



CHAPTER 17

# TURNING POINT: TOWARDS A U.S.-CHINA PARTNERSHIP FOR THE GLOBAL TRADING SYSTEM

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## Executive Summary

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The relationship between China and the U.S. has reached a turning point. More than three decades of trade expansion between the two countries under the multilateral trade system has created deep commercial and investment ties. Despite this, today, China and the U.S. increasingly find themselves on opposite sides of a range of contentious trade issues.

At the same time, the basis of past and present commercial ties – in which China served as a production base for American consumer and industrial goods – is changing rapidly as both countries face new sets of economic challenges. In particular, China is shifting from being a global center of production, to a global consumer market. In short, the time is ripe, and perhaps urgent, for China and the U.S. to take their trading relationship to a new level.

A new framework for their trade could help both countries address imminent issues in their respective growth paths. There are discussions – both officially and unofficially – on the best framework for the U.S. and China to evolve their trading relationship. Perhaps the most prominent of these include bilateral frameworks, such as a U.S.-China free trade agreement (FTA) and regional/preferential trade agreements (PTA) such as the Trans-Pacific Trade Partnership currently being negotiated.

While both the bilateral FTA and regional PTA appear to have many merits as trading frameworks, a conclusive case cannot be built. An FTA may sound great in theory, but putting it into practice will require concessions that both sides may be unable to make, regarding disputed issues such as intellectual property protection, market access and technology. As for PTAs, these frameworks may help expand trade between their members, but only

when backed by a strong dispute resolution function, and open, fair trade principles, such as those commonly found in the multilateral system under the World Trade Organization (WTO).

Indeed, the case for PTAs strongly resembles the case for the multilateral system, with one missing element: the former has a closed members list, whereas the multilateral system is built on principles of inclusiveness. It is commonly acknowledged that the entrance of new players expands the trade pie for the benefit of all. Therefore, there is good reason to encourage a number of PTAs to widen their membership. In fact, this plurilateral approach already exists and is practiced under the WTO.

Today, plurilateral frameworks – which allow trade liberalization to take place at a faster pace – are a notable benefit of the multilateral trade system, but not the only one. In the harsh light of the stalled Doha Round, it may be easy to overlook the benefits of the multilateral system, but the U.S. and China would do well not to fall into the same trap. Both countries have benefitted immensely from the multilateral system, and its principles of transparency, openness, and adherence to rules and dispute settlement, first under the General Agreement on Tariffs and Trade and then under the WTO. Both countries have every reason to anchor the next phase of their trading relationship along these same principles.

To do so would be the right way to evolve their partnership, but it would not be sufficient. Many criticisms of the WTO point to legitimate issues that need to be addressed, if only to bring the system up to date with present day realities regarding technology, global value chains, the rise of services and other areas.



Pushing ahead with these reforms would be very much in the interests of both China and the U.S. Both countries would gain from the exports boost and jobs created, as well as more generally from the WTO having its systems and processes updated to meet the demands of the 21st century. In short, if the U.S. and China – as the world’s two largest trading economies – put their force of intent behind the WTO’s reform agenda, this might well provide the boost that the agenda needs to move ahead.

Finally, the U.S. and China could build on their partnership to initiate discussions towards an international agreement on investment. This would provide much needed coherence to a global foreign di-

rect investment environment which is in dire need of multilateral principles of transparency, fairness and adherence to common rules. Here again, a convergence of interests is clear.

In short, there are a multitude of reasons for China and the U.S. to recognize that the only way to address the many challenges facing the global community is through multilateralism and collective responsibility. In partnership, China and the U.S. can enhance multilateralism, make it a more effective force for solving the world’s problems, and in doing so, create an enormous global public good which will be recognized for generations to come.

