Paulson Policy Memorandum

BIT by BIT: A Path to Strengthen US-China Economic Relations

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July 2013

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Introduction

The fortunes of the US and Chinese economies are inextricably linked, now more than ever. Over the last decade, bilateral trade has increased five-fold to more than $500 billion. The United States is China's largest trading partner and China has surpassed Mexico to become America's second-largest partner. The total value of US investment in China was $54 billion at the end of 2011 while Chinese investment in the United States is estimated to have increased six-fold to more than $23 billion over the last five years.[1] The large and growing volume of trade and investment between the two countries demonstrates the interdependence and complementarity of their respective economies.


Photo: Flickr/US Department of State

That fact alone, however, is not an adequate foundation for a stable, much less full-fledged, bilateral economic relationship. The positive aspects of US-China economic relations are being overshadowed by their controversies. The docket of trade disputes is filled with US-China cases, from suits over renewable energy subsidies and export restraints, to disputes over intellectual property rights and the imposition of antidumping penalties and countervailing duties. On the investment front, the two sides trade charges and countercharges on the relative openness of each economy to investment from the other. Most significantly, the complex and politically charged fissures over economic cyber-espionage, if unaddressed, imperil progress on all fronts.

Despite its benefits, the US-China relationship remains only partially developed, insufficiently balanced, and politically fragile. And this is in large part because Beijing and Washington lack an affirmative, forward-looking trade and investment negotiating agenda to deepen and improve economic ties.

Instead, they are each pursuing regional arrangements, separate from and perhaps in exclusion of the other. Washington, for instance, is negotiating the Trans-Pacific Partnership (TPP), an agreement that

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some Chinese analysts—incorrectly, in our view—have described as an effort to “contain” China’s economic influence in the Asia-Pacific region. For its part, China remains focused on Asia-only configurations that exclude the United States, most notably the Regional Comprehensive Economic Partnership (RCEP), prospective trilateral free trade negotiations with Japan and South Korea, and other forms of economic discussion within the framework of the ASEAN Plus Three.[2]

Certainly, the United States and China are free to choose their own negotiating partners and exercise their World Trade Organization (WTO) rights to address unfair trade practices. And there is no question that America’s legitimate concerns about Chinese trade practices have grown significantly in recent years. Yet both countries must also identify areas where they can enhance trade and investment for mutual benefit. An active negotiating agenda should aim to do just that. Such cooperation would not only create opportunities for American and Chinese farmers, workers, ranchers, and businesses, but also build confidence in both countries that the two sides are deriving tangible benefit from all aspects of the relationship.

It is incumbent on both governments to forge a 21st century economic agenda—one that allows the two countries to identify policies and conclude agreements that re-anchor the US-China economic relationship and shows how strengthening that relationship can benefit the global economy. A bilateral investment treaty (BIT) will be one important component of this 21st century relationship. It is also a logical place to start.

This policy memorandum explains why—and offers guidance and counsel to both sides about how to move toward an agreement.

Toward a US-China Bilateral Investment Treaty

A BIT is a particularly good starting point for reinvigorating the bilateral economic relationship, especially when contrasted with alternative approaches. A US-China free trade agreement (FTA), while more comprehensive than a BIT, is not a realistic goal at present because the differences between the two sides are too significant to expect the successful negotiation of such an agreement.

The WTO is another obvious platform for increasing US-China coordination and cooperation but will not be a promising venue so long as the Doha Round remains dormant. Bilateral dialogues, especially the Strategic and Economic Dialogue (S&ED), chaired by the US Secretaries of State and Treasury with a Chinese vice premier and State Councilor, play a vital role in strengthening working relationships, coordinating macroeconomic policy, and resolving sector-specific concerns. They are, however, no substitute for a legally binding, economy-wide agreement.

A BIT, by contrast, could serve as a powerful and achievable foundation upon which to build a new affirmative economic agenda. A BIT presents the opportunity to negotiate and agree on common standards for the treatment of investors and their investments in both countries. It is a legal instrument that will enable investors in both countries to mitigate political, legal, and regulatory risks, thereby encouraging even greater cross-border investment flows. And, as an agreement that would further open the Chinese market to US investment, it has the potential to reinforce China's ongoing domestic reforms. A successful BIT would allow the US-China economic relationship to be defined less by its disputes and more by its potential. It would also serve as a template for how the two countries can work together as leaders on rules-based approaches to economic policy issues.

