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The Road Ahead for U.S.-China Relations

Thank you, Adam for that kind introduction and for your leadership of the Peterson Institute. This is my first visit here since Pete Peterson passed away, and I want to extend my condolences again both to the Peterson family, and the team here at the Institute that was so important to him. Let me also thank the Peterson Institute for hosting me once again and the Chinese Academy of Social Sciences for their partnership in convening this conference. It is a pleasure to join you all for this important and timely discussion.

Over forty-six years ago, President Nixon made his momentous trip to China, ending decades of silence between Washington and Beijing and jumpstarting economic relations between our countries – one the leading developed economy and the other still an emerging economy. Today, the United States and China are the world's primary engines of economic growth, together accounting for nearly forty percent of global GDP.

The U.S.-China economic and strategic relationship is the most important bilateral relationship in the world, but it is complex and multidimensional, and its character has changed over nearly fifty years of normalized relations. It is a relationship marked by contradiction: China has learned much from the US in building a powerful modern economy, and benefited greatly from its access to US markets, but China's remarkable growth has also been fueled by practices that we consider unfair, and harmful to our own industrial base. These concerns have been addressed through constructive engagement over many US presidential administrations, resulting in both progress and great tension, particularly as both parties balance economic and strategic issues.

We meet as relations between our two nations are strained, and at one of the lowest points in recent memory. Some view rising tensions as inevitable, and Professor Graham Allison raised the alarm by drawing attention to the Thucydides trap – the rise of Athens creating fear of inevitable conflict in Sparta, which made war, in that case, inevitable. However, it would be tragic if the lesson learned is that rising conflict and ultimately even war are unavoidable. The real point is that it requires enlightened leadership and diplomacy on both sides to avoid having this become a self-fulfilling prophecy.

While the rhetoric and policies of the Trump Administration are fanning the flames of conflict, it would be a mistake to dismiss the current state of affairs as simply a reflection of the Administration's nationalist America first policies. This is the rare issue where voices at both ends of the political spectrum often align -- a point I have made to Chinese leaders as a measure of the urgency for them to show that US concerns are being taken seriously, and that progress is being made. China is no longer a weak developing economy, and there are higher expectations about meeting broadly accepted international standards with regards to trade and competition.

In my view, the Trump Administration tariffs are likely to make matters worse, and its rhetoric lacks the respect that we should show between two great nations. But it is a moment when China needs to look beyond the rhetoric from the White House, and even the provocative trade policies, to find a way to demonstrate that real issues are being resolved. Constructive engagement remains the best course, working together where we agree and narrowing our differences where we do not, and advocates for this approach need to be able to point to facts on the ground that demonstrate it is working.

The issues are not new.

China's economy is not as transparent or open to market forces as it should be, as its own economic policy pronouncements over the past several years have made clear. Reforms that would address this are in China's own interest, because future economic performance is far more likely to meet the needs of the Chinese people if the reforms are implemented. Progress on these reforms would also reduce tension between the US and China and avoid growing conflict with other developed economies.

Understandably, China strives to avoid domestic disruption, which is inevitable as reforms are implemented, and to sustain its stunning record of growth. But it would be short sighted to retreat from reform policies that would both make China stronger and reduce growing international tension.

The record is mixed, but the trend is worrisome. It was progress earlier this year when China indicated that it would permit increased foreign investment in financial institutions, but stories of bureaucratic as well as legal obstacles to foreign investment across sectors continue. The consumer sector in China has been growing, which is critical to building a more stable long term economic future and to addressing the needs of China's growing middle class, but allocation of resources continues to reflect the emphasis on traditional industrial sectors of the economy and state owned enterprises. There is a real danger that with a political decision to emphasize central authority, China may also be doubling down on counterproductive economic policies.

Excess industrial capacity, an issue I raised repeatedly in my official capacity, particularly in steel and aluminum, remains a significant issue. We made progress during my tenure, with China agreeing to steel capacity reductions, and an international monitoring process to evaluate whether the situation was getting better or worse. But the rate of capacity reductions remains below the pace that China demonstrated was feasible in an earlier period of reform, and the health of the global steel and aluminum markets requires more sustained progress.

