China, "New Starting Point for Cooperation and New Driving Force for Development: Opening Statement at the Leaders Roundtable of Belt and Road Forum for International Cooperation," May 15, 2017, <http://www.fmprc.gov.cn/web/zyxw/t1461700.shtml>.

disclosure mechanism. And the business community needs to set up a channel for regular communication with local community and peoples.

Conclusions

The international community has had more specific observations on China's foreign aid than before, with some issues such as transparency, environmental impact, communication with local communities, and promotion of employment and growth having been dealt with in wide and detailed discussions. Therefore, to further promote the international influence of its foreign aid, China needs to pay sufficient attention to the above questions.

First of all China needs to improve information disclosure to showcase its development contribution. Taking into consideration China's per capita income, its contribution of foreign aid has been relatively higher. According to Justin Yifu Lin and Wang Yan, China's official development assistance (ODA) accounted for 0.09 percent of its GNI in 2014, which was lower than some OECD member countries. Yet compared with its per capita income of \$7,400 in 2017, China has made relatively larger ODA contribution as a share of its GNI.⁵ Alongside the official aid, there is also the aid contribution made by China's private sector. The donation and charity activities of Chinese enterprises usually have been made on a voluntary basis, which may not have been widely acknowledged in the local community. China's incomplete information disclosure mechanism on foreign aid contribution has been the key factor in the underestimation of China's contribution both by the international community and local peoples.

Equitable distribution of discourse influence in global development governance is also needed. China's foreign aid is part of South-South cooperation that has the advantages of diversity, flexibility, and adaptability. Its weakness lies in the lack of systematic theory, policy, and model building, with the development experiences limited and not integrated. China needs to make good use of the diversified forums of South-South Cooperation and encourage more voices of developing countries in development conceptualization and discoursemaking, which will also be conducive to the strengthening of South-North Cooperation.

⁵ Lin and Wang, *Going Beyond Aid*.

09

Infrastructure

Addressing the Global Infrastructure Deficit: Channels for U.S.-China Cooperation

Ziad Haider¹

Introduction

Hard infrastructure, from airports and railways to power stations and fiber-optic networks, is vital to enabling trade, economic growth, and development. Yet, the world is facing a severe infrastructure deficit. Estimates of annual spending shortfalls are in the hundreds of billions of dollars. In the developed world, countries are struggling to maintain existing infrastructure; take advantage of modern technologies; and adapt to changing patterns of economic activity. In the developing world, countries face these same difficulties, as well as the challenge of rapidly expanding the overall infrastructure stock to meet the needs of growing economies and populations. Leaders around the world have recognized that inadequate investment in infrastructure undercuts not just growth but also, in many parts of the world, stability. As such, addressing the global infrastructure deficit has become a priority in international economic forums and institutions.

As the world's largest economies, the United States and China have a unique responsibility and potential to address this deficit. Both countries have security, economic, and commercial interests in ensuring an adequate global supply of infrastructure. Yet the United States and China also have divergent interests in some areas and differ in their approach to infrastructure investment. Scope for cooperation may exist that could mitigate this competition and produce positive outcomes for both countries and the global economy. However, opportunities for cooperation must be pursued within an understanding of trends in the relationship and each country's strategic priorities, recognizing that win-win outcomes may not always be possible.

¹ The author expresses his sincere thanks to David Parker for his research and inputs.

The Cost of Failure

The McKinsey Global Institute estimates that \$3.3 trillion in infrastructure investment is needed every year through 2030 to meet current forecasts for GDP growth.² When compared to current levels of infrastructure investment, this translates into an estimated gap of \$350 billion per year. Achieving more ambitious growth and development targets, such as those outlined in the UN Sustainable Development Goals (SDGs), will require an even greater increase in spending: an estimated \$1.1 trillion annually above current levels.³ This gap is pervasive and growing, even in areas where infrastructure investment has been relatively robust, such as Asia.⁴

The cost of failing to address these gaps is significant. In addition to producing weaker growth, a failure to invest in infrastructure could contribute to increased instability in the developing world. Lack of access to appropriate sanitation and other public health infrastructure can increase the likelihood, frequency, and severity of infectious disease outbreaks. Underinvestment in green energy and transport infrastructure or in climate change mitigation, particularly in the coastal areas where many of the world's largest cities are located, has the potential to accelerate climate change and amplify its negative effects.⁵ Any of these crises-in-waiting would likely spill rapidly across borders with economic and security consequences.

The Global Response

These high stakes have made infrastructure a top issue in international development and generated a range of institutions and initiatives with cooperative and competitive dynamics.

At the global level, these include the G20's Global Infrastructure Connectivity Alliance (GICA) and the World Bank's Global Infrastructure Facility (GIF). Regional development banks, such as the Asian Development Bank (ADB) and the European Bank for Reconstruction and Development (EBRD), have expanded their already significant investment in infrastructure. Newer institutions, such as the New Development Bank (NDB) and the Asian Infrastructure Investment Bank (AIIB), have emerged. Countries have also launched individual initiatives.

² Jonathan Woetzel, Nicklas Garemo, Jan Mischke, Martin Hjerpe, and Robert Palter, *Bridging global infrastructure gaps*, McKinsey Global Institute, June 2016, <http://www.mckinsey.com/industries/capital-projects-and-infrastructure/our-insights/bridging-global-infrastructure-gaps>.

³ United Nations, *World Investment Report 2014: Investing in the SDGs: An Action Plan*, 2014, http://unctad.org/en/PublicationsLibrary/wir2014_en.pdf.

⁴ Asian Development Bank, *Meeting Asia's Infrastructure Needs*, 2017, <https://www.adb.org/sites/default/files/publication/227496/special-report-infrastructure.pdf>; Asian Development Bank and Asian Development Bank Institute, *Infrastructure for a Seamless Asia*, 2009, <https://www.adb.org/sites/default/files/publication/159348/adbi-infrastructure-seamless-asia.pdf>.

⁵ UNDP's Asia-Pacific Regional Centre and UN-Habitat, *Asia-Pacific Issue Brief Series on Urbanization and Climate Change No. 1: Urbanization and Climate Change*, 2012, <http://www.undp.org/content/dam/rbap/docs/Research%20&%20Publications/poverty/RBAP-PR-2013-Urbanization-Climate-Change-Issue-Brief-01.pdf>.

