UNABRIDGED VERSION

Delusions of Decoupling

Remarks by Henry M. Paulson, Jr.

At the New Economy Forum

Beijing, China

Ladies and Gentlemen, good afternoon.

And as we gather once again for this second New Economy Forum, let me especially thank my good friend Mike Bloomberg for establishing this forum and his all-star team of organizers.

Also a big thank you to the Beijing Municipal Government, Mayor Chen Jining, and to my friends here in the Chinese capital.

I'm delighted to once again share my thoughts.

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Now, if you're anything like me, you've probably spent the last year watching the state of the global economy with trepidation.

And to be blunt:

Things are not going well.

As a young investment banker in the 1970s, I had some fairly straightforward principles.

One of the most important was that economic competition would be incredibly fierce, but ultimately, need not be zero-sum.

That's because while firms, products, services, and ideas compete fiercely in a marketplace, a player can alternately win *or* lose in any month, quarter, or year.

Monday's "winner" may be Tuesday's "loser."

You sell more this year but could sell less than your competitor the next.

The point is, in the end, those of us who've spent our lives around markets, business, and economies have learned a basic truth:

It is enduring and persistent competition that produces the very best long-term results for any company and country.

It's competition that makes economies grow, that makes societies richer and that generates more opportunities.

And real competition requires a level playing field and a fair go for all players.

So this principle is particularly important at a time when the Chinese state is enlarging, not shrinking, its direct role in companies that would compete better and more fairly if they were run on a commercial basis.

But it also has some implications for the notion of decoupling.

And that's because competition also requires that there be more than one player on the field.

If you *disconnect* from others, you can certainly insulate yourself from some risks. But, frankly, you don't end up stronger and you create other risks in the process.

That's why it should concern every one of us who cares about the state of the global economy that the *positive*-sum metaphors of healthy *economic* competition are giving way to the *zero*-sum metaphors of *military* competition.

And those zero-sum notions—appropriate to the battlefield but not always to the marketplace—are now driving tangible economic policies and meaningful real-world choices.

Over the past year, I've heard so many of these military metaphors applied to business and markets:

"It's a trade *war*"

“It’s a technology *war*.”

“It’s “*weaponizing*” export controls.

These are good examples of metaphors deliberately derived from military combat.

But as someone who has spent 40 years working around economies, markets, and firms, these military metaphors are pretty jarring.

After all, in a *true* war—when armies and navies fight—you win by destroying your opponent.

But what some of our politicians seem to have forgotten is that trade, cross-border investment and finance can benefit more than one side.

So the now-popular thinking that seeks to militarize these—to *forego* these mutual benefits—is exactly the sort of thinking I had in mind last year when I warned that an economic iron curtain was descending as both the US and China came under growing pressure to decouple in four areas—flows of goods, capital, people, and technology.

Today, I’m sad to say that the pressure in Beijing and Washington have not lessened in the last year.

In fact, they are increasing.

And yet over the past year, the rest of the world—outside the United States and China—has made it abundantly clear that they have not forgotten the principles of first-year university economics:

They all continue to want a commercial relationship with both of the world’s two largest economies.

They are not going to accept a decoupling from one as the price for maintaining access to the other.

And so, if either of our two countries tries to force a *comprehensive* decoupling on third countries, these others simply will not follow. And we would risk isolating ourselves, the United States or China, from the rest of the world.

That would cut off American or Chinese companies, workers, and citizens from important economic opportunities not just in each other’s markets but in a global economy that *should* be growing for all.

But we have another self-interested reason for caution: without the inherent competition of intensive connections economies become less efficient and ultimately less productive.

They risk becoming a shell of what they can, and should, be.

As an American, I believe my country's openness has forged the fires of competition that made our economy the envy of the world.

Now, I've spent decades—first in investment banking, and then as the American Treasury Secretary—arguing against anti-competitive behaviors, including, to the leaders right here in Beijing.

I've called out China's anti-competitive practices—and those of other countries too.

And at the end of the day, this is why I believe comprehensive "decoupling" should concern us.

And it's why I welcome last month's public statement by Vice President Mike Pence that the Trump Administration does *not,* in fact, take "decoupling" from China as its strategic goal.

"Decoupled" economies aren't ones in which our countries *truly* have to deal with the challenge from others.

And decoupled economies doom themselves to multidimensional conflict because, once decoupled, they are much less likely to work jointly with their newfound adversary on other issues and interests.

So if we decouple economically, good luck trying to work together to combat common foes such as nuclear proliferation, climate change, global pandemics, or any of the other threats to global stability.