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In addition to strengthening bilateral cooperation, the negotiation and completion of a BIT would present the United States and China—the world's two largest economies—with the opportunity to shape global investment rules. New trade and investment rules are being written in various negotiations, including in the Transatlantic Trade and Investment Partnership (TTIP), TPP, and RCEP. If the United States and China can successfully negotiate a BIT, they will be at the forefront with other leading nations setting investment standards for the 21st century.

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BIT Basics

Investment treaties today serve as one cornerstone of the rules-based international economic system that promotes economic growth, openness, transparency, and the rule of law. Some 3,000 BITs are currently in force around the world, both between developed and developing countries and between developing countries themselves.

These treaties typically guarantee investors nondiscriminatory treatment so that the host government cannot favor local investors at the expense of foreign investors. This obligation applies to all government actions relating to foreign investment, from decisions to grant operating licenses and the enforcement of laws and regulations to marketing approvals for goods and services. If a host government accords the foreign investor less favorable treatment, it is in violation of the non-discrimination obligation.

Photo: US Department of Agriculture

BITs also typically give foreign investors the right to transfer funds into and out of the host country without delay, using a market rate of exchange. This obligation covers all transfers related to an investment, including interest, proceeds from liquidation, repatriated profits and infusions of additional financial resources after the initial investment has been made. These treaties ban trade-distorting measures such as local-content requirements, which require investors to use domestic inputs or suppliers when manufacturing goods or supplying services, as well as export quotas, which require investors to export locally produced goods.

BITs contain a suite of protections grounded in international law, protecting investors from unfair or arbitrary treatment and requiring that any expropriation or nationalization be accompanied by fair market value compensation.

Finally, and most important, BITs permit investors to bring claims for treaty breach and to seek monetary damages before an independent arbitral tribunal. Permitting investors to pursue international arbitration effectively depoliticizes investment disputes and ensures that every investment dispute will not automatically result in legal or political tensions between the two states. Governments in general have a good track record of paying such awards, which, if necessary, may be enforced in any of the 136 countries that are signatories to the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards.

US and Chinese BIT Practice

When the United States and China first held BIT talks in the 1980s, China rejected as a matter of principle the international law standards and dispute settlement provisions customarily found in such treaties. Early BITs concluded by China with other countries were still marked by ambivalence on these points. For example, China required that its local courts, not an international tribunal, rule on whether an expropriation had taken place. Only its courts could determine whether the case should go before an arbitral tribunal to assess the amount of damage and compensation.

Even as China's BIT practices have converged with international norms and US practice over time, China and the United States maintain different perspectives.

More recently, however, in order to protect its growing investments overseas, China has overcome its theoretical objections to these core provisions and signed BITs or FTAs with several countries, including Germany, the Netherlands, Japan, South Korea, New Zealand, Canada, and Peru that include all of the standard BIT protections and permit all to be enforced through investor-state as well as state-to-state arbitration.

Still, even as China's BIT practices have converged with international norms and US practice over time, China and the United States maintain different perspectives over one important obligation. Unlike many other countries' treaties, US BITs not only protect an investment after it is made but also guarantee the right of an investor to make an investment in the first place. More specifically, they require that investors be treated no less favorably than any domestic or third-country investor with respect to any terms and conditions of the investment, such as the form of enterprise (corporation, branch, partnership), the level of ownership in the enterprise (minority or majority stake), and sectors in which they may invest. In other words, US BITs provide investors with effective access to the market by prohibiting governments from imposing on the investor any restriction or condition that it does not also impose on a domestic or third-country investor.

This so-called "market access" obligation poses a dilemma for China, which prohibits or restricts foreign investment in certain sectors of its economy, requires foreign investors to take on local partners as majority (or minority) owners, or otherwise constrains the choice of how to invest, in what to invest, and with whom to invest. For example, China requires US investors to partner with a Chinese company in order to invest

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in the manufacturing of biofuels, automobiles, civilian aircraft, and power generation equipment, as well as in telecommunications services, accounting and auditing, banking, and securities. In its BIT negotiations to date, China has therefore resisted any type of "market access" obligation in order to preserve complete discretion over investment approvals and has instead insisted on grandfathering—without specifically identifying—all existing rules and regulations that impose restrictions on investors.

But it would overstate the two sides' potential differences to view a US BIT as requiring China to eliminate immediately all discriminatory restrictions on US or other foreign investors. When the United States negotiates BITs and FTAs, it typically accommodates market access restrictions imposed by the other party by making the obligation subject to expressly defined, negotiated exceptions for measures, sectors, or activities in which the partner reserves the right to discriminate against US investors.