Some of these, like China's Belt and Road Initiative (BRI)⁶ and Japan's Expanded Partnership for Quality Infrastructure,⁷ are externally focused; others, such as Georgia's Spatial Arrangement Plan⁸ and Iran's Sixth Five-Year Development Plan,⁹ are efforts to invest or attract investment in their infrastructure sector.¹⁰

The motivations behind these efforts and their specific areas of emphasis are diverse. However, present as a backdrop in all this activity are the strategic implications of infrastructure development. From the roads of the Roman Empire to the Trans-Siberian Railway to the rail network of British India, connectivity infrastructure has played a vital role in facilitating trade and the extraction of resources, enabled the timely relay of information, and supported the projection of military power as well as political influence. Understanding this strategic dimension remains critical to evaluating the scope for U.S.-China cooperation in the infrastructure arena.

The U.S.-China Context

The United States and China appear to have a shared interest in addressing the global infrastructure deficit. First, both have committed to supporting ambitious development targets, including those outlined in the SDGs, which outline the global development agenda through 2030, as well as the G20 Hangzhou Declaration.¹¹ In the case of the SDGs, infrastructure is mentioned as both a standalone goal (SDG 9) and plays a key role in achieving a number of other goals, such as expanding access to clean water and sanitation (SDG 6) and improving the sustainability of cities (SDG 11). Second, appropriately addressing the infrastructure deficit could help support development and integration in many parts of the world, generating global economic growth as well as new markets for U.S. and Chinese firms. Third, addressing infrastructure gaps is critical to reducing the risk of instability and transnational threats, whether stemming from vulnerability to extreme weather events or inadequate opportunity for youth populations. This could be from direct effects, such as flood-proofing of cities, or indirect effects, such as the creation of additional urban and rural jobs through enhanced growth and connectivity.

⁶ National Development and Reform Commission, Ministry of Foreign Affairs, and Ministry of Commerce of the People's Republic of China, *Vision and Actions on Jointly Building Silk Road Economic Belt and 21st-Century Maritime Silk Road*, March 28, 2015, http://en.ndrc.gov.cn/newsrelease/201503/t20150330_669367.html.

⁷ Ministry of Economy, Trade and Industry, *The 'Expanded Partnership for Quality Infrastructure' initiative directed toward the G7 Ise-Shima Summit Meeting announced*, May 23, 2016, http://www.meti.go.jp/english/press/2016/0523_01.html.

⁸ "What will Georgia look like in 2020? Government announces major development plan," Agenda.ge News, September 16, 2016, <http://agenda.ge/news/65365/eng>.

⁹ "Iranian Government Earmarks \$462 million for Rail Expansion," *Financial Tribune*, January 18, 2017, <https://financialtribune.com/articles/domestic-economy/57677/iranian-govt-earmarks-462m-for-rail-expansion>.

¹⁰ For the most complete list of active infrastructure-related initiatives available, see "Initiatives," Center for Strategic and International Studies Reconnecting Asia, <https://reconasia.csis.org/database/initiatives/>.

¹¹ The Hangzhou Declaration was released by the leaders of the G20 economies following the Hangzhou Summit in September 2016, the first time that China had hosted a G20 leaders' summit. In addition to promotion of strong, sustainable, balanced, and inclusive growth, the Declaration places a specific emphasis on "lifting and enhancing infrastructure investment," emphasizing its potential role in both boosting aggregate demand and catalyzing structural reforms. G20 Research Group, *G20 2016 China: Hangzhou Action Plan*, September 5, 2016, <http://www.g20.utoronto.ca/2016/160905-action.html>.

However, the United States and China also differ in their approaches to infrastructure investment. Recent decades have seen the United States shift away from prioritizing direct participation in large-scale infrastructure projects toward creating an enabling environment for high-standard infrastructure investment, such as by enhancing host government technical capacity and connectivity-related soft infrastructure. In its engagements at the multilateral development banks, the United States is a strong advocate for greater transparency and for strengthening safeguards in areas such as environmental protection and debt sustainability. Even as U.S. companies are involved in infrastructure projects globally, they do not have the level of government support that their competitors do.¹² For example, the Export-Import Bank, the official export credit agency of the United States, cannot finance projects greater than \$10 million until it achieves a quorum on its Board.¹³

By contrast, China is playing a larger and more direct role in physical infrastructure development.¹⁴ China's signature geoeconomic initiative, Belt and Road Initiative (BRI), reflects its ambitions to generate strategic influence in part through promoting Sino-centric patterns of trade and investment by investing in infrastructure.¹⁵ Even prior to BRI's debut, China had emerged as the world's single-largest source of development finance through policy banks, state-owned enterprises, and other public and government-linked actors, including the China Development Bank and China Export-Import Bank.¹⁶ Much of this money has been directed into large-scale infrastructure projects that are frequently designed and implemented by Chinese companies and executed by Chinese labor.¹⁷ Relative to other major development actors, China is also less transparent in its practices, which creates barriers to effective cooperation and challenges to clearly understanding the impact of Chinese activities.¹⁸

¹² Charles J. Hall, "Export Financing in an Increasingly Competitive World: Challenges from China and Beyond" (remarks at Center for Strategic and International Studies, July 6, 2017), <https://www.csis.org/events/export-financing-increasingly-competitive-world-challenges-china-and-beyond>.

¹³ Ziad Haider and Arun Kumar, "Trump's Global Infrastructure Opportunity," Center for Strategic and International Studies, February 3, 2017, <https://www.csis.org/analysis/trumps-global-infrastructure-opportunity>.

¹⁴ Nadège Rolland, *China's Eurasian Century? Political and Strategic Implications of the Belt and Road Initiative*, National Bureau of Asian Research, June 6, 2017, <http://nbr.org/publications/issue.aspx?id=346>.

¹⁵ Scott Kennedy and David A. Parker, "Building China's 'One Belt, One Road,'" Center for Strategic and International Studies, April 3, 2015, <https://www.csis.org/analysis/building-china%E2%80%99s-%E2%80%9Cone-belt-one-road%E2%80%9D>.

¹⁶ Henry Sanderson and Michael Forsythe, *China's Superbank: Debt, Oil and Influence—How China Development Bank Is Rewriting the Rules of Finance* (New York: Bloomberg Press, January 22, 2013), <https://www.amazon.com/Chinas-Superbank-Influence-Development-Rewriting/dp/1118176367>; Boston University Global Economic Governance Initiative, *China's Global Energy Finance: Chinese Development Bank (CDB) and Export-Import Bank of China (Ex-Im)*, <http://www.bu.edu/cgef/#/intro>.