When China floods markets with excess supply, it creates an unfair advantage that makes it difficult for producers in the US and other developed economies to compete. That is why there was broad support in the G20 to tackle this issue in 2016. That consensus, forged through US led diplomacy, broadened the conversation beyond US versus China – it was the US leading the world to press broadly for policies to reduce excess capacity, and China agreed to this approach. The current US approach is far more unilateral – imposing tariffs on questionable grounds not just on China, but also on our closest allies – putting the US in conflict with not only China, but also with Canada and Europe. This weakens American leadership and will work against efforts to achieve lasting change, even as it heightens the level of conflict between the US and China.

Intellectual property is another area of continued pronounced tension. Although China has enacted more robust systems to ensure the rule of law, it still practices policies that provide China with unfair advantage. For example, the price for American firms to do business in China is often to transfer proprietary intellectual property. And while China has made tremendous progress in innovation, particularly by investing in areas like robotics, it continues to attempt to acquire or import technologies from the U.S. and other highly developed nations, often raising serious national security considerations in the review of proposed acquisitions.

Reviews like CFIUS are appropriate to protect legitimate national security interests, but risk undermining the free flow of foreign direct investment if used simply to block foreign investments to protect domestic economic competitiveness. The challenge today is that a plan like Made in China 2025, which sets out a strategic vision for independence and dominance in technology development, can cause economic and national security concerns to blend together. There needs to be greater respect for the legitimate concerns that some acquisitions raise, and a full and open dialogue to keep the level of hostility over these issues from growing. Already the new FIRRMA legislation in the US expands the scope of acquisition reviews. And there have have been proposals to go farther. It is in the interest of both the US and China to enhance opportunities for foreign direct investment in both directions, but with growing tension, it will take an affirmative effort to achieve that objective.

On the longstanding issue of currency, after years of heated conflict, we finally made progress, a trend reflected even in the Treasury reports on exchange rate practices issued under the current Administration. It is too early to conclude the extent to which earlier progress has evaporated, but it would be a real step backwards should that happen.

The recent trend of a weakening RMB is concerning. Between a strong dollar and domestic interventions in China that largely rest on domestic concerns, it is uncertain to what extent the depreciation of the RMB is intentional. But even the appearance that China may be slipping back into currency practices to gain unfair advantage is a real problem. A willingness to allow the RMB to increase in value is critical, and that extends to defending it when necessary. As I was concluding my tenure at Treasury, I raised the concern that excess capacity could become the currency issue of the next decade if not addressed effectively, and now there is a danger that the currency issue, which caused enormous tension for many years, could again be a cause of concern.

More broadly, China continues to restrict the impact of market forces in its economy. Subsidies that allocate resources inefficiently and skew competition remain entrenched. The result is inefficiency that hinders growth and makes China more vulnerable to risk. With respect to infrastructure growth, even China's impressive building boom is not immune from basic economic principles — namely that when supply exceeds demand, economic drag results. That is especially true if central planners bet on the wrong projects. And in the most extreme cases, inefficient public capital allocation raises concerns about bubble creation and sinking money into investments that lack enduring value.

Clearly, the U.S.-China relationship has reached a fraught moment, and China's approach poses significant challenges. But the path to this point has not been a straight line, and there will continue to be areas of sharp disagreement, even as we cooperate on other matters. The question is how to manage the relationship to avoid having the conflicts boil over and grow out of control.

For many years, dialogue was formal and transactional. That began to change in 2006, when former Treasury Secretary Hank Paulson spearheaded the China-U.S. Strategic Economic Dialogue. During the Obama Administration, we continued to transform the bilateral relationship, engaging broadly and productively, tackling issues from trade and currency to cybersecurity and sanctions cooperation. We used the Strategic and Economic Dialogue to develop relationships at a leader level, a ministerial level and a working level, to work through hard issues, and to make progress bilaterally and on issues of global governance.

Both the Bush and Obama Administrations understood the challenges China poses. We refused to ignore transgressions, economic or otherwise, but we found that through persistence and greater mutual understanding, we could make progress in some areas, and that China would commit to changing some of its most troubling policies. There is much more to accomplish, but it continues to be the case that constructive engagement is a better alternative to conflict, especially at a time when leaders on both sides need to evaluate whether rising conflict is inevitable.