There are, of course, areas *directly* connected to our national security or critical areas of national advantage—and these are no-brainers for decoupling and protection.

But beyond these, a *true* decoupling would mean that we end up with less competitive economies and a less stable and peaceful world.

No matter *what* country we come from, the bleeding of military prisms and ideas into economic policies and markets should concern us all.

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And that's my headline for you: I believe we are now headed in *precisely* the wrong direction.

We are headed for more decoupling, not less—despite the various professions of constructive intent from both Washington and Beijing.

Last year, at this forum I warned of an economic iron curtain.

I spoke of the barriers to the flows of goods, capital, people, and technology, some of which predated the trade war.

Others have been imposed as a *result* of it.

But their net effect is the same:

Flows of *goods,* for example, have been impeded by the failure of China to open up big parts of its markets to foreign competition.

And then they have been further impeded by unilateral, reciprocal, or retaliatory tariffs from both the US and China.

Like so many others, I am hopeful that before too long I will be able to enthusiastically congratulate Secretary Mnuchin, Ambassador Lighthizer, and Vice Premier Liu He for accomplishing what the whole world is waiting for—completing phase one of a US-China trade agreement.

But even when this is done, it won't be the end of the story, for reasons known to all three of those gentlemen and to all of you. But it would be the first trade deal between the US and China in nearly 20 years. And it is long overdue.

And further progress in US-China relations will have to be hard fought and hard won.

It will likely come step by step, not in one fell swoop.

For instance, it is important to note that some tariffs are almost certainly going to remain in place.

And so, decoupling in flows of goods will likely continue because the very *idea* of tariffs has been re-legitimated after taking a wallop from the dismal failures of the 1930s.

The originators of America's disastrous Smoot-Hawley Tariff Act of 1930 would be ecstatic.

Did you notice, for example, that when the United States recently won a WTO case against the European Union over aircraft subsidies, its first response was to look at possible tariffs on things like French wine and Italian cheese?

And even if you don't mind paying more for authentic Brie and Camembert, you surely must acknowledge that these things have little to do with aircraft subsidies.

What that tells *me* is that we are now living in a world where tariffs have become normalized and even applauded.

And that is not a world that will be good for trade.

Beyond goods, I also warned about interruptions to flows of *people*.

And indeed, these have been impeded over the last year by new restrictions on visas, people-to-people exchanges, and the interaction of students and scholars.

There's plenty of responsibility to go around for this: Both Beijing and Washington are moving in this direction.

China has had some longstanding visa and access barriers.

The United States has made some recent adjustments of its own.

And in America's case, at least, this chips away at our openness—which has been an important, distinguishing characteristic.

Indeed, it is a characteristic that has distinguished us from China.

And this is going to mean that Americans and Chinese will have far fewer opportunities to collaborate, especially in the natural and social sciences, and in engineering.

But what concerns me most is what's happened to flows of *capital* and *technology* over this past year.

Both areas are vulnerable to significant policy changes and big negative headwinds.

And both capital and technology flows are, therefore, at acute risk from political pressures and some of the policy changes under consideration in the American and Chinese capitals.

I will now talk a bit about those risks to financial markets.

And then I'm going to talk about technology and propose a few modest remedies.

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Financial markets function best when they are transparent and open.

And this *should* be an area of mutual benefit—especially right now when sound financial markets are more important than ever to protect global economic stability.

For the United States—which has liquid, sophisticated, transparent, and hitherto open capital markets—financial services are an area of tremendous competitive advantage.

For China, meanwhile—which has suffered from illiquid, underdeveloped markets, and too *little* transparency—this is an area that has been largely closed to the world for much too long.

And this has contributed to the misallocation of capital, inefficiencies, hidden debt, and risk across the Chinese financial system.

The good news is that there actually *is* some good news:

First, China has begun to open its capital markets.

For example, while we await the specifics, I welcome September's announcement by the China Securities Regulatory Commission that foreign firms will be able to take 100% ownership in onshore ventures starting next year.

Importantly, this is an area which will also be covered by the impending agreement between the United States and China.

Such an agreement would reflect not just American pressure but China's own self-interest.

Indeed, it is something that reformers in China have *themselves* advocated for many years.

Opening up offers American and global firms the opportunity to contribute to developing China's capital markets.

And that, in turn, would be an important element of moving toward a market driven economy with a market priced currency.

This should create more opportunities for American companies and workers, as well as those from China.

But the two sides are going to have to build on that.

After all, China is transitioning to a service economy.

And the United States is a leader in financial services. In fact, America is the global leader in *every* area of finance, including banking, securities markets, accounting, and investing.

