

## **NSD Policy Talk Presentation: US-China Economic Cooperation.**

**Guest Speaker: Brandeis University Professor Peter Petri.**

**11/12/13 Tuesday 2:00-3:00PM.**

### ***English Summary***

It's a great time to be here as the world trade system of the past 50 years will experience a tremendous change in the ways the rules are written, they will be reinvented, though we don't quite know how it will work.

There are two Trade agreements in Asia Pacific being developed:

TPP – Trans-Pacific Partnership

RCEP – Regional Comprehensive Economic Partnership

The two most important countries, China and the US, are not a part of the same group. Maybe there will be a US-China free trade agreement.

Four years ago academics began studying the TPP. They were asking, what will be the US China trade relations? Can they remain to be separate? Petri's analysis says that it doesn't make sense. They will likely develop a 3<sup>rd</sup> track that will involve both China and the US. Three years ago there was not a good attrition, and the TPP was not accepted by China. Over the last 6 months, China has changed its stance, now at least possible.

### **There are two possible scenarios**

China might join the TPP – this is unlikely because it's already so far along, but the Ministry of Commerce has been exploring it. The economist Ma Jun explored the TPP and finds it to be positive. So what do Chinese policymakers think? DC is preoccupied with other issues right now, like keeping the government open

### **China-US FTA**

China-US FTA is another possibility, and it could either happen all at once, or sequentially, through bilateral investment agreements, tariff liberalization, or addressing other issues. This was initially proposed by Hank Greenberg, former CEO of AIG, and at a dinner he asked Premier Wen Jiabao, who said, it's worth looking at. A HK think tank called the Fung Institute did a study under Nobel Laureate Michael

Spence which found that the two countries are inescapably bound together over the next two decades, and so maybe an FTA is a solution. Professor Petri is currently participating in a study with a Chinese think tank and the American US Chamber of Commerce, which says there is a possibility it will happen at the local government level.

## TPP economics

Computational general equilibrium (CGE) models are used. The technology is getting better. They model markets for every country, and sector, generate supply and demand equations, and make a number of major macroeconomics equations like savings = investment hold, and then compute equilibria using large data sets. Then there is a shock introduced in the model, for example, lower tariffs, and then the effects are calculated. So far, they aren't tight enough, but there's a lot of data, and they're a good start

## CGE model problems

Have not done a very good job at actually predicting outcomes. It's hard to measure the income effect, and disaggregate how much growth can be attributed to trade. NAFTA is an example, as CGE models were used back then, and we can compare the model's prediction with the end result, which was off by a factor of 2.5-3.

- CGE models also currently ignore productivity and FDI
- Another issue is the way that people have used the models, they often over inflate the effect of the shock
- Some will model two countries who completely liberalize all trade barriers, which might be unrealistic. The Australian Productivity Division is critical of CGE.

## Innovations in the current models

Researchers have introduced heterogeneous firms into the structure of the model. In each sector of the economy, there are firms which are very productive, though some aren't. Even if the sector stays the same, the average productivity might rise if the market share of highly productive firms increases. From this comes a 2-3 threefold addition to international trade which was missing in older models. The models are improving the role of productive firms. This is in the last decade of the literature on international trade. In our careful study of the liberalization, we've partially removed tariff and non-tariff barriers, because when you make agreements, only some firms will utilize them, and negotiators only make partial agreements. As to how barriers will be reduced, there are three parts. First, estimate the force by which the agreement

is made, assign a score to the agreement, how thoroughly each of these chapters deals with a particular problem, have a matrix which measures how much the quality of the agreement impacts the reduction in barriers, and it generates a policy effect matrix. Then, look at what parts of the barriers can be reduced. Force multiplied by the policy effect factor will be well below one, generally about 40%, which leaves about 60% of the barriers in place at negotiations.

## Negotiations

We are in an advanced state of the TPP, with 19 rounds of negotiations, each one being a big deal; 500-600 people are involved, they divide into small groups and negotiate their small issues, there are also inter-sessional meetings. There are 29 chapters and hundreds of pages of text. Most of the text is written, but it's bracketed, which means there are several different proposed pieces by different countries. The heads of state will need to ultimately resolve the issues that the negotiators cannot. Obama was going to go to the ASEAN meeting, but because of the US government shut down he had to cancel.