¹⁷ Howard W. French, *China's Second Continent: How a Million Migrants Are Building a New Empire in Africa* (New York: Knopf, 2014), <https://www.amazon.com/Chinas-Second-Continent-Migrants-Building/dp/0307956989>; Ana Cristina Alves, *China's Economic Statecraft and African Mineral Resources: Changing Modes of Engagement*, South African Institute of International Affairs, January 2013, <https://www.saiia.org.za/occasional-papers/17-china-s-economic-statecraft-and-african-mineral-resources-changing-modes-of-engagement/file>.

¹⁸ AidData, "Tracking Chinese Development Finance—BETA," http://china.aiddata.org/content/about_the_project.

Cooperative Channels

Despite the divergences, opportunities may exist for enhancing cooperation on infrastructure development through bilateral and multilateral channels.

Bilaterally, the United States and China, as part of the U.S.-China Comprehensive Economic Dialogue, should formally discuss infrastructure-related topics, including BRI. Specifically, the Treasury and Commerce Departments, with support from the interagency, should establish a regular dialogue with Chinese counterparts responsible for oversight of the BRI to seek clarity on the projects involved and associated financing and standards. This might be organized with the National Development and Reform Commission or relevant leadership from the Belt and Road Leading Group, with the intention of also exploring potential alignment with U.S. infrastructure-related initiatives in Eurasia.¹⁹ Recognizing that BRI may provide commercial and development dividends for U.S. interests, Commerce and State should also work through this dialogue and in other venues to actively support U.S. firms seeking to join BRI projects.²⁰

Multilaterally, there are numerous potential opportunities for cooperation, beginning with the G20, where Washington and Beijing should continue to emphasize the importance of quality infrastructure as defined in the Hangzhou Action Plan. The Global Infrastructure Connectivity Alliance (GICA), launched by the G20 in 2016, represents a promising effort to harmonize and improve coordination across these various initiatives.²¹ The United States and China should seek to enhance support and resourcing for GICA, especially in order to ensure it is able to fulfill its mandate to support greater infrastructure investment transparency.²² The Global Infrastructure Hub, launched by the G20 in 2014, represents another promising initiative that the United States and China should seek to support, particularly with regards to its work on public-private partnerships and development of its Concession Management and InfraCompass tools.²³

Regarding the role of MDBs in infrastructure investment, the United States and China should encourage the MDBs to implement and further build upon the Joint Declaration of Aspirations on Actions to Support Infrastructure Investment that was issued by 11 MDBs in 2016 as a statement on their collective efforts and strategic plans to help strengthen cooperation and address global infrastructure deficits.²⁴ In the Asia-Pacific region, the United States and China should also work together and with the other members of APEC to build on

¹⁹ Xinyi Yang and David A. Parker, "Buckling Down: How Beijing Is Implementing Its 'One Belt, One Road' Vision," *cogitASIA*, May 7, 2015, <https://www.cogitasia.com/buckling-down-how-beijing-is-implementing-its-one-belt-one-road-vision/>.

²⁰ Ziad Haider, "Can the U.S. Pivot Back to Asia?: How Trump Should Respond to China's Belt and Road Initiative," *Foreign Affairs*, May 23, 2017, [https://www.foreignaffairs.com/articles/china/2017-05-23/can-us-pivot-back-asia.\[\]](https://www.foreignaffairs.com/articles/china/2017-05-23/can-us-pivot-back-asia.[])

²¹ G20 Research Group, *Global Infrastructure Connectivity Alliance Initiative*, July 2016, <http://www.g20.utoronto.ca/2016/global-infrastructure-connectivity-alliance.pdf>.

²² G20 Research Group, *G20 2016 China: Hangzhou Action Plan*.

²³ Global Infrastructure Hub, *Global Infrastructure Hub: A G20 Initiative*, 2015, <https://www.gihub.org/>.

²⁴ G20 Research Group, *MDBs joint declaration of aspirations on actions to support infrastructure investment*, 2016, <http://g20chn.org/English/Documents/Current/201608/P020160815360318908738.pdf>.

the Cebu Action Plan,²⁵ specifically the pillar on “accelerating infrastructure development and financing,” as well as the work of the Asia-Pacific Economic Cooperation (APEC) Investment Experts’ Group²⁶ as part of developing and implementing a new Multi-Year Plan on Infrastructure Development and Investment.²⁷

At the intersection of bilateral and multilateral engagement lies the issue of U.S. policy toward the China-led Asian Infrastructure Investment Bank (AIIB). While full AIIB membership will likely remain both inadvisable and politically impossible for the foreseeable future, the United States should continue to endorse cofinancing and cooperation between the AIIB and other MDBs and consider strengthening U.S. direct engagement. At an appropriate time and in close coordination with allies, especially Japan (as the other G7 member that has thus far withheld from joining the AIIB), this might include designating a senior-level U.S. observer to the AIIB, potentially the assistant secretary for international finance from the Department of Treasury. If such a step were to be taken, it should be done to demonstrate U.S. willingness for positive engagement, but also with an explicit official commitment for U.S. firms to be able to bid on AIIB projects and adherence to high standards in the AIIB’s operations.

Finally, for the United States, all of this must be accompanied by enhanced coordination with allies and partners on infrastructure-related issues. This should be done not only to avoid unwarranted perceptions of an emerging “G2” approach to global economic governance, but also to help create greater transparency and more global support for high standards and other U.S. priorities.

Conclusion

Reflecting the broader dynamic in the U.S.-China relationship, competition between the United States and China in the realm of infrastructure is to be expected. Both countries are major global powers whose strategic interests are, in some cases, at odds.²⁸ Even ignoring this strategic backdrop, divergent approaches and priorities in infrastructure investment are likely to remain enduring sources of tension. However, both countries have shared interests in mitigating the socioeconomic and security risks associated with the current global infrastructure deficit. Constructive engagement through bilateral and multilateral channels has the potential to not just manage these risks, but also net economic and commercial benefits for both sides and provide important ballast to the relationship given trends in China’s economic and security policies.

²⁵ Asia-Pacific Economic Cooperation, *APEC Finance Ministers Launch Cebu Action Plan*, September 11, 2015, http://www.apec.org/Press/News-Releases/2015/0911_FM.

²⁶ Asia-Pacific Economic Cooperation, *APEC Moves to Bridge Asia-Pacific Infrastructure Funding Gap*, July 30, 2015, http://www.apec.org/Press/News-Releases/2015/0730_PPP.aspx.

²⁷ Asia-Pacific Economic Cooperation, “Annex B—APEC Multi Year Plan on Infrastructure Development and Investment,” October 8, 2013, http://www.apec.org/Meeting-Papers/Leaders-Declarations/2013/2013_aelm/2013_aelm_annexB.aspx.