## Turning Point: Towards a U.S.-China Partnership for the Global Trading System

### Taking Stock

Some 40 years after President Richard Nixon’s seminal visit to China, the relationship between the U.S. and China is at a turning point. Since 1972, and especially since the normalization of ties in 1979, the relationship between the U.S. and China has become one of the world’s most important economic partnerships. Two-way trade has grown from a mere US\$95.9m in 1972, to US\$7bn in 1985 and US\$460bn in 2011. American companies are among the leading investors in China, with investments in China worth over US\$50bn as of 2010. Today, China is a leading source of revenue for U.S. companies such as General Motors and Yum brands.

Economic ties have created the basis for a number of social, cultural, educational and scientific ties as well. In 2011, there were nearly 200,000 students from China in the U.S., accounting for nearly one quarter of all foreign students in the U.S. Interest in China is also growing on the U.S. side, with the

number of American students studying Mandarin estimated to have tripled in the past five years alone, up to 60,000.

Suffice to say, the U.S. and China are trading more with each other, investing more in each other and learning more about each other. This should be the basis for a long and fruitful partnership, and one that would not only produce many mutual benefits, but also yield many co-benefits for the global community. Indeed, we hope that will be the case. But there are worrying signs.

Despite – or maybe even because of – the depth of commercial ties, the two countries seem to be on divergent paths in international trade. Both have launched cases against one another through the World Trade Organization (WTO) settlement system; some rivalries have seeped into geopolitical spheres, with the U.S. pushing forward with its ‘pivot’ to Asia and a Trans-Pacific Partnership that excludes China. There are also accusations of commercial spying and hacking on both sides.

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Small misunderstandings can easily grow into much larger ones, especially in a digitally connected age. These needlessly complicate a bilateral relationship that, due to the sheer size and significance of the two countries, is destined to involve at least some measure of competition.

Commercial competition between two countries can be helpful to both. Free and open trade between two countries can also be mutually beneficial, when carried out on fair terms and according to agreed rules. It can enhance the productivity and the overall prosperity of both. And this can be the case for China and the U.S. Ongoing commercial competition between two countries of such size and diversity will inevitably lead to trade disputes, but this is to be expected.

But, as Singapore's former Prime Minister Lee Kuan Yew has noted, "Competition between the United States and China is inevitable, but conflict is not." Yet, all too often the bilateral relations between the two countries seem to veer towards confrontation.

The task before us, then, is to create conditions for the U.S. and China to direct their relationship on the path to stability, harmony and shared prosperity. Clearly, rebuilding mutual trust is essential. We also know that mutual trust can only come from cooperation and shared experience. In other words, we need to find ways for the U.S. and China to understand each other, working side by side, towards shared goals, particularly in the trade arena which has been the bedrock of the relationship in the last 30 years.

## The Sources of Past Ties

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Hence, at the heart of the U.S.-China relationship are trade and economic ties. Trade and economics were the foundation of past ties, and they will continue to be the key building blocks for the future. The challenge is that the specific conditions that initially brought China and the U.S. together as trad-

ing partners have changed. Each is facing demands which are not easily fulfilled if it is primarily within a relationship built on American companies outsourcing manufacturing to China, and China exporting goods back to the U.S. or around the world.

For the U.S., which faces fiscal adjustment and a protracted period of deleveraging, consumer spending will likely be flat in the years to come. American companies need to look abroad for their major sources of growth, and the emerging markets led by China are obvious candidates. Indeed, China is already an important buyer of U.S. products, and as it grows wealthier, imports from the U.S. will likely increase.

China is already becoming an important global consumer market. China also needs to rebalance its economy away from secondary industries, such as manufacturing, towards tertiary industries, such as services and retail. This is a major opportunity for the U.S., which leads the world in services exports. For Chinese companies looking to globalize and find markets abroad, close ties with the U.S. could offer many benefits.

In short, both countries face economic transitions where successful adjustment can be facilitated through positive engagement with the other. The key question is, what is the best framework for mutually beneficial engagement between the U.S. and China, given their respective needs and priorities?

In the past, a complementarity of needs defined and drove the U.S.-China relationship forward for more than three decades. However, it is important to note that this commercial relationship would have been almost impossible to achieve without the supporting framework of the multilateral trade system, and specifically, the WTO.