Including the market access obligation in the US-China BIT, subject to specified exceptions, would have significant benefits. It would: (1) provide transparency and legal certainty about which sectors are open to US investment; (2) establish a "floor" under the current level of market access, preventing China from imposing additional restrictions on sectors in the future; and (3) create an opportunity during the negotiations for China to consider, and the two sides to negotiate, whether existing restrictions could be liberalized.

The Benefits of BIT

Although the market access issue has thus far proved to be a roadblock, creativity and a concerted effort by both sides certainly could produce a solution. And there is reason to believe that China might be willing to reconsider its position. For example, China is in the process of transferring some authority to approve foreign investments from the central government to the provincial and local governments and is transitioning some requirements for approval into requirements for simple registration.

In recent months, Chinese officials have loosened restrictions on foreign investment in Chinese capital markets and signaled the potential for further liberalization. In addition, China has agreed to launch BIT negotiations this fall with the European Union, which will seek market access commitments similar to those in US BITs, according to public statements by EU Trade Commissioner Karel De Gucht.[3] These developments, coupled with Beijing's renewed interest in BIT negotiations with Washington, suggest that China may be prepared to discuss market access as well as investment protection in the context of BIT talks with the United States.

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Benefits of a BIT to China

With China having completed a leadership transition, it now stands at an economic crossroads. Some in China argue that the country has benefited in recent years from stronger state guidance following the global financial crisis and that the government should increase its control over the economy to spur the next era of growth. Yet other leaders clearly believe that China should accelerate the pace of economic reform away from a state-centric model. Simply put, there remain divisions among Chinese policymakers about the pace and scope of reforms.

China faced a similar decision point more than a decade ago when it negotiated the terms of its accession to the WTO. At that time, former President Jiang Zemin and former Premier Zhu Rongji used the market opening commitments required by WTO accession to propel and accelerate domestic economic reforms. In a similar fashion, the current leadership of President Xi Jinping and Premier Li Keqiang could use a BIT with the United States, and perhaps TPP in the longer term, to reinforce policies that reduce domestic economic distortions, increase market access and transparency for all, and allow greater freedom for businesses from every country, including Chinese private businesses, to compete.

By increasing the volume and scope of cross-border investment between the United States and China, the BIT would help China to rebalance its economy away from an overemphasis on investment in fixed assets and toward greater reliance on consumption, especially by households. To succeed in its transition, China must move up the value chain into innovative industries that pay higher wages and facilitate greater consumption for the average employee. This process will be accelerated if more Chinese firms have exposure to experienced American firms and learn from their more developed managerial and technical expertise.

By making cross-border capital flows and investments easier, a BIT will also help reorient the Chinese economy toward the private sector by increasing the pool of capital available to private companies, which will help them become more innovative and efficient. The increase in capital will be especially beneficial for small- and medium-sized enterprises that often have difficulty securing loans and are forced to rely on the informal lending market. Increasing the growth of private sector firms will give more Chinese citizens the opportunity to create wealth and facilitate healthy competition with state-owned enterprises (SOEs), so that they evolve into more efficient and dynamic companies.

Finally, a BIT would place China's investment relations with the United States on a stable treaty basis. This would not only mitigate the uncertainty created by the sometimes shifting political winds on attitudes toward inbound Chinese investment, but would also make American companies more comfortable investing in China at a time when concerns about indigenous innovation, cyber theft, and rising labor costs have led to growing wariness.

Benefits of a BIT to United States

A BIT would help to level the playing field for US firms competing with Chinese companies and prohibit China from using regulations to favor Chinese firms, whether private or state-owned. Most important, the non-discrimination obligation would prohibit the Chinese government from giving special advantages to Chinese state-owned firms (as well as private firms) that are not available to US investors. In fact, the non-discrimination obligation would address one of the most persistent and widespread concerns of US companies operating in China.

According to the US-China Business Council, favoritism toward Chinese companies, both private and state-owned, is a factor in five of the top ten challenges that US companies face in the China market: administrative licensing, competition with Chinese enterprises, uneven enforcement and implementation of laws and policies, investment restrictions, and standards and conformity assessment procedures.[4] A BIT would prohibit any Chinese government measures adopted in one of these areas, or in any other area of regulation, that discriminate against US investors.

The BIT would also address another important competitive concern: the use of government authority by SOEs in China to advance their own commercial interests or disadvantage US firms. In some cases, the Chinese government may delegate to an SOE the authority to regulate the same sector in which it operates. In those circumstances, the BIT rules apply equally to the actions of SOEs as they apply to the government itself. If an SOE, for example, has the authority to grant operating licenses, promulgate regulations, or establish product standards, those activities of the SOE are subject to the rules of the BIT, including the requirements to accord non-discriminatory treatment, fair and equitable treatment, and to compensate US investors in the event of an expropriation.