Beyond bilateral economic engagement, the Obama Administration partnered with China on multilateral topics of shared interest, including the Paris Climate agreement and efforts to prevent Iran from developing nuclear weapons. The current US Administration, in my view mistakenly, reversed policy in each of these cases. But the ability of the US and China to work together on issues of common concern remains very significant, and in the current climate, North Korea's nuclear program is an extremely critical area.

China has always been an essential partner in efforts to press North Korea to change its policy. As North Korea advanced its nuclear and missile programs, the Obama Administration ratcheted up pressure on China and garnered international support, including from China, for heightened sanctions. The Trump administration doubled down on sanctions and rhetoric, and China responded with further pressure on Pyongyang. While I am skeptical that we are on the verge of a meaningful nuclear agreement with the DPRK, it is important that China remain engaged in pressing North Korea, including through economic pressure. The reality is that the DPRK/China relationship is a lifeline for North Korea, and that creates a unique ability to impose economic consequences. In the context of my remarks today, it is a vivid reminder of how important it is that the US and China preserve the ability work together on issues where we have common interests, even as we press for change when we disagree. And reports even today of increased oil shipments from Russia and China to North Korea are troubling.

In twenty short months, the current administration has shifted to a far more adversarial stance that puts at risk hard-fought progress, encourages China to continue practices that are unfair, and threatens U.S. standing in an increasingly multipolar economy. It has withdrawn us from the global community while feeding the narrative that conflict with China is inevitable.

Early in the Trump Administration, it appeared that China's leaders were prepared to be patient, and they responded with restraint. As rhetoric turned into aggressive tariffs, China's response has only reinforced this negative turn by escalating international tension, which in turn energizes populism and nationalism in the United States. We now see yet another effort to launch ministerial discussions to establish a constructive dialogue led by the current Treasury Secretary, Steven Mnuchin, and Vice Premier Liu He. I hope this effort is more successful than the false starts to date. But success will require that both leaders empower their economic teams to represent them and bring back actionable policies so that the current war of words and tit for tat tariffs can be replaced by the kind of constructive engagement that can lead to lasting progress. It has been difficult to tell from the outside who, if anyone, actually represents our President in bilateral discussions with China, which makes it very hard for both sides.

There will be no winners if a trade war continues, and that is especially true for working people. This ill-conceived trade policy has failed to achieve its objectives, as the trade deficit reached record levels this summer. And with US fiscal policies that will cause the fiscal deficit to skyrocket, our trade deficit will continue to grow. The real measure of progress is not a snapshot of trade flows, but whether China's markets are more open for US products and services and US investment; whether currency policies continue to reflect the progress of recent years; whether intellectual property is properly protected; and whether lasting reforms are being implemented in China's economy.

Current US policies also create uncertainty more broadly about the future of global economic governance. By stepping back from its traditional role as the leader in promoting global norms, the US is creating a vacuum at a time when China rightfully expects a greater voice in multilateral institutions. This is a far cry from the US engaging China to adhere to standards that we developed as it takes a seat at the table as one of the two major economies of the world, and it does not serve US interests well in the long run.

In an environment of growing tension, even hostility, there is a real risk that miscalculation or posturing could very quickly spin out of control. For example, China's retaliatory sanctions are already hurting American workers; and US tariffs are already adding to inflationary pressures.

But the Thucydides trap is not inevitable.

There is an alternative to conflict, and that is to restore the kind of engagement which worked in the previous two administrations. Decades of diplomacy showed that it is possible to cooperate, compete, and disagree at the same time. We proved that the U.S. could partner with China on global issues, make progress on bilateral economic relations, and still seek accountability on human rights and other issues. The progress that resulted was mutual, and from the U.S. perspective, it was self-interested and rational. Through further engagement, China has the potential to take greater ownership of the rules-based economic system, and such a role comes with matching obligations that China should be held to. But the United States needs to live by those rules if we are to demand that others do the same.

Engagement is China's best option for avoiding the conflict it sometimes believes is inevitable, and it is the most sensible course for the U.S. to preserve its global standing and prosperity. Finally, let us not forget that this bilateral relationship is more important than the U.S. and China alone. The US-China relationship has great bearing on both the global economy and geopolitical stability. When we work together, we create a magnet for other nations to join, as we demonstrated both on climate change and the Iran agreement. The future will bring many ups and downs, but the first step is clear: pull back from the precipice at which we have arrived and restore constructive dialogue to forcefully press US interests.

Thank you, and I look forward to your questions.