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MEMORANDUM ON

PRIORITIES FOR 2021 ECONOMIC TALKS WITH CHINA

To: The Chair of the US Delegation for Bilateral Economic Talks with China
From: Nicholas R. Lardy
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Background: Economic negotiations with China must be a component of a consistent overall strategy to promote US interests, rather than one element of a menu of mutually inconsistent and constantly changing initiatives. The foundation of this strategy should be a comprehensive program of US economic renewal that maintains American technological leadership, rather than a defensive strategy that seeks to slow China's technological and economic rise. This strategy of addressing problems at home must include the rebuilding of crumbling infrastructure, reversing recent cuts in federal support for research and development (R&D), and a smarter immigration policy that brings to the United States talented science and technology specialists who will strengthen the US economy.

The overall strategy must recognize that regime change from the Chinese Communist Party, a crisis of the Chinese economy, or even a sharp decline it its growth trajectory are all unlikely over the time horizon of this administration. The incoming administration should assume that China's economy and its influence on the overall world economy will continue to expand.

Neither a general decoupling from China nor the promotion of regime change should be an element of this overall strategy.

PRIORITY 1: Be selective with requests

Recognize that economic negotiations with China are likely to continue to generate only modest results if the United States makes simultaneous demands for far-reaching changes in multiple Chinese economic policies. Better to start with well formulated requests on one or two high priority areas where there is at least a modicum of potential Chinese receptivity. Recently, for example, the authorities in China have themselves emphasized that most state-owned enterprises should be increasingly evaluated on their economic returns. This opens the door to potentially productive negotiations leading to a curtailment of subsidies to state-owned companies.

A corollary of this approach is that the US delegation should be relatively small: Not every government department and agency needs to be represented.

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PRIORITY 2: Work with allies

Coordinate, to the maximum extent possible, with US allies and partners. They share many of the same concerns about China's industrial policies, especially subsidies, and other unfair trading and investment practices. China is more likely to modify its policies in the economic realm if it hears a consistent message from Europe, Japan, South Korea, Canada, as well as the United States rather than facing unilateral demands from the United States. Remember that China has no allies. The United States has a huge advantage in this space; it should be leveraged to its advantage rather than being squandered by imposing tariffs on goods from Japan, South Korea, India, Canada, Mexico, Turkey, the European Union, and Australia.

PRIORITY 3: Recognize that the "tariff war" has failed

Recognize that US tariffs imposed on imports of Chinese goods have failed to achieve any of their announced objectives:

- **a.** The US bilateral trade balance with China has deteriorated further and the US global trade deficit has also gotten worse, in both cases for a variety of macroeconomically related reasons. In any case, the size of the US global trade position cannot be influenced by tariff policy; rather it is determined by the US domestic investment-savings imbalance.
- **b.** Trump administration claims to the contrary notwithstanding, tariffs have not been paid by Chinese exporters, but rather so far have imposed a tax of almost $50 billion on US importers, most of which has been absorbed by US consumers.
- **c.** Tariffs have not led to a resurgence of manufacturing jobs in the United States; indeed, even before the economic downturn caused by the COVID-19 pandemic, manufacturing jobs were being lost.

PRIORITY 4: Recognize China's unstoppable expanding role

Even if "containing" China or regime change were judged to be desirable, there is little the United States can do to significantly slow China's economic rise and its increasing role in the global economy. Similarly, any regime change is likely to stem from China's internal dynamics rather than external influences. And, in any case, the United States has a long history of economic and other forms of cooperation with non-democratic regimes.

- **a.** China is leading the global recovery from the COVID-19 pandemic, primarily because it was successful in controlling the pandemic within three months of the initial outbreak. In contrast, the United States and several other advanced economies continue to struggle more than six months after their initial outbreaks.
    - **i.** China has had a V-shaped economic recovery in both the second and third quarters of 2020. The International Monetary Fund now forecasts that China's economy will expand by 2 percent and 8 percent, respectively, in 2020 and 2021.
    - **ii.** Thus, China's economy in 2021 will be about 10 percent larger than in 2019. The United States and almost all other economies in 2021 will be smaller than in 2019.
- **b.** China continues to go from strength to strength in its global trade.
    - **i.** Although US imposed tariffs reduced China's exports to its largest market, its total exports were up 5 percent in 2019, while global exports fell by 3 percent.

   ii. China's share of global trade is rising even more strongly in 2020, year to date, while the US share is collapsing.

c. China has substantially liberalized access by foreign firms to its immense domestic financial market and is now an increasingly important destination for foreign portfolio investment.

   i. Chinese regulators have allowed multiple securities, asset management, insurance, and other financial firms from the United States, Europe, and Japan to convert existing minority positions in joint ventures with Chinese partners to majority foreign-owned firms and have licensed a number of new wholly foreign-owned financial firms.

   ii. US investors now hold well over $1 trillion in Chinese bonds and equities, up from $240 billion in 2007.

PRIORITY 5: Avoid a policy of "decoupling"

Recognize that the implication of the above is that a US-led general decoupling from China is likely to be a high-cost, low-benefit policy for the United States and a nonstarter for its allies and partners.

a. Other countries have shown little interest in participating in a US-led decoupling strategy, given China's growing global economic and financial role. Their appetite for joining a US-led effort to promote regime change in China is even less. China accounted for 30 percent of global economic expansion in 2019, and its share in 2020 will almost certainly be larger. Thus, a US decoupling strategy would be a policy of economic self-isolation from a major source of global growth and trade. Non-US firms would quickly fill the void left by a unilateral US decoupling, gaining a larger and larger share of China's imports, currently running at $2 trillion annually.

b. A unilateral US decoupling would impose huge costs on US households and businesses that have benefited from the availability of lower-cost goods from China.

c. Even a narrower US decoupling in technology is likely to be a high-cost strategy for the United States.

   i. Shutting US semiconductor companies out of the China market, as the United States now seems to be doing, for example, would reduce their revenue sharply, causing capital expenditures by these firms to fall by $13 billion and leading to the loss of 124,000 US jobs.

   ii. More importantly, declining revenue would lead to deep cuts in R&D expenditures by US semiconductor firms, meaning the United States could lose its long-standing global leadership position in an industry that is crucial for US economic competitiveness and national security.

ACTIONABLE TO-DO LIST:

- Craft a coherent China policy to promote US interests.
- Adopt and work toward obtainable goals. These would not include slowing China's economic rise or promoting regime change.
- Coordinate with allies that share concerns on Chinese trade and investment practices, including state subsidies and protection of intellectual property.

- Focus economic negotiations on one or two high priority topics where there is at least some indication of Chinese receptivity. Avoid an omnibus approach that includes demands for far-reaching changes in multiple Chinese policies.
- Avoid weaponizing trade policy, for example through tariffs on Chinese imports, since the costs to the United States will likely exceed anticipated benefits.