For China, more efficient markets—consistent with global best practices—would enhance the financial security of Chinese investors and savers. And it would lead to the better allocation of capital in China.

It would also minimize volatility and instability, which was an acute challenge to China in 2015 and is certain to recur the next time China's capital markets are stressed.

Financial openness in China and the opening up of China's capital markets would also facilitate the development of China's national *carbon* market.

This has more potential than just about anything to reduce carbon emissions in China and mitigate a formidable, certain, and significant risk to the economic security and social stability of China and the entire world.

That, in turn, would also help to create and open up new opportunities for environmental goods and services and financial products—areas where the United States is a leader.

But *none* of this will happen if we continue on a trajectory of financial decoupling.

So I'll be blunt:

China needs to open up further.

It needs to resist the *defensive* temptation to protect domestic firms that would, in fact, become much stronger if they were subjected to best-in-class foreign competition.

And here in China, these nominally "foreign" firms are actually staffed largely by Chinese professionals.

They service Chinese clients.

And they contribute to the modernization of Chinese financial practices.

So on everything from fostering competition to assimilating better practices, financial opening is in China's interest.

And in enhancing the role of the market here, a more level Chinese playing field would eventually create jobs for Americans, since American companies and products would presumably find more opportunity.

But Washington needs to resist some temptations, too.

Decoupling China from US markets by delisting Chinese firms from US exchanges is a terrible idea.

So is forcing Chinese equities out of the MSCI indexes.

It is simply contrary to the foundations of successful capitalism for politicians and bureaucrats to instruct *private* American players how to deploy *private* capital for *private* ends.

And by the way, Americans benefit from *public* investments involving China too.

Indeed, pension fund returns resulting from passive investments in Chinese entities deliver yield and, ultimately, help Americans retire more comfortably.

That is a good worth preserving, even as we press for more transparency in Chinese accounting practices and corporate governance.

Decoupling China from US markets in this way would, of course, harm China.

And perhaps that is the intent of those who advocate this idea.

But it would not be in America's interest. It would eventually threaten US leadership in finance, as well as New York City's role as the world's financial center. And it would help other financial centers like Tokyo, London and Singapore. And, over time, Shanghai.

China is already the world's second largest economy, its largest manufacturer, and its largest trader.

It has 119 companies in the Fortune Global 500, which is about the same number as the United States at 121 firms.

Unless something goes terribly wrong in China, no other nation will wish to decouple from its financial markets.

So China will be a big part of the global financial picture in decades to come.

Meanwhile, these changes won't do much for American leadership, much less for American centrality.

The global economy will, quite simply, be a safer place if we have greater harmonization and coordination of financial regulation and standards, and accounting principles.

There is no doubt in my mind that listing in the United States has helped to incentivize better governance, accounting, and disclosure by some Chinese companies.

And US investors have benefited from investments in Chinese firms that adopt heightened standards.

As the Treasury Secretary who presided over America's response to the 2008 financial crisis, which could have been as bad as or worse than the Great Depression, I can tell you with certainty:

That crisis might have devastated the world economy.

But our response to it was made more effective because we had the ability to coordinate monetary and fiscal policies with other key economies, including China's.

And so when the *next* crisis comes—and a crisis *will* come, because financial crises are inevitable—we will regret it if we lack mechanisms for the world's first and second-largest economies to coordinate.

Also, let's not forget that China is a very large purchaser and holder of US treasuries.

This helps support US monetary policy, enabling lower interest rates, and supporting our spending and lack of saving.

China's future decisions here could significantly impact interest rates and the ability to manage our deficit.

That's why the unilateral, reciprocal, and retaliatory steps on both sides concern me so much.

What we need now are a few affirmative steps to signal that we *still* see the prospect of a shared future, despite obvious and intensifying realities of our strategic competition.

Here's one idea.

China is *already* considering a step that could have a positive influence on US decision-making:

One of the primary issues of concern in financial services has been the difficulty of accessing the records of Chinese companies listed on US exchanges.

So if China permits the Public Company Accounting Oversight Board to conduct inspections of Chinese accounting firms, it would build trust and confidence in the quality and transparency of these listed Chinese companies.

And I suspect it will also have a salutary effect on the US debate.

But without such steps, we are moving *not* toward more financial integration but toward a potentially destabilizing decoupling.

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And that brings me to what I view as the even *greater* challenge of decoupling:

American and Chinese technology systems and standards are being separated.

And the *world's* systems and standards may become Balkanized as a result.

The technologies that underpin the fourth industrial revolution—from artificial intelligence, or "AI," to quantum computing to 5G telecommunications will transform the worlds of commerce and combat.

