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Can Chinese Market Reforms Help American Companies?

By: Ben W. Heineman Jr.
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Recent reforms—and a pending bilateral treaty—could make it easier for U.S. firms to compete in the country. But obstacles to full competition are significant

At the recent Third Plenum political gathering, the Chinese Communist Party (CCP) made headlines around the world by committing to a greater role for the market and for competition in China's government-directed economy. Whether and when the Party will translate that rhetoric into reality is a critical question for the future. But a vital related question is this: Will the Party allow American companies to compete—freely and fairly—in China?

In its Plenary announcement, the CCP said that in the future the market should have a "decisive" role in resource allocation, instead of a "basic" role as set forth in past Party pronouncements. Though seemingly innocent, this linguistic shift was, in fact, a big deal—and possibly even radical. In an important related point, the Party also indicated that market reforms would constrain the powerful State-Owned Enterprises (SOEs) which are subsidized, promoted and controlled by the Chinese government. Private Chinese businesses will be allowed to compete more directly against SOEs and to help

reform them, and management of these companies will be made more professional and separated from government.

The potential for American companies to compete more freely in China is a fundamental issue in a related Chinese government action: on-going negotiation of a China-U.S. Bilateral Investment Treaty (BIT). In theory, this treaty would allow U.S. companies to invest with fewer restrictions in a much broader range of important Chinese industries, such as autos, financial services, transportation, chemicals and energy. It would also diminish Chinese favoritism for domestic businesses, especially the SOEs. The U.S. would reciprocate by allowing greater Chinese investment in American sectors and companies, unless clear U.S. national security interests were threatened.

Although there are many obstacles to the BIT, the newly announced Chinese market reforms improve its prospects. An influential segment of the CCP now believes that market pricing and competition will accelerate the innovation needed to sustain economic growth and liberty, both considered integral in avoiding political instability. This is a new form of an old strategy: Use growth to satisfy the people, suppress broad movements for more accountable government, and maintain CCP control. And competition, innovation and growth in the economic sphere would be more robust with unconstrained international—not just Chinese—players operating in the nation's economy.

This is why, before the Third Plenum reforms, China and the U.S. in July announced a breakthrough in the BIT after five years of stalled talks. First, China agreed, in theory, that U.S. companies investing in China would be treated like Chinese investors, with impediments for foreigners lessened or removed. Second, China agreed that "non-discrimination" for foreigners would apply in all sectors of the economy, unless China negotiated exceptions such as the defense industries. And, in related action, China and the EU have recently announced an agreement to negotiate their own Bilateral Investment Agreement.

In addition to treating all investors the same, the BIT deals with other key issues that concern foreign investors in China. It could, for example, protect against expropriation of assets, assure fair payment if expropriation occurs, allow transfer of investment funds into a country without delay, give investors the rights to select foreign country management using market rates of exchange, and direct disputes to international arbitration. A completed treaty could also restrict performance requirements like local content, mandated technology transfers, or export quotas that manipulate markets.

The motives for such an investment agreement are clear on both sides. China, which invests about $5 billion a year in the United States, nonetheless faces opposition on many proposed U.S. investments or acquisitions. While Lenovo can buy IBM's computer business and Shuanghui can acquire Smithfield Foods, the U.S. has stymied deals involving Chinese purchases of, or investments in, American oil companies, wind entities, and telecommunications businesses. U.S. companies, which spend about $50 billion on foreign direct investment in China per year, nonetheless face a daunting array

of regulatory restrictions, political risks and unfair competition from Chinese corporations, especially the SOEs.

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But the barriers to the China-U.S. BIT are major—and, in the short term, hard to overcome. In China, there is still strong support of "national champion" enterprises (especially the SOEs) against international companies as part of growing strains of broader nationalism. There is also great uncertainty about the shape and pace of the new reform, due, in part, to the possibility that market freedoms will lead for demand for the rule of law, a force which can undermine Communist Party authority. Moreover, a whole variety of controversies in other dimensions of the bilateral relationship (such as the recent air-defense identification zone crisis between China and Japan) can impede progress in the negotiations.

Similarly, many Americans are suspicious of China on issues like cyber-security, intellectual property, currency manipulation, unfair competition from state capitalism, and a growing projection of military power and diplomatic leverage in the region. Some of the most suspicious voices reside in the Senate, which most approve any bilateral agreement by a two-thirds vote and must, before that, pass trade promotion authority legislation allowing the President to submit trade agreements for an up or down vote, and disallowing amendments on Capitol Hill. Such legislation has historically been been necessary for successful international trade talks since other nations don't want to negotiate twice—once with the executive and then with Congress.

The specific hard issues in the BIT negotiation—for example, which sectors are not included, how to constrain SOEs, limiting performance requirements like technology transfers—are thus hostage to the fortunes of the China-U.S. bilateral relationship and the tectonic forces of geopolitics.

Yet, it is possible—if uncertain—that the recently announced Chinese economic reforms are truly a break with the past and presage significant changes in the Chinese economy, especially because they were given such prominence and because President Xi Jinping or Premier Li Keqiang will lead a new economic coordinating unit. And it is possible—and also uncertain—that international competition will have a role in a reformed Chinese economic order.

In addition to the China-U.S. Bilateral Investment Agreement, two other major trade talks involving the United States, but excluding China, are taking place: a EU-U.S. negotiation and the Trans-Pacific Partnership (TPP). Both talks are driven by the need for more economic growth in the affected regions, but they are also stimulated by a desire to counter China's economic prowess by agreeing to non-Chinese regulatory and product standards (which will, effectively, become world standards).

As with all trade talks that threaten vested domestic interests, both talks are problematic, with results in the TPP negotiations due, optimistically, early next year and

in the U.S.-EU negotiations by the end of 2014. But their existence, or better yet their completion, provides an incentive for China to have investment agreements with the U.S. and Europe.

The mere phrase “trade talks” makes our eyes glaze over. Immediate negative problems—Iranian nukes, the Syrian civil war, disputes over airspace between China and Japan—will always dominate media reports and attention. But the prospects of genuine economic reform in China, a deepening of China-U.S. investment, significant trade talks in both the Atlantic and the Pacific—while slow in process and uncertain in outcome—are among the important, potentially positive developments which we could just as profoundly affect the world in the years ahead as those other, more high-profile perils.

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