

**George Bush China-U.S. Relations Conference:
Development, Energy, and Security
October 22-25, 2007
Washington, D.C**

FORUM FINAL REPORT

Forum Title: *China-U.S. Trade and Investment Forum: Achieving Global Partnerships in the 21st Century*

Session Summary: The session's focus was on China-U.S. bilateral trade and investment, the continued growth of which will require economic adjustments in both countries that will need to be based on transparent, sound, market-oriented policies and social justice to be sustainable in the long run.

The morning session examined major outstanding bilateral trade differences that need to be resolved in a cooperative manner. After a broad overview of China's trade structure and global trade patterns, structural adjustments programs in this area were discussed and the focus moved to China-U.S. bilateral trade relations. The objective is to address key areas of concern that require relatively urgent action to resolve bilateral disputes and enhance trade. Major trade subtopics explored included issues related to intellectual property rights, product safety, work environment, high technology exports, and liberalizing the yuan.

The afternoon session focused on bilateral investment (foreign direct investment and portfolio investment). The session started with an update on the direction and speed of China's financial sector reform. That was followed by micro-issues of interest to the business community, such as opening China's financial sector services (banking, brokerage and mutual fund services, insurance), and attracting China's savings surplus to the U.S. in the form of foreign direct investment and portfolio investment that could generate U.S. jobs and provide a good return on investment to China—a win-win situation. Each session was followed by a panel discussion with audience participation.

Findings/Recommendations:

China's Trade Structure and China-U.S. Bilateral Trade: The perception on China's trade policy needs to change, as new and better empirical data on China's trade with the world is slowly flowing in. China is a trading nation with exports of some \$1 trillion in an economy of \$3 trillion. This compares with U.S. exports of \$1 trillion in a \$13 trillion economy. China's global exports during this decade have been growing at about 30 percent a year, with imports growing at 20 percent. China's services exports currently constitute some \$110 billion with services imports being slightly larger, resulting in a small deficit in services that will not offset the large merchandise trade surplus. China's high import elasticity of demand for services will be good for the global and U.S. economy as well. Some major characteristics of China's trade include: (1) a merchandise trade surplus that has increased rapidly, along with growth in demand for higher value-added intermediate goods; (2) a growing deficit in trade of primary goods; (3) an increasing trade surplus in capital goods; (4) increasing sophistication of China's exports; (5) a growing specialization of exports in the manufacturing sector and not in services; and (6) a de-linking of exports from imports, as China substitutes domestic inputs for imported inputs with increased technological sophistication. Despite the

perception of export-led growth, China's exports contribute only some 20-25 percent of GDP growth, and less than 8 percent of the nation's work force is devoted to the external sector. The bulk of China's growth is driven by domestic demand that needs to be rebalanced, since China's internal market is fragmented. Structural transformation in domestic demand will lead to more steady growth in China.

From a bilateral trade perspective, four issues were discussed. First, China's export growth, which is a direct result of the country's entry to WTO, has made U.S. exports to China (including Hong Kong) the third largest after Canada and Mexico. However, the challenge is to liberalize the yuan to make bilateral trade more equitable. Second, it was noted that it was in China's best interest to enforce proper Intellectual Property Rights (IPR) if multinational companies are to enter China and transfer high level technology. China tends to focus more on the level (threshold) of counterfeiting which is of concern for MNCs. Third, product safety is an issue both for the Chinese as well for importers of Chinese products and the problem could be alleviated by importing appropriate technology for monitoring standards and proper enforcement. Finally, the future of bilateral trade is more dependent on dialogue than on legislation; hence the Strategic Economic Dialogue (SED) and the Joint Commission on Commerce and Trade (JCCT) are important mechanisms to achieve this goal.

As for the exchange rate issue, it was agreed that the yuan needs to be more flexible and the move toward greater flexibility should be more rapid, while the Chinese believe in gradualism because of concerns over unemployment and social unrest. The rigidity of the yuan is reflected in large current account surpluses and rising foreign exchange reserves (approximately \$1.4 trillion now) that are major causes of global imbalance in trade and capital flows.

China's Financial Sector Reforms and China-US Financial Services Outlook: China's banking sector is going through major changes as they move from directed lending to more commercial-based lending. The banking system is dominated by four major state-owned banks (BOC, CCB, ABC, and ICBC), which have a market share of 50 percent and some 20,000 banking institutions that employ some 2.5 million people. The growth in banking has encouraged cash to flow from under mattresses to banks. Yet, the non-performing loans at the four major banks amount to 25 percent of loans outstanding and they are primarily with state-owned enterprises. Non-performing loans (NPL) could potentially be more serious than what we are led to believe. While asset quality has been improving with foreign investment in the banking sector, there is still inadequate system of credit controls and the government continues to control borrowing and lending rates. Chinese banks need to introduce a system of risk and credit analysis to reduce NPL.

China's capital market is in a frenzy (a bubble), with total market capitalization of over \$3 trillion (higher than the country's nominal GDP). The Shanghai "A" share stock has grown by over 100 percent this year, with Price/Earning ratio approaching 65 largely due to the fact that the bulk of the shares are held by the government and only a minority of the shares held by the public, who have high savings and are not willing to invest their funds in banks where the real rate of return is close to negative. China's capital market defies logic and a market correction could see P/E ratios drop easily by 50 percent. The capital market is slowly going through changes as new laws are introduced to increase financial disclosure and transparency. China's accounting standards are moving toward international standards and are on the right path. However, China's capital market is

characterized by small number of institutional investors, high transactions costs, and inadequate regulation and supervision. In a nutshell, there are a lot of challenges ahead for China's capital markets.

As is well known, the financial sector is most important for an economy. Further financial sector reforms are needed to encourage sound economic investment opportunities and prevent overinvestment with low investment efficiency of capital. While China signed on to financial sector access when they joined the WTO, the nation is yet to meet those obligations by creating and maintaining a reformed regulatory regime. For example, the insurance industry is undercapitalized and uncompetitive, and entry of pension funds has been restricted.

China's overseas investment--both foreign direct investment as well as portfolio investment--is focused on investment in natural resources, infrastructure development abroad, and improving access to technology and product innovation. The State of Texas, for example, is trying to attract Chinese investment (saving) by offering various incentives that could lead to local job creation, increase the tax base, and diversity the state's economy.

Future Collaborations: Since China's trade and financial sector reforms will continue for the foreseeable future that will have a significant impact on bilateral trade and investment, these topics need to be followed closely during the next forum.

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