²⁸ United States Office of the Director of National Intelligence, *Global Trends: Paradox of Progress*, January 2017, <https://www.dni.gov/index.php/global-trends/letter-nic-chairman>.

The Belt and Road Initiative: Progress, Problems, and Prospects

Fang Jin

It has been nearly three years since President Xi Jinping launched the Belt and Road Initiative (BRI) in the autumn of 2013. A lot of progress has been made thus far.

First, a consensus has been reached at the governmental level with a large number of countries. President Xi and Prime Minister Li Keqiang introduced the idea, framework, and approaches during their official visits to many countries along the Belt and Road. By the end of 2016, more than 100 countries had expressed their support for and willingness to participate in the building of the BRI project, and 39 countries and international organizations have signed 46 agreements with China for this.¹

Second, on the practical level, major progress has been made on improving infrastructure connectivity in that many projects on the construction of railways, energy pipelines, and electricity have been initiated or implemented.

Third, multiple frameworks of financing mechanisms have formed to provide support for the BRI. The Asian Infrastructure Investment Bank (AIIB) and the Silk Road Fund are operational. The RMB was successfully integrated into the Special Drawing Right (SDR) basket.

Fourth, on international production cooperation, China has signed dozens of bilateral agreements with other countries, including Kazakhstan.

Despite these achievements and progress, we should not neglect the problems during the implementation of the BRI. For example, the implementation of some projects was too hasty, without sufficient consideration of their long-term economic benefits. On many occasions the projects rely too much on the support of governments and policies. Another extreme is sometimes the implementing agencies put too much emphasis on the benefits of the BRI for China itself, especially only calculating the narrow interests of businesses without considering the concerns of local governments, communities, and companies. Furthermore, some countries are positive about the BRI but not willing to make their own contributions. They take for granted that China should pay for most of the cost since it is very enthusiastic in promoting the BRI and must benefit enormously from it. Lastly, there is no lack of suspicion, resistance, and even public criticism in the international community toward the BRI, including those countries along the One Belt, One Road (OBOR) and some regional powers.

¹ National Development and Reform Commission of the People's Republic of China, *Building the Belt and Road: Concept, Practice and China's Contribution*, May 2017, http://www.ndrc.gov.cn/gzdt/201705/t20170511_847228.html.

There may be several reasons behind those suspicions. On the one hand, China has not been effective in conducting external communication about the BRI and its implementation approach in the early stage. As there are one thousand versions of Hamlets in one thousand hearts, there are many interpretations and understandings about the BRI, which are very confusing for international community. There are various stakeholders relevant to the implementation of the BRI; however, China has mostly been engaging with the government bodies without paying sufficient attention to the concerns of businesses, civil society organizations, and local communities. This issue was best illustrated by China's engagement with Myanmar.

Therefore, the most important issue for China in the next step is to conduct a better analysis of the interests of various stakeholders, including itself. Based on this analysis, more targeted communication can be made for more well-aligned strategies and policies for the effective implementation of the BRI. Considering the increasingly complicated challenges we face and the lagging of the reform of international institutions, the first step for China should be working toward a community of common interest before talking about building a community of common destiny. Through this frank communication about each other's interests and concerns, China can better convey its message to neighboring countries and persuade them of the mutual benefits of cooperation. The community of common interest can further develop into a community of responsibility in that various stakeholders should contribute their share and take advantage of their advantages for common interests. Only when the two steps are achieved will the building of a common destiny community be feasible.

Specifically, China needs to deal with the following questions. First, it should not avoid talking about its own interests. As a reflection of traditional culture, Chinese people are shy in talking about interests. On the other hand, they tend to talk in big but empty words and theories, which, however, lead others to think they are not reliable. The neighboring countries are even more of the opinion that China must have hidden the huge interests it can gain from the BRI. The BRI China launched was well-thought and would certainly benefit China in terms of economic development, industrial upgrading and transformation, RMB internationalization, and regional integration among other things. This is not only very natural but also legitimate. But the BRI project should be first and foremost about economic development instead of other things. With the enhanced infrastructure connectivity, deepening of economic cooperation, and increasing interactions between people, better political and diplomatic relations can develop between and among countries under the BRI, which is beneficial for China and other countries involved.

Second, China should also take care of the interests of other countries along the BRI. It cannot be overstated that these emerging and developing countries have strong interests in overcoming the shortage of infrastructure and strengthening their economies. Because of this, the BRI launched by China has won an enormous response from the international community. We should pay attention to not only the interests of these countries' governments, but also the interests of their companies, civil society organizations, as well as individuals, so as to get their support and participation in building the BRI project.

Third, the interests of countries beyond the BRI should also be taken good care of. BRI is an open project rather than a strict geographic concept. At the early stage of implementation, countries along the BRI were prioritized and may benefit more. However, the project is a public good for regional and global economic development, and therefore can also benefit countries beyond the BRI. In fact, the biggest contribution of the BRI to the world lies in the innovation of global economic governance. There are no embedded, binding decisionmaking mechanisms, or strict timelines and roadmap unilaterally set by China. All countries can voluntarily choose their own ways and approaches to joining in based on their own needs. On the contrary, the existing system was based on a set of mandatory rules and mechanisms, dominated by major powers and far from inclusive and open. This is why the United States was so reluctant in seeing China launch the AIIB. What really concerns the United States may be not the closer relations between China and countries along the BRI, but the fact that the completely different concept China introduced brought great challenges to its leadership.

How can we bring nations outside BRI to join this initiative? For example, the United States is a global power with global interests, though it hasn't joined nor expressed its support for the BRI, its attitudes and the interaction between China and the United States can certainly exert an impact on this initiative. The stability and prosperity of the countries along the BRI are in line with both the interests of China and the United States. Many American firms have investments in these countries. They have rich experience, advanced technology, and ample funding, and we should certainly create the right conditions for cooperation among Chinese, American, and local firms.

Therefore, we should focus our attention on communication with the American public, think tanks, and media on the importance and benefits of BRI so we can build the broadest, most comprehensive, and actively participated BRI community of shared interest.

10

Climate Change and Energy

The U.S.-China Climate and Energy Relationship

Joanna Lewis

China is of utmost importance in the climate change challenge due to its role as the largest emitter of greenhouse gases in the world. As such, in recent years it had become a strategic partner of the United States, the second-largest national emitter of greenhouse gases, in policy discussions surrounding climate change and clean energy. During the Obama presidency, the United States pursued an aggressive bilateral agenda to scale up cooperation with China on clean energy and climate change. The Trump presidency brings a new approach to the issue—one that moves the United States further away from its allies, from its alliances on climate and energy with China, and alienates it from ongoing multilateral climate negotiations.