Let's just take AI as an example:

AI will increasingly be used in many commercial applications, from product design to inventory management, shipping to insurance, billing to payment.

AI algorithms will be embedded in many products, systems, and supply chains.

And the goal of all this is simple: to make things more efficient, more precise, and, of course, exponentially faster.

But if the US and China—and Japan and Europe and India and Brazil, for that matter—have different technology standards, their systems are going to be incompatible.

And without interoperability, it will be impossible for them to participate in one another's economies or cross-border supply chains that underpin much of today's global commerce.

So the problem isn't just that diverging standards will limit bilateral trade and investment—although that will certainly be an unhappy effect.

The problem is bigger:

If we slash ties and forbid technical exchange, it will fracture the global innovation ecosystem and curtail an enormous amount of potentially world-changing basic research.

We also risk creating a permanently fractured regulatory foundation, shredding the supply chains that link individual economies in one of the most powerful economic engines of the 21st century.

At best, each country will create its *own* standards. So the United States and China—and many others too—could isolate themselves within their own national economies.

At worst, we end up with a debilitating global competition over standards that fracture the entire world into technological blocs.

Just consider the historical role of the United States:

In recent decades one of America's greatest strengths has been as a standard setting nation.

But if the US sequesters its technology, it will lose that unique advantage and role.

That's because it will likely force the *rest* of the world to adopt a Chinese standard in order to continue participating in Chinese and global markets and, in some cases, because they seek to co-innovate with China.

I'm not aware of any country that is prepared to abandon a commercial and technology relationship with China.

Blocs only work if participants are segmented and don't straddle both sides of the fence.

So forging an exclusive technology bloc would isolate and weaken the US economy by reducing the ability of US firms and workers to participate in a significant part of global trade—not just with China but the rest of the world too.

If third countries hop on board with Chinese standards, then China alone will end up with access to these markets, leaving the United States in the cold.

And the reverse is true too, so China has the same problem.

If third countries hop on board with exclusive American standards, then it is China that will be shut out of these markets.

So China needs to think hard about its unwillingness to open up the architecture of its domestic standards.

It should permit meaningful competition with foreign technologies and rethink its relentless drive to indigenize technology.

So, first, we have a standards challenge.

To address this, we need a set of common technology standards to facilitate global trade and investment in some of these new areas.

Of course, there will *always* be fierce competition for technological breakthroughs that are so commercially beneficial that the innovating company can set a new global standard to its own advantage.

Similarly, there will *always* be technological breakthroughs so critical to our respective countries' national security that they should be protected.

As an American, I take my nation's national security as the highest priority of all.

But when technologies *also* have the potential for widespread and beneficial commercial use, sequestration risks ceding economic leadership to a rival company and country.

And since any country's national security is ultimately dependent on its economic competitiveness, this tradeoff would need to be made with *incredible* care.

A decision, after all, to protect *too* much of a country's technology will ultimately undermine both economic competitiveness *and* national security.

Second, then, we need interoperability.

At a time when Washington and Beijing are competing to win the future of 5G telecommunications architecture, I know that isn't a fashionable thing to say.

But here's the problem:

For all but the technologies in our *most* secure communications backbone, we should fight for at least *some* degree of interoperability as the best way to limit the scope of what I have called the “economic iron curtain.”

This would mean, for example, that Huawei agrees to make its technology interoperable with other systems.

And so if a European telecommunications provider wants to buy 5G from a *non-Chinese* supplier, those purchases will be interoperable with the already installed Huawei 4G systems.

For Chinese firms in other industries, that kind of step to open up Chinese technology and make it more interoperable with global technology could serve as an example of the need to adhere to standards acceptable to *multiple* parties.

Without this, I believe we will face impossibly stark choices that risk Balkanizing the world.

Now, I’m not naïve about any of this.

In fact, when I spoke on this topic last November, I spent a great deal of time talking about the realities of strategic competition between the United States and China.

And here’s the news:

Strategic competition isn’t going away.

And that means there will, *of course*, be a necessary strategic decoupling in some areas—not least the most sensitive advanced technologies vital to national security, our communications backbones, and Internet governance.

But here’s the key:

Even as we each build a high fence around a small yard to protect our national security we must not, in the bargain, impair our individual and shared economic security—and that of the rest of the world.

But that’s not what’s happening right now.

Instead, regulators in both Washington and Beijing are talking not about *small* yards with high fences but Olympic Stadium-sized yards and fortresses ringed by moats.

For the sake of our people's prosperity and the global economy, there just has to be a better way.

We need a framework to manage competitive US-China relations within these new realities.