American industry has a very large input in this process. There is a discussion how to pass another bill called a Trade Promotion Authority which the President needs in order to sign a trade agreement. It's a deal congress passes, when you have a trade agreement you can bring it to congress so they can first pass this bill. No other country will want to negotiate with you unless you have trade promotion authority, because they won't know if the congress will end up revising it later. Columbia and Korea got support of 85% of US Congress, these are generally relatively bipartisan issues.

## Can China come in at this point?

It is very late at this point in time as Obama wants to get it done because he doesn't trust that he'll get it done in his term if he introduces China.

## Issues

- Tariffs are important but not most important because many have been eliminated.
- Services are very important for US, services sector is the fastest growing segment, entertainment, banking, education, and if we can make progress on this, it will be good for industry.
- Investment flows is another issue.
- Intellectual property protection, these are the areas where the US still has an advantage. The trade-off comes by giving into each side
- Manufacturing goes to emerging countries

Does it have much to offer each party? Otherwise it may end up like DOHA, which didn't offer enough to the advanced economies, and fell apart.

Not to prohibit the SOEs, to make sure they compete in the same way a commercial enterprise would. There is one set of rules that says they should compete. If they get subsidies, they'll have to repay government, which is an Australian proposition, but it is a weak way of enforcing. If you find the SOE gets subsidies, impose large penalties, the US proposition is that you have remedies for penalizing, like tariffs, and stops in trading. No one forgets about China in the debate on TPP.

The RCP offers \$250B of income gains, \$100B to Japan, and other countries gain \$300B. There are very large gains, which you then multiply by the probability of that actually happening. ASEAN countries have trade agreements, but China, Japan, and Korea don't have agreements. The key point is that for China these are all negative, China will be at a disadvantage with the TPP because other member countries will have tariff advantages.

Gains come from higher productivity, more trade between sectors, within sectors, more variety, and there is a new branch of economics which is studying the benefits of variety to consumers, and it suggests that each dollar goes further to meet consumer needs.

### **Who would gain most from a TPP?**

First is Vietnam, then comes Japan, New Zealand, Singapore, whose economies focus on services and high technology products, at the bottom are the North American countries. The North American countries ask, what rules will trade operate under in the next decade? – This is what the US wants to know, and they want services and intellectual properties to be represented in that system. The US benefits not so much from the numbers but from the ability to remain influential. If you expand the TPP from 12 to 16, the last four countries will experience an enormous benefit.

### **What happens when you put China in the TPP?**

That's what the economist Ma Jun has done. RCEP, TPP, China-US agreements offer about the same size in terms of benefits, which is sort of surprising. China has more exports of manufacturing, whereas the US has more exports of minerals, agricultural products, and services.

Professor Petri predicts a lot more two way trade. The argument that is thrown around is that it is "one more problem for the American manufacturing industry," which Petri says is already small, but he admits that workers will have to move to other sectors, and this will create some opposition.

Lastly, TPP and RCEP overlap, and one might ask, will they become competitive with each other, but Professor Petri says the probability is small.

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## Q&A:

*Comments from Director General of the Financial Research Institute of the PBOC:* Among the different possibilities, the 3<sup>rd</sup> one is a consolidation path: He wonders if China should join, many experts are arguing that China should join. But many people in China tend to believe the US really doesn't want China to join at this stage. If that is the case, China can also open negotiations with TPP members whose largest trade partners with China. All of these other possibilities will tend to dilute the effect of the TPP. At this stage if China will not join, he's worried the Asia Pacific will be divided. If China feels it has been excluded, and suffered disadvantages, the Chinese market itself may become less liberal to TPP countries. China would become number one in terms of trade volume in the world. But If China and the US don't determine a win-win strategy, the world will be divided.

*Huang Yi Ping:* If we involve China now it will become messy, but allowing China to join later is complicated. 12 years ago when China joined the WTO, they were desperate so they accepted the rules. But 3-5 years later, will it actually be possible to join? You might spend 3 years negotiating the rules. When China is the largest economy it may request a new set of rules.

*Petri:* You have identified the crucial issues. In the long run, it doesn't make sense for China and the US to have their own sets of rules, the reasonable people in Washington know this, so he worries less about whether this would led to a long term rupture between the two countries, but he does think there could be a tactical problem.