The Bilateral Relationship

The U.S.-China relationship is of particular strategic importance, and clean energy cooperation has become the centerpiece of the bilateral relationship. The United States and China have been cooperating on climate change and clean energy for several decades.¹ Since 2009, this cooperation has been greatly enhanced and expanded, resulting in thousands of people from both countries working together to do collaborative research, to share experiences and information, and to develop commercial ventures to deploy clean energy technology.²

The Obama administration made climate change a cornerstone policy issue, particularly during the president's second term. Progress on the Clean Power Plan, along with several other policies aimed at reducing emissions from the power and transportation sectors, laid the foundation for the United States to put forth new international climate targets. This renewed domestic focus on climate policy gave the United States the moral authority to

¹ Joanna I. Lewis, *The State of U.S.-China Relations on Climate Change: Examining the Bilateral and Multilateral Relationship*, Woodrow Wilson International Center for Scholars, China Environment Series 11 (2010): 7–39, <https://www.wilsoncenter.org/sites/default/files/Feature%20Article%20The%20State%20of%20U.S.-China%20Relations%20on%20Climate%20Change.pdf>.

² United States Department of State, *U.S.-China Memorandum of Understanding to Enhance Cooperation on Climate Change, Energy and the Environment*, July 28, 2009, <https://2009-2017.state.gov/r/pa/prs/ps/2009/july/126592.htm>.

engage with key countries, including China, to try to mobilize the adoption of a new global climate treaty.

Climate change and clean energy has been a powerful, unifying issue in the U.S.-China bilateral relationship, until recently. High-level engagement between the leaders of the two sides, including but not only through the Strategic and Economic Dialogue (S&ED), allowed both countries to discuss politically sensitive issues, from trade barriers to international security, and it ensured that the two largest national economies in the world had a diplomatic means of diffusing potential conflict.³ With President Trump's decision to withdraw from the Paris Agreement, China's leadership has responded with the disappointment and disapproval now shared by many other countries around the world. Despite the U.S. withdrawal, China has made clear that it will stick to its commitment to fulfill its Paris pledges.⁴

Multilateral Achievements

In 2016, there was a concerted shift in the nature of bilateral climate change agreements, moving away from issues of exclusively bilateral importance and toward using the bilateral relationship to shape multilateral responses. The U.S. effort to reach a global climate deal in Paris through bilateral agreements with China is one such example. Two other key areas where bilateral agreement between had important implications for global climate action is in the Montreal Protocol, and the International Civil Aviation Organization (ICAO).

The Paris Agreement

In 2014, the U.S. government made a strategic decision to announce its intended nationally determined contribution (INDC) to the Paris Agreement jointly with China. The United States announced its intention to achieve an economy-wide target of reducing its emissions by 26–28 percent below its 2005 level by 2025 and to make best efforts to reduce its emissions by 28 percent, while China announced its intention to achieve the peaking of CO₂ emissions around 2030 and to make best efforts to peak early and to increase the share of nonfossil fuels in primary energy consumption to around 20 percent by 2030.⁵

The joint announcement had a major impact around the world. It was the first time China had come forward so early and so aggressively to announce its climate targets, and the first time the two largest emitters made such an announcement jointly. The announcement set the stage for other countries to announce their own climate targets over the following months, so that by the time leaders gathered in Paris at COP 21 in December 2015, 180 countries representing nearly 95 percent of global emissions had already announced their

³ Mercy A. Kuo, "Assessing the US-China Strategic and Economic Dialogue: Insights from Daniel B. Wright," *The Diplomat*, July 20, 2016, <http://thediplomat.com/2016/07/assessing-the-us-china-strategic-and-economic-dialogue/>.

⁴ "Trump Gives the World More Reasons to Save Our Planet," *China Daily*, June 2, 2017, http://usa.chinadaily.com.cn/opinion/2017-06/02/content_29589556.htm.

⁵ White House, "U.S.-China Joint Announcement on Climate Change," November 11, 2014, <https://www.whitehouse.gov/the-press-office/2014/11/11/us-china-joint-announcement-climate-change>.

own climate targets.⁶ This was crucial to building the international momentum that led to a successful new agreement being reached.

The Kigali Amendment

The Montreal Protocol on Substances that Deplete the Ozone Layer (a protocol to the Vienna Convention for the Protection of the Ozone Layer) has been hailed as the most successful environmental treaty in history.⁷ While the Montreal Protocol was not intended to be a climate agreement, sometimes addressing one problem creates unintended consequences, especially when dealing with complex air pollution chemistry and greenhouse gases. The phase-out of CFCs led to the creation of hydrofluorocarbons (HFCs), an ozone-depleting substance (ODS) substitute that can be up to 10,000 times more potent than carbon dioxide. President Obama and President Xi first discussed the issue of phasing out HFCs at the Sunnylands summit in June 2013. Between 2013 and 2016 bilateral discussions continued and momentum built in the international negotiations to put forth an amendment to the Montreal Protocol to address HFCs.

On October 15, 2016, at the 28th Meeting of the Parties to the Montreal Protocol in Kigali, Rwanda, 197 countries reached an agreement on an amendment to phase down HFCs. Under the amendment, countries committed to cut the production and consumption of HFCs by more than 80 percent over the next 30 years. The U.S. Environmental Protection Agency (EPA) estimates that this phase-down schedule will avoid more than 80 billion metric tons of carbon dioxide equivalent emissions by 2050, and avoid up to 0.5 degrees Celsius warming by the end of the century. Developed countries will begin reducing HFC consumption beginning in 2019.⁸ Developing countries were notably divided into two groups, with China falling into the first group of countries that must freeze consumption in 2024, and India falling in to the second group, that will not begin freezing emissions until 2028. All developing countries will also be eligible for financial support to aid in their transition away from HFCs.

The CORSIA Resolution

One category of carbon dioxide emissions that has long been omitted from international climate talks is that of aviation emissions. Airplanes are responsible for about 2.5 percent of global carbon dioxide emissions, but also emit oxides of nitrogen and produce contrails, the combined effects of which could more than double aviation's impact on global warming.⁹

⁶ White House, "Remarks by President Obama at the First Session of COP21," November 30, 2015, <https://www.whitehouse.gov/the-press-office/2015/11/30/remarks-president-obama-first-session-cop21>.