This may not be evident at first glance. But surely no two countries have benefited more from participation in the multilateral trade system under the WTO, than the U.S. and China. The multilateral system offered China the best of both worlds – flexibility to pursue development and economic expansion backed by the security of common codes



of practice, rules-based norms, a level playing field and the fail-safe option of impartial, effective and enforceable dispute resolution through the WTO.

The number of claims lodged by both China and the U.S. under the WTO system may seem alarming. However, two large countries with as much two-way trade as China and the U.S. are bound to have disagreements. The WTO dispute settlement system resolves such disputes peacefully and in accordance with agreed rules for trade. Far better for countries to engage in tedious legal proceedings before the WTO, than to settle their disputes through confrontation or other means.

Perhaps the greatest benefit of WTO membership for both countries is to enable them to trade with all members every day in every part of the world, within a commonly held set of trading rules.

In particular, the basic WTO rules prohibit discrimination in commerce that affects international trade. Without the legal protection against trade discrimination to which it is entitled under the most-favored-nation (MFN) rule as a WTO member, for example, China would surely have met many more obstacles during its rise and return in recent years to global economic pre-eminence.

As it is, China has grown at an average annual rate per capita of nearly 8% since entering the WTO in 2001. Chinese exports have increased six-fold since joining the WTO. Internal reforms required by WTO rules have spurred economic growth in China and helped to lift millions of Chinese out of poverty. This is all true despite the fact that China has had barely a dozen years to benefit from participation in the multilateral trading system.

On the other hand, the U.S. has benefited since the establishment of the system, with the creation of the General Agreement on Tariffs and Trade (GATT) in 1947. According to the Peterson Institute for International Economics, the benefits to the U.S. alone from freer trade and from other forms of economic integration since World War II total US\$1tr in added income for the American people

annually. This represents an increase of 10% in the overall U.S. gross domestic product (GDP), and amounts to an annual income gain of US\$10,000 for every American household.

The Peterson Institute estimates that the American people could gain another US\$500bn annually in national income by eliminating all the remaining barriers to trade and investment worldwide. That would provide an additional US\$5,000 in annual income for every American household.

So, it cannot be denied that China and the U.S. – individually and in partnership – have benefitted immensely from the multilateral trade system.

## **Taking U.S.-China Trade Relations Forward: Bilateral, Regional or Multilateral?**

While both China and the U.S. continue to regard multilateralism as the centerpiece, both countries appear to be drifting away from multilateralism. For sure, the system is not perfect, and especially in view of the stalled Doha Round, there are many questions about its effectiveness. Many of these questions are rightly addressed at the WTO, which seems at times to be paralyzed to act, even when it knows that the times demand change.

It is perhaps understandable that many countries, including both the U.S. and China, have in recent years explored trading partnerships that are bilateral or regional in nature. Globally there seems to be an acknowledgement that, if the 150 plus members of the WTO cannot come to an agreement on trade liberalization – especially when under the single undertaking principle that “nothing is agreed until everything is agreed” – it may be easier for two countries or a small group of countries to achieve liberalization on the side.

As a result, bilateral and preferential trade agreements have proliferated. According to the WTO, as of January 2013, over 350 regional or preferential trade agreements came into force.

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These alternatives – bilateral and regional trade arrangements – have been proposed as frameworks for the U.S. and China to consolidate their relationship and move it to the next stage. Both alternatives are worth considering for their benefits and costs.

To many, it would seem natural for the U.S. and China – based on their bilateral interests – to press ahead for something such as a U.S.-China free trade agreement (FTA). The logic appears simple: the U.S. and China are the world's two largest trading nations and their economies are very complementary, so a U.S.-China FTA could provide total sufficiency for both economies.

A U.S.-China FTA would be very strong and could dominate global markets to the advantage of both, especially if the U.S. and China could agree upon contentious issues such as intellectual property protection, market access, technology development, military and industrial equipment, and the liberalization of agriculture markets. The list of issues to be resolved by a U.S.-China FTA is long, and each one represents a major conundrum. And if these issues can be managed through an FTA, they could boost bilateral trade significantly and open up new grounds for partnership.