And a major part of that *has* to be a framework for managing a technology competition that, unlike our trade dispute, will *not* be negotiated but contested in the marketplace.

The problem is that emerging and foundational technologies have become the third rail of US-China strategic competition.

That's why you hear people talking about a "technology Cold War."

We need to *deal* with this third rail by setting into place some guard rails to keep the competition around sensitive and complex technologies from spinning out of control.

But before the two sides can move from *third* rails to *guard* rails, they need to remove some of their festering differences step by step.

So I'll just list these for you:

China has taken some steps to better protect intellectual property and the impending trade agreement will include some welcome news here. But much more is needed to give innovators and foreign companies greater confidence in the Chinese system.

For instance, China should eliminate the ownership ceilings that implicitly force technology transfer to Chinese joint venture partners.

China will need to more credibly agree to combat cyber theft.

And it should set remedies into place that actually penalize offenders.

But perhaps most importantly, I encourage Chinese leaders to take steps that would allay the very real fear that Beijing's long-term goal is to assimilate Western technologies, adapt them, indigenize them, and then ultimately exclude foreign companies from the Chinese market and erect barriers to fair competition in third countries.

If that's going to be the vision of all things "Made in China," it will be extremely debilitating for trust and confidence.

For its part, the US needs to take some steps too.

It needs to eliminate barriers aimed at punishing Chinese but that hurt Americans in the bargain, such as using a national security rationale to impose tariffs on steel.

Another example of a poor decision would be to block the acquisition by American cities of Chinese-designed subway cars.

These aren't *supposed* to be made in China. So if they're made in the *USA*, made by *Americans*, and made in *American* manufacturing plants on the South Side of Chicago, then surely they can also be made to *American* standards with *American* safeguards.

And both countries could surely set an example by working with other nations to modernize the WTO. Why shouldn't both countries want to develop and strengthen the multilateral rules governing intellectual property protection, digital trade, technology transfer, data storage, cross-border data transfer, and privacy?

With these simple steps as a basis, we can then move on to more complex steps that build in a few guard rails around the difficult issues of technology:

For instance, why not pursue a code of conduct and principles to govern scientific research with foreign scholars?

Both nations could support a convention that sets meaningful limits on cyber warfare—although enforcement would, of course, be an incredibly difficult challenge.

Both sides could agree to support a roadmap and communication protocols for dealing with cyber terrorism.

Both could agree to support the establishment of a Global Technology Protection Board to help identify and punish cyber thieves.

Both could try harder to support the development of global commercial technology standards.

For example, it's important to make the most advanced commercial and healthcare technologies compatible, and the algorithms that underpin them transparent.

But this isn't a job for just two countries.

Ultimately, we need *others* to join us in owning these problems.

We need others to help us define a workable technological future.

In the financial crisis, President Bush looked to the G20 to help coordinate collective action.

It’s time for a similar group to develop rules of the digital highway for software and hardware in fields like machine learning and 5G.

As these technologies become more prevalent across our societies, they will create new types of intelligent linkages made up of data and algorithm-driven decisions.

We need to help one another avoid the worst outcomes.

And we need to help one another harness the very best of these technologies to improve our societies.

Now, others have put forward configurations of a G20-like idea before, but they have failed to achieve the necessary results.

A “T” group for technology, or a “D” group for data.

But however many countries are to be in it—10, 15, or 20—we need the world’s most technologically capable countries to begin the hard work of setting standards and norms of conduct for both military and commercial applications.

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Before closing, a final point:

National security and competitiveness begin at *home*.

We need to keep pressing to change unfair and uncompetitive Chinese industrial policies. But we also need a powerful affirmative strategy to address this challenge at home.

The United States needs to renew its commitment to technological and scientific excellence.

This means increasing and sustaining federal funding for government research and development to at least 1 percent of GDP.

It means support for commercialization of new research and increased investments in our nation’s scientific infrastructure, including high-tech innovation labs that can develop the next generation of digital communications. It should make more spectrum readily available at competitive rates for the next generation of 5 and 6G technologies.

And America must do more to attract and retain the world's best talent. We cannot continue to push away the best scholars and students with harsh rhetoric and an antiquated immigration system.

Federal policies should strive to balance security with openness.

After all, openness has *always* been our national comparative advantage.

And despite what some people say, I believe openness actually *underpins* our national security.

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Ladies and gentlemen, I am disheartened by how many of my fears from last year have come true.

But there is time yet to rise to the moment.

There *will* be some natural decoupling.

But the delusions of a wholesale, comprehensive decoupling and an economic iron curtain will leave our countries, and the world, worse off.

We need to avoid that outcome.

We need to avoid it now.

Thank you.