⁷ Patrick Low, "Why the Montreal Protocol Is the Most Successful Climate Agreement Ever," *South China Morning Post*, October 26, 2016, <http://www.scmp.com/business/article/2040177/why-montreal-protocol-most-successful-climate-agreement-ever>.

⁸ United States Environmental Protection Agency, *Recent International Developments under the Montreal Protocol*, 2016, <https://www.epa.gov/ozone-layer-protection/recent-international-developments-under-montreal-protocol>.

⁹ Jessica F. Green, "The World Is about to Get Tough on Aviation Emissions. Here's What You Need to Know," *Washington Post*, October 14, 2016, <https://www.washingtonpost.com/news/monkey-cage/wp/2016/10/14/the-world-is-about-to-get-tough-on-aviation-emissions-heres-what-you-need-to-know/>.

Aviation emissions were not included in the Kyoto Protocol or the Paris Agreement, in part due to the challenge of addressing cross-border emissions.

At their meeting in March 2016, President Obama and President Xi committed to working together to reach a successful outcome this year on the ongoing negotiations to reach a deal on a global market-based measure for addressing greenhouse gas emissions from international aviation at the ICAO. After close bilateral engagement between the United States and China, as well as extensive multilateral negotiations among ICAO's member states, an agreement was reached on October 6, 2016. The ICAO Carbon Offset and Reduction Scheme for International Aviation (CORSIA) resolution says that countries will cap aviation emissions at 2020 levels by 2027. The rules are voluntary until 2027, however, and countries are encouraged to opt in prior to that date. As of 12 October 2016, 66 states, representing more than 86.5 percent of international aviation activity, have stated their intention to voluntarily participate in CORSIA.

Opportunities for Expanding Bilateral Cooperation

President Trump's approach to dealing with China will likely be decidedly different from that of the Obama administration. The primary bilateral dialogues with China, the U.S.-China S&ED and the Joint Commission on Commerce and Trade (JCCT), have been restructured by the Trump administration to potentially deemphasize energy and climate cooperation. The new framework for high-level negotiations, the "U.S.-China Comprehensive Dialogue," has four main tracks: diplomacy and security, economics, law enforcement and cybersecurity, and society and culture.¹⁰ It is not clear which of the components of the S&ED and JCCT might be preserved in this new framework but even less clear is where the past focus on bilateral energy and climate cooperation fits into this new framework, or who in the administration would champion such discussions.

There are several areas where the United States and China could develop new programs of cooperation that would be of mutual interest. This includes dialogue topics ranging from domestic investment environments and bilateral trade in low-carbon goods and technologies, to climate-resilient development and national security. As the two largest clean energy economies in the world, Washington and Beijing might mount a joint effort and exchange on job training in key clean-energy industries, including in coal communities. In addition, as the role of China in global multilateral financial institutions grows, there is room for both countries to shape the use of public finance for green and low carbon investment, and to help determine the rules for such investments around the world.

Conclusions

Bilateral engagement between the United States and China on climate change allowed for the two countries to leverage their size and significance to mobilize action from other countries, thereby helping the United States achieve several multilateral outcomes in which it

¹⁰ John K. Veroneau, Timothy P. Stratford, and Ashwin Kaja, "Trump, Xi Kick Off Economic Relationship," *Global Policy Watch*, April 21, 2017, <https://www.globalpolicywatch.com/2017/04/trump-xi-kick-off-economic-relationship/>.

had a stake. As U.S. climate change politics evolve under the new Trump administration, this will most certainly influence U.S. bilateral engagement with China. While there are many untapped areas for fruitful cooperation, it is possible that not only will cooperation not be expanded, but also that existing cooperation will be greatly diminished. If so, the United States will lose the leverage it gained from partnering with China to help shape global multilateral environmental processes.

The next four years will no doubt bring significant changes to the U.S. relationship with China, and climate change may no longer be at the center of bilateral or regional discussions. Even if bilateral engagement is scaled back, domestic climate action in China is likely to continue. China has launched sweeping climate change policy initiatives at all levels of government and throughout the economy, and continuing these programs is in the self-interest of China's leadership.

Finance, Trade Policy, and the Implementation of the Paris Agreement

Zhang Zhongxiang

This essay will focus on three key issues in the context of the Paris Agreement (PA): finance, trade and climate, and PA implementation. To the extent possible, discussion of each issue will cover four aspects: description of the problem, existing efforts to address the problem, policy solutions, and suggestions for Sino-U.S. cooperation (or ways of managing differences).

Finance

Financial support from developed countries has been one key issue of greatest concern to developing countries. At the Paris climate change conference, China proposed and insisted on “a concrete roadmap” to scale up the level of pre-2020 financial support by developed countries to achieve the goal of jointly providing \$100 billion annually by 2020 for mitigation and adaptation. China also insisted on “making finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development.”

However, developing countries consider the finance section of the PA to be too weak, which does not contain any compulsory language to scale up climate finance, and demand that it be strengthened in subsequent negotiations. On behalf of developed countries, Australia and the United Kingdom delivered in October 2016 a roadmap for meeting the collective target of \$100 billion per year by 2020. This roadmap report suggests that public support will increase to \$66.8 billion in 2020 from \$43.5 billion in 2014 and would be leveraged to mobilize private finance to reach the full collective pledge.¹ It enhances transparency on how developed countries plan to reach the collective target. The increase in climate funds and the relatively high share of public finance are encouraging signals.

However, this report, as well as the widely debated climate finance report produced by the Organization for Economic Cooperation and Development (OECD), overestimates the net climate support provided to developing countries.² Both reports also reveal the persistent neglect of adaptation needs in the poorest countries, with less than 20 percent of international climate finance going to adaptation. The PA specifies a balance between climate mitigation and adaptation. While balance could be interpreted differently, by any

¹ Department of Foreign Affairs and Trade of Australia, *Roadmap to US\$100 billion*, October 2016, <http://dfat.gov.au/international-relations/themes/climate-change/Documents/climate-finance-roadmap-to-us100-billion.pdf>.

² Ibid.; Organization for Economic Co-operation and Development, *Climate Finance in 2013–14 and the USD 100 billion goal: A report by the OECD in collaboration with Climate Policy Initiative*, 2015, <http://www.oecd-ilibrary.org/docserver/download/9715381e.pdf?expires=1497888253&id=id&accname=guest&checksum=8A0BD B16696F8B2C0F6DBAB13FD077B0>.

standard 80 percent versus 20 percent of international climate finance would not be considered a balance between climate mitigation and adaptation.