The big question is 'if' it will happen. There is an assumption that it would be possible or even easier to resolve these issues in an FTA, no matter that the U.S. and China's interests on many of these issues oppose one another. The U.S. and China have been at loggerheads over many of these issues for years now, and framing them in an FTA will not necessarily make the solutions appear more palatable to each side. It may take many months or years to even agree on which issues should be addressed in an FTA. We might well end up with an intractable negotiation between the two countries.

It is true that exploring the possibility of an FTA could have its own rewards. In fact, they will likely give China and the U.S. a better understanding of each other's perspective, needs and challenges,

which is invaluable if they are to work together. But this alone will not make vested interests and 'deal breakers' on each side go away.

The other issue with a U.S.-China FTA is that for all the size and might of the world's two largest economies, they cannot proceed alone. They need the stability, predictability and governance mechanisms of the WTO framework.

Moreover, a U.S.-China FTA in isolation would likely leave the rest of the world much worse off. Other countries might feel compelled to form their own coalition to protect themselves from the detrimental effects of a U.S.-China trade bloc. Of course, both blocs would be exclusionary and undermine basic principles of global community and shared responsibility.

## The Case for Multilateralism

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If, on balance, a U.S.-China FTA does not appear to be an obvious pursuit at the present juncture, can we consider a slightly wider arrangement, in the form of a regional or preferential trade agreement among several countries, including both the U.S. and China?

Let us take for example the much discussed Trans-Pacific Partnership (TPP) which is heavily promoted by the U.S. as the commercial centerpiece of its pivot to Asia. The TPP's benefits are widely touted by its members, who in joining, agree to harmonize tariffs, rules and practices to promote trade within the group.

Many have wondered why the TPP does not encompass China. Surely, the co-benefits will be felt by all members. This is true for China joining, or indeed any other country in the region. So why not widen the group? Let any country that agrees to adhere to the rules of the group join in to form a coalition of the willing. The concept for this is open regionalism, which was discussed under the Eminent Persons Group of the Asia-Pacific Economic Cooperation (APEC) in the early 1980s.



Its present day form is plurilateralism, which we promote as a way for trade liberalization to take place without the prerequisite of an overall global consensus under the WTO's single undertaking mentioned above.

As it is, negotiating outside the WTO and with a defined, seemingly exclusionary list of participants, the countries negotiating the TPP, or any other preferential trade agreement, will at some point have to understand how they will enforce the agreement, even after all the terms are agreed. They will need a dispute settlement system for just that one agreement.

It may even resemble the WTO's dispute settlement system. But why create another system when an effective one already exists within the WTO? Why proceed outside the WTO when it makes so much more sense to proceed within the WTO?

Practical matters aside, when such agreements are pursued outside of the WTO, the further risk is that they will have needless geopolitical implications. Is the U.S. trying to isolate China with the proposed TPP? Are the U.S. and the E.U. trying to create a common economic bulwark against China and other emerging economies with the so-called Trans-Atlantic Trade and Investment Partnership?

Neither of these questions would arise if these negotiations were conducted within the WTO. The TPP and even the Trans-Atlantic Partnership could, with the consent of the WTO membership, be incorporated into the WTO, though no one involved in the negotiations has suggested this. As it is, suspicions arise and the negotiations add to the drift of the U.S., China and so much of the rest of the world away from multilateralism.

If the plurilateral idea works regionally, the nations of the world should consider expanding this within the existing multilateral framework. And China and the U.S. share a mutual interest in leading the way within the framework of the WTO.

Today, we need global solutions more than ever. The great advances in information and communi-

cations technology have made the world more connected and interdependent than ever before. Problems in one corner of the planet may have global repercussions. There are a host of contemporary global issues, such as climate change, security, natural resource scarcity and demographic change, which must be addressed by the global community acting in concert.