US companies would benefit greatly from expanded access to the Chinese market to increase their revenue amid sluggish growth at home and in other advanced markets.

The BIT would also end the occasional practice of requiring US firms, as a condition for approving their investments or taking advantage of local incentives, to transfer their technology to local Chinese companies or to use Chinese technology.

US companies would benefit greatly from expanded access to the Chinese market to increase their revenue amid sluggish growth at home and in other advanced markets. For American workers, enhancing the ability of US companies to invest in the Chinese market will create, not eliminate, jobs in America. Academic research has repeatedly found that expansion abroad by affiliates of US multinationals tends to preserve and support their American-parent jobs, not destroy them. This is especially true when affiliates expand to serve new customers—long the primary goal of many US multinationals in China. In 2009, the manufacturing affiliates of these companies in China sold about two-thirds of their output to local Chinese customers, not into global markets. Indeed, the share of these Chinese affiliates' sales back

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to the United States fell from 16.3 percent in 1999 to just 10.2 percent in 2009.[5]

The bottom line is that US companies need to invest in China and other foreign markets to compete successfully in the global market. And BITs help them to do so by mitigating the political, legal, and regulatory risks associated with those investments. In the case of China, US firms can ill afford delay in concluding a BIT and leveling the playing field with their UK, Dutch, Korean, and Japanese competitors whose investments already enjoy BIT protections.

Conclusion: Alignment of Economic Interests

More robust investment flows facilitated by the BIT would not only benefit the United States and China individually but also bring their long-term economic interests into better alignment. The recent announcement that Chinese meat producer Shuanghui aims to acquire US pork company Smithfield Foods offers a good example.

For China, the acquisition contributes to the supply of safe, high-quality product to meet rising demand from Chinese consumers, as well as access to technology and know-how to improve agricultural productivity and food safety in China. For the United States, the presence of a large Chinese-owned company that is exporting to China represents an influential new stakeholder in the effort to reduce market access barriers in China, such as those that have restricted trade in some US agricultural products. More broadly, investments of this type give China a stake in the US economy other than in low-yield US Treasuries, the accumulation of which has the perverse effect of exacerbating economic imbalances, leading to currency misalignment and potentially to measures that restrict bilateral trade.

The rising tide of trade and investment between the United States and China is delivering significant benefits on both sides of the Pacific. Now that the Chinese leadership transition is complete, the US and China should return to the negotiating table with renewed energy. Successful conclusion of a BIT would re-anchor the bilateral economic relationship in the 21st century, placing investment relations on an international plane, driving economic reforms in China, and helping US companies succeed in one of the world's most important markets. A successful BIT would also show the potential of the world's largest economies to craft balanced, rules-based agreements that benefit the global economy.

Endnotes

[1] "Chinese Direct Investment in the US," Rhodium Group, accessed at http://rhg.com/interactive/china-investment-monitor.

[2] The ASEAN Plus Three comprises China, Japan, South Korea, and the ten member countries of the Association of Southeast Asian Nations.

[3] European Commission, "Commission proposes to open negotiations for an investment agreement with China," Brussels, May 23, 2013, accessed at http://trade.ec.europa.eu/doclib/press/index.cfm?id=900.

[4] US-China Business Council 2012 Member Survey, accessed at www.uschina.org/info/members-survey/2012/pdfs/uscbc-2012-member-survey-results.pdf.

[5] United States Bureau of Economic Analysis, Operations of US Multinational Companies in the United States and Abroad, Kevin B. Barefoot and Raymond J. Mataloni, Washington, DC, US Government Printing Office, November 2011, accessed at http://www.bea.gov/scb/pdf/2006/11November/1106_mncs.pdf.

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About The Paulson Institute

The Paulson Institute, an independent center located at the University of Chicago, is a non-partisan institution that promotes sustainable economic growth and a cleaner environment around the world. Established in 2011 by Henry M. Paulson, Jr., former US Secretary of the Treasury and chairman and chief executive of Goldman Sachs, the Institute is committed to the principle that today's most pressing economic and environmental challenges can be solved only if leading countries work in complementary ways.

For this reason, the Institute's initial focus is the United States and China—the world's largest economies, energy consumers, and carbon emitters. Major economic and environmental challenges can be dealt with more efficiently and effectively if the United States and China work in tandem.

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