Negotiators need to agree on what should be included in climate finance, how best to account for climate financing, and what the next steps are to both increase funding for measures to build resilience to climate impacts and how to balance climate mitigation and adaptation.

The Paris Committee on Capacity Building (PCCB) aims to support developing countries in their climate action efforts. PCCB is now up and running. Negotiators agreed that in 2017 it will focus on supporting implementation of countries' national climate plans.

The U.S. finance contribution in the PA context depends on the U.S. stance on the PA, given that on the campaign trail Trump promised to cancel U.S. involvement in the PA and cut U.S. international obligations to provide climate-related funding. President Trump has already proposed to cut climate-related funding in his first budget proposal. This includes proposed budget cuts for the Global Climate Change Initiative, which, as a presidential development initiative, integrates climate change considerations into U.S. foreign assistance. This would also affect entities such as the Green Climate Fund and the Climate Investment Funds, supported by George W. Bush's administration with \$2 billion partly to boost renewables abroad.³

To what extent the United States will retreat remains to be seen. In this context, however, there is one area offering a promise of Sino-U.S. cooperation. That is to control public investment flows to projects with high pollution and carbon emissions both domestically and internationally.

There is concern around the environmental impact of China's overseas energy finance. Between 2007 and 2014, 66 percent of overseas power-generation projects financed by Chinese policy banks went to coal-fired power projects, with 28 percent going to renewable power plants. By contrast, during the same period the World Bank had not financed any coal-fired power generation project, and 88 percent of the overseas power generation projects financed by multilateral development banks (MDBs) go to renewable power plants.⁴

Hervé-Mignucci and Wang found that for overseas coal-fired power projects, while Chinese banks offer Chinese companies relatively easy access to low-cost finance, they do not seem to be offering more favorable rates than other multilateral development banks and export credit agencies (e.g., the KfW Development Bank, Japan Bank for International Cooperation, Japan International Cooperation Agency, and Asian Development Bank).⁵ Moreover, China's

³ "Lean, not green: America's proposed budget cuts will be bad for the environment," *Economist*, March 23, 2017, <http://www.economist.com/news/international/21719466-and-signal-they-send-even-worse-americas-proposed-budget-cuts-will-be-bad>.

⁴ Kevin P. Gallagher, Rohini Kamal, Yongzhong Wang, "Fueling Growth and Financing Risk: Benefits and Risks of China's Development Finance in the Global Energy Sector," Boston University Global Economic Governance Initiative, May 2011, https://www.bu.edu/pardeeschool/files/2016/05/Fueling-Growth.FINAL_version.pdf.

⁵ Morgan Hervé-Mignucci and Xueying Wang, "Slowing the Growth of Coal Power Outside China: The Role of Chinese Finance," Climate Policy Initiative, November 2015, <https://climatepolicyinitiative.org/wp-content/uploads/2015/11/Slowing-the-Growth-of-Coal-Power-Outside-China.pdf>.

support for exports is technology blind. There is no clear differentiation between financing for power versus nonpower projects, or for coal power versus noncoal power projects.

U.S. has led efforts toward ending overseas coal financing. The Obama administration set new guidelines to end most overseas coal financing through the U.S. Export-Import Bank and the Overseas Private Investment Corporation. Since then, the United States had pushed the issue with dozens of countries and brought the issue before the OECD. The UK, France, the Netherlands, and several Nordic countries as well as the World Bank have since enacted similar restrictions, most of which allow coal financing only for the world's poorest nations.

In September 2015, the United States and China committed to "controlling public investment flowing in projects with high pollution and carbon emissions both domestically and internationally." In November 2015, the OECD countries committed to common standards for coal subsidies, also potentially significantly restricting international finance for coal power.

The ambition of China's commitments to control public investment depends on the definition of public finance, the scope of the commitment (for example: Which projects will no longer receive public support? Will only coal power generation projects meeting specific criteria be eligible to funding? Are there any exceptions for some projects depending on who is receiving public money?), and whether they are implemented strictly no matter what China's level of commitments is.

Trade and Climate

The Paris Agreement is built on a bottom-up approach. The decentralized nature of the climate agreement means that countries have considerable flexibility in determining their own climate targets and instruments incorporated in their nationally determined contributions (NDCs). Moreover, under the PA, countries will be mandated to submit an updated NDC every five years, with parties expected to progress in the level of ambition in each round in line with their national circumstances.

In the context of trade, one issue is the potential introduction of border carbon adjustments (BCAs). BCAs are a policy tool intended to respond to carbon pricing that differs across jurisdictions. BCAs could come in the form of import duties or the forced surrender of emissions allowances from domestic emissions trading schemes. While BCAs are legally and politically controversial, they are unarguably considered a potential policy option to address carbon leakage and competitiveness concerns.⁶ BCAs in the form of emissions allowance requirements under the U.S. proposed cap-and-trade regime were the most concrete

⁶ Zhongxiang Zhang, "Competitiveness and Leakage Concerns and Border Carbon Adjustments," *International Review of Environmental and Resource Economics*, Vol. 6, No. 3 (2012): 225–87, <http://dx.doi.org/10.1561/101.00000052>; Samuel Kortum and David A. Weisbach, *Border Adjustments for Carbon Emissions: Basic Concepts and Design*, Resources for the Future, March 11, 2016, <http://www.rff.org/files/document/file/RFF-DP-16-09.pdf>.

unilateral trade measure put forward to level the carbon playing field.⁷ In the U.S. Senate, the Boxer Substitute of the Lieberman-Warner Climate Security Act (S. 3036) mandates that starting from 2014 importers of products covered by the cap-and-trade scheme would have to purchase emissions allowances from an International Reserve Allowance Program if no comparable climate action were taken in the exporting country.⁸ In the U.S. House of Representatives, the American Clean Energy and Security Act of 2009 (H.R. 2998), the so-called Waxman-Markey bill, sets up an “International Reserve Allowance Program” whereby U.S. importers of primary emission-intensive products from countries having not taken “greenhouse gas compliance obligations commensurate with those that would apply in the United States” would be required to acquire and surrender carbon emissions allowances.⁹

In the PA context to date, Mexico is the only country to explicitly refer to the possibility of border carbon adjustments in its NDC. The Mexican NDC states that its 25 percent emissions-reduction commitment could be increased to 40 percent, subject to a number of conditions, including border carbon adjustments. While only one NDC includes an explicit reference to border carbon adjustments, this does not mean that others may not consider it.¹⁰