Unresolved, these problems will affect China and the U.S. as they will affect every nation. So multilateralism must be the overarching architecture of how the world works, and, together, China and the U.S. must lead the way in making it work, simply because it is in their own interests for the world to work well.

The truth is, despite their differences, China and the U.S. share a single economic fate. Neither can succeed economically without the success of the other. And the best way for both to succeed is by working together openly, transparently, under commonly held norms about fairness and shared goals. In other words, much like the multilateral trade system works today.

## **A China-U.S. Partnership: Remaking the Trading System for the 21st Century**

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If neither bilateral nor regional preferential trading arrangements provide a workable framework for future trade relations, why have they attracted so much attention? Or in other words, when we know that the multilateral system provides so many benefits to all parties, why is it perceived as ineffective and stalled?

Alas, it is true that the problems of multilateralism, and especially of the WTO, are widely known and are a source of much criticism. It has been said that the single greatest element blocking progress in multilateralism is political will. Consider that against the backdrop of China and the U.S., having recognized the benefits offered by the multi-

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lateral system, agreeing to invest themselves in the improvement of the system. Surely that constitutes sufficient will to break through on any number of issues facing impasse?

In fact, U.S. and China have every reason to invest in resolving the issues facing the WTO, even considering only their own respective interests. There is even a fair amount of convergence between American, Chinese and global interests with regard to the reform of the WTO.

Many of these changes have been discussed within the WTO, by its members and the public. A few priorities stand out:

- The WTO needs to bring its systems and processes up to date with the ever-changing realities of global production and supply chains.
- The WTO's rules and procedures need modernizing to keep pace with the fact that today, the WTO has 158 members whereas the trading system had only 23 members at the founding of the GATT; plurilateral arrangements are one such alternative, but there are others that should be explored.
- The WTO needs to step up the pace of liberalization on IT and new areas such as global services and environmental goods and services.
- And even the WTO's key strengths, such as dispute resolution, need updating so that they can still be effective today.

Clearly, this is a long-term, ambitious agenda, but one that both the U.S. and China have every interest in supporting.

Consider the task of updating the WTO's systems to track global supply chains and production systems. When the WTO was formed, many consumer goods were made in one country and shipped to another country where they were consumed. Today, global supply chains have fragmented and globalized. Even a very simple product may cross multiple borders during the production process. As

a result, trade in intermediate goods accounts for more than half of regional trade in East Asia. It is increasingly difficult to determine where a product undergoes 'substantive transformation' along its way to production. In our world of global supply chains, products are no longer 'from' anywhere. They are 'from' everywhere.

Moreover, what matters most in profiting from production is not the site of a substantive transformation; it is the value added. When tallied according to value added, the shape and structure of world trade – and of various bilateral trade balances – looks very different from when it is calculated under current 'rules of origin' according to where traded products are supposedly 'from'. However, the standard trade flows tracked by the WTO, and many countries, still rely on outdated concepts of production. They attribute 100% of the value of a product as from its country of origin, which is often its last point of assembly.

This is more than just another trade statistic. When politicians in the U.S. are told that the U.S.-China trade deficit is more than US\$300bn, they may form incorrect assumptions about their own economy and that of China, and the interconnections between the two. These misunderstandings may have geopolitical consequences.

This is but one example of how current trade rules are no longer attuned to 21st century realities. At a minimum, we need to update the WTO's information systems, so that they accurately reflect the two countries' true trading relationship.

Other agenda items that we have laid out above would yield great benefits for both China and the U.S. as well. One is trade in services. An international services agreement could potentially accelerate U.S.-China partnership to expand and diversify the delivery of services in China and thereby support China's economic rebalancing.

The Peterson Institute recently studied a potential global services agreement within the WTO and found that such an agreement would boost global



exports by US\$1.129tr, create 8.6 million new jobs and boost global GDP by US\$1.04tr.

Similarly, extending the WTO Information Technology Agreement (ITA) to cover more products would result in a GDP boost of US\$147bn, accounting for US\$178bn in exports and 3.7 million new jobs. More countries should be encouraged to sign the ITA and efforts should be made to address non-tariff as well as tariff barriers to IT trade.