- Whatever the rules are, it would be much harder to sustain if China wasn't apart of writing it, although China will even more willing to accept rules that favor the US now, than if the US tries to impose them on China later on, and these calculations are going through everyone's head.
- Think of what this would do to our project. Would have to renegotiate with all of the members, all countries made their calculations with the idea that China wasn't involved, but it's the US Presidents' calculation of whether it would be worth sacrificing not getting a deal done in his Presidency in order to have a much better deal
- In Petri's view, the issue of technology is one in which China and the US have a lot at stake, investment is another, and a fairly long range of issues, but at a minimum there will bilateral agreements. We also must consider the domestic situation. The President and the US Congress are not best friends at the moment. I don't think that will happen, as it requires trade something certain

for something much bigger and more valuable. There is a possibility that it will happen. But it will be completed after the end of Obama's effective Presidency.

Q: Countries like Japan have major stakes, Malaysia has a big gain, requirements very high for Japan, but how much negotiation power does Japan have? If that's the case, should China try to join if it's going to conclude in 2014 or 2015?

A: You've put your finger on an important point – it's partially an issue of timing. In the US, If you don't do something by March/April 2014, forget it until after the congressional elections, so the discussion of whether to finish it must be decided quickly. Malaysia, Japan, and Australia have big interests at stake and are tough negotiators. If the issue of China entering came up two years ago, before Japan entered, it would be much easier. It's a shame that weeks or months influence policies that are effective for decades. Petri is optimistic about the long term, but concerned about the short-term. All three paths can get to same place. It's about timing and sequence but not the end point.

Q: The Shanghai FTZ is very popular, what is your opinion about this? Why did China establish this so quickly?

A: Petri thinks it's great for the history of Chinese experiment with economic reform, to find new financial services models, systems for capital movement, and he doesn't think it's due to the TPP. Financial liberalization, Convertible currency, opening a capital account, making RMB reserve, it's a good plan for how the economy reforms, it's also a good plan for how the real sector reforms, real sector needs the kinds of international rules that the trade system is now creating, it's helpful as it plans its own reforms to keep in mind how the international system is developing.

Q: A CGE model question – how to deal with the state owned enterprises, since the CGE model design is based on subsidies and the consumption problem, how will Chinese enterprises benefit from this approach, given that it is so narrow? It doesn't for example take into account that the financial sector is still not that open, the allocation of resources is not that efficient, so will the trade agreement help China deal with this, will they get good results from this?

A: State owned enterprise – not something a country would change just because of a trade agreement, more likely China does want to change the rules under which its state owned enterprises operate, and hope what China envisions is more consistent with the international provisions. For example, the idea that the SOEs would compete on a level playing field is the goal we think China wants. It should be possible within a 5-10 year period to make the rules for SOEs consistent with international norms

Q: If China and the US would initiate bilateral trade agreements, like an FTA, is there

an ideal social operational paradigm, because these are super large economies, there is no coordinator, so who is in charge of arbitration?

A: This would be a first. There isn't room for a 3<sup>rd</sup> party to help the large countries find a middle ground. The advantage of having a small group is that you can tailor an agreement to the sensitivities of the two parties, if for example China is most sensitive about the SOEs that can be emphasized. For example, for Japan to come into the TPP there needs to be a US-Japan bilateral negotiation, and Japanese has issues for which they don't want to give their rights away, and the US auto sector do not want to give any more access to the Japanese, but that's the kind of thing you can deal with if you negotiate bilaterally.

Q: China has been investing in R&D, China's role in technology sector has increased, but perhaps the CGE model doesn't take this into account fully. What will be the impact on Chinese income if it doesn't join the TPP? How will the value of the TPP for each country change over time?

A: Professors Petri and Huang Yi Ping discuss.

*Petri:* The impact on Chinese income will be negative if not included, but if included it would be positive.

*Huang Yi Ping:* Chinese income will probably grow by 8%, but with the TPP it will fall because the income will be reduced by 0.5%; the key word is comparative statics.

*Petri:* China will be much bigger, but the US won't be much bigger. By 2025, this will be twice as important to a US policy maker, still very important to Chinese policy maker, so now is the time to plan ahead.

*Huang Yi Ping:* It reminds him of an Asian currency unit: The Japanese wanted to settle on a deal as early as possible because 10 years later they will have a relative decline. If that's the case, it's in the US's best interest to include China now while its bargaining power is strong, as it will be reduced later. This is something CCER has been working on as a school, Peter and the Brookings Institute will have more collaboration with us on this issue.

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