Depending on the extent to which the United States retreats from the PA, the United States could be confronted with potential carbon tariffs imposed by other parties, on the same grounds that the United States used to threaten other countries for not taking actions comparable with its own. In this regard, it would be beneficial if the United States would remain a party to the PA, but would water down some initiatives and efforts undertaken under the Obama administration. The United States seems to be going in this direction. President Trump already proposed to cut climate-related funding in the first budget, and signed an executive order instructing the U.S. Environmental Protection Agency (EPA) to begin rewriting the 2015 Clean Power Plan regulation that limits greenhouse gas emissions from existing power plants. Given that the rule on Clean Power Plan is tied up in litigation on the U.S. Court of Appeals for the DC Circuit and that the agency will have to justify reversing the regulation and reaching the opposite conclusion of the EPA under the Obama administration—which argued it was technically feasible and legally warranted to reduce carbon pollution by about one-third by 2030, compared with 2005 levels—to revisit the

⁷ Zhongxiang Zhang, “The U.S. Proposed Carbon Tariffs, WTO Scrutiny and China’s Responses,” *International Economics and Economic Policy*, Vol. 7, Nos. 2/3 (2010): 203–25, <https://ssrn.com/abstract=1594743>; Zhongxiang Zhang, “Competitiveness and Leakage Concerns and Border Carbon Adjustments.”

⁸ United States Senate Democrats. “The Boxer Substitute Amendment to S. 3036, the Lieberman-Warner Climate Security Act of 2008,” <https://democrats.senate.gov/2008/05/29/the-boxer-substitute-amendment-to-s-3036-the-lieberman-warner-climate-security-act-of-2008/#.WUgNdO3yvcs>.

⁹ United States Library of Congress. “H.R.2998—American Clean Energy and Security Act of 2009,” <https://www.congress.gov/bill/111th-congress/house-bill/2998/text>.

¹⁰ Clara Brandi, *Trade Elements in Countries’ Climate Contributions under the Paris Agreement*, International Centre for Trade and Sustainable Development, 2017, http://www.ictsd.org/sites/default/files/research/trade_elements_in_countries_climate_contributions.pdf.

matter and rewrite the regulation will trigger a laborious rule-making process and a possible legal fight.¹¹

Implementing the Paris Agreement

The Paris Agreement aims to strengthen the global response to the threat of climate change by keeping a global temperature rise this century well below 2 degrees Celsius above pre-industrial levels and to pursue efforts to limit the temperature increase even further to 1.5 degrees Celsius. Under the Paris Agreement, all parties have outlined their climate action plans known as NDCs, to be implemented from 2020 and expected to be scaled up over time.

While the PA establishes legally binding obligations of conduct, it does not establish a legally binding obligation for countries to actually achieve their contributions. Negotiators need to work on details of the PA and put in place a process to design the rules and processes that will guide countries in fulfilling their existing climate commitments and scaling up their commitments over time. Countries agreed to start in 2018 a facilitative dialogue to take stock. Negotiators need to decide how the 2018 process will proceed. Any rules and processes, once agreed, help to assess where countries stand both individually and collectively in terms of meeting their own pledges and the collective target, and lay out updated national climate plans to accelerate climate action and close the emissions gap.

Transparency in the implementation of countries' contributions is the backbone of the PA. The PA for the first time establishes a universal transparency system. This new system substantially increases the transparency requirements for mitigation actions by developing countries, and at the same time, meets the developing countries' demand for including adaptation and increasing transparency for developed countries' provision of support.

In designing an enhanced transparency framework, negotiators in subsequent conferences need to strike a balance between common guidelines and flexibility. On the one hand, common guidelines are applied for all countries regarding what information should be included and how countries can improve the quality of their reported information over time. On the other hand, flexibility allows different responsibilities for developing countries based on their national circumstances and capacity constraints.

On the campaign trail, Trump promised to cancel U.S. involvement in the PA and cut U.S. international obligations to provide climate-related funding. While President Trump continues to attack climate change policy, he has not indicated whether the United States would remain. U.S. Energy Secretary Rick Perry said that he believes that the United States should remain part of the deal, but renegotiate it. White House spokesman Sean Spicer said that the administration expected to make a decision on whether to remain a party to the deal by the time leaders of the Group of Seven wealthy nations meet in late May.

¹¹ Juliet Eilperin and Brady Dennis, "Donald Trump moves to erase Barack Obama's legacy on fighting climate change," *Washington Post*, March 29, 2017, <http://www.smh.com.au/world/donald-trump-moves-to-erase-barack-obamas-legacy-on-fighting-climate-change-20170328-gv8kru.html>.

According to Article 28 of the PA, any country leaving this UN deal will take four years. Even if the United States decides to withdraw from the PA, it gets what it wants in four years. As discussed earlier, by doing that the United States will pay high political and diplomatic costs.

To what extent the United States will retreat remains to be seen. On the one hand, in a bid to make the United States fully energy independent, Trump does support renewable energy, along with sources such as fossil fuels. On the other hand, Trump lost the popular vote, and a large number of states, cities, and counties across the United States have been taking great actions and efforts toward climate mitigation and wide use of renewables, even in those states where Trump won. Sixteen Fortune 500 big businesses across the U.S. economy (Apple, BHP Billiton, BP, DuPont, General Mills, Google, Intel, Microsoft, National Grid, Novartis Corporation, PG&E, Rio Tinto, Schneider Electric, Shell, Unilever, and Walmart) signed a petition on April 26, 2017, urging President Trump to keep the United States in the PA on climate change.¹² A poll released in April 2017 shows that President Trump's stance and policies on climate change are opposed by a majority of Americans.¹³ All these may restrict the space of the Trump retreat.

In the meantime, the European Union and China are leading the global community in keeping collective pressure on the United States, restricting its potential damage to a minimum. In Paris, China had shown itself both a great collaborator and leader in global governance. With a potential vacuum left from the U.S. retreat, China should take this opportunity and strengthen its role in the global governance of climate change. Meanwhile, it should avoid taking too many responsibilities that go beyond its capabilities and capacity.

¹² "Letter to White House re Paris Agreement," April 26, 2017, <https://www.c2es.org/docUploads/business-letter-white-house-paris-agreement-final-04-26-2017.pdf>.

¹³ Jason Le Miere, "Trump's Climate Change Policy Is Strongly Opposed by Americans, Poll Shows," *Newsweek*, April 6, 2017, <http://www.newsweek.com/trump-climate-change-policies-poll-580049>.

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