At a time when global attention is rightly turning to issues of sustainable development, the WTO can do much to ensure that environmental goods and services are available where they are most needed. The recent APEC initiative listing eligible goods and services can be helpful. For example, China and the U.S. could begin by working together on a sustainable energy trade agreement as a plurilateral agreement within the WTO. Freeing trade in environmental goods and services can be an important part of such an agreement.

In addition, a sustainable energy trade agreement could also include other issues that affect green growth. It could limit import and export restrictions on energy products. It could carve out a limited exception from WTO subsidies rules for certain carefully defined green subsidies. It could begin to fulfill some of the promises that China, the U.S. and other G-20 countries have made about reducing the trillions of dollars worldwide in climate-damaging fossil fuel subsidies.

Why should China and the U.S. take the lead in such an initiative? A better question is: why shouldn't they? Both need new technologies, both need new markets and both understand that the whole world must find new ways of growing economically, while surviving environmentally.

## **Expanding Multilateralism to Address Global Challenges**

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There is one additional new initiative that is critical to the advancement of a harmonious U.S.-China

relationship for the future, and whose accomplishment would represent great progress for the cause of multilateralism: that of an international agreement on investment.

The story of U.S. investment abroad is well known. U.S. foreign direct investment (FDI) has for many years spurred worldwide growth. China has been one of the beneficiaries of American FDI and continues to be one of the world's most attractive FDI destinations, and this may well continue.

But today, a new and exciting story is developing about Chinese investment abroad, which has grown from just under US\$1bn at the turn of the century, to over US\$60bn annually today. Chinese investment abroad is globally very diversified and covers all industries. But from time to time, it is thwarted by misconceptions about its nature and provenance. The U.S. needs investment to create jobs and kick-start growth. How can we unlock Chinese investment for the benefit of U.S. workers, businesses and the overall economy?

Negotiation of a bilateral investment treaty between China and the U.S. would be a good start. But it will not be enough. More than 3,000 such international investment agreements already exist. These outline rights and responsibilities for investors and investments, but when taken together, the network is large, complex and, in some cases, contradictory. Moreover, these 3,000 treaties protect only two thirds of the existing stock of global FDI, and cover only one fifth of possible bilateral investment relationships. The United Nations Conference on Trade and Development calculates that an additional 14,000 bilateral treaties would be needed to provide full coverage of international investment.

Trade and investment are two sides of the same coin in global commerce. We need global rules on investment akin to the global rules we have long had on trade. In short, we need a multilateral agreement on investment, which would provide a transparent, rules-based framework for making investments worldwide.

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Conceivably, a multilateral investment agreement could be negotiated by the members of the WTO, and could become part of the WTO system and subject to WTO dispute settlement. This is by far the best way to support the continued growth of global FDI.

There were discussions towards a multilateral agreement on investment almost two decades ago. However, the idea proved too contentious, with the investor and investee countries lined up on opposite sides. But the world has changed since then. Today, each investee country is also a potential investor. Is China an investor or an investee? It is both. The same is true of the U.S.

Worldwide, an increasing convergence of investment concerns has replaced old notions and allegiances as far as investment rights and protections are concerned. This helps make the time right for the global community to move forward on an international agreement on investment.

## **Conclusions: From a Trust Deficit to a Trusting Partnership**

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Cooperation can be habit-forming. Successful cooperation by China and the U.S. in strengthening the WTO and restoring the global commitment to multilateralism in trade can help build the confidence and the impetus the two countries will need to tackle together other tasks of multilateralism.

China and the U.S. can cooperate, and through their cooperation, help construct a multilateral trade system that meets their own needs, while providing an enormous global public good. In doing so they will recognize the value of multilateralism, and give credence to the notion that all nations should work towards its improvement.

In a time of acknowledged complexity, global interconnectedness, and many rising risks to our growth and prosperity, this contribution may be the greatest legacy of the U.S.-China partnership, at the beginning of